ABI

ASSOCIAZIONE BANCARIA ITALIANA

ITALIAN BANKS' POSITION PAPER ON CAPITAL ADEQUACY REVISION

31 May 2001

In order to draft this presentation of the position of the Italian banking system on the proposed amendments to the capital adequacy accord, ABI conducted a formal, co-ordinated survey of the various views and proposals on the questions left open by the Basel Committee and European Commission papers.

Based on the comments received and the products of several interbank working groups, ABI together with the working group on credit risk rating has drafted the following position paper.

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Executive summary

The Italian banking system appreciates the supervisory authorities' ***effort to embrace business practice*** in determining the allocation of capital.

The new proposal, in fact, offers a ***recognition of the parameters that actually affect the banks' risk profile***. Moreover, many of the observations that ABI submitted to the authorities, either directly or via the European Banking Federation, at the conclusion of the previous round of consultations have been ***accepted***, at least in part, in the papers issued in 2001.

Nevertheless, there are reasons for ***concern*** that while the underlying goal seeks to attenuate the disparity between management and supervisory philosophies, ***some of the choices made conform to an excessively conservative, prudential logic, to the point that they threaten to undermine the intention of creating requirements that are more correct and more "sensitive" to the underlying risks.*** These decisions could undercut the level playing field for intermediaries, redesigning via regulation the structure of supply in one key segment of the financial market, namely banking.

The risk, that is, is that in the end ***there will be a generalised increase in the prudential capital requirement against credit risk***. Specifically, the current provisions for adopting Internal Ratings-Based Approaches for setting capital adequacy requirements would severely penalise the banks by comparison with the present situation, especially if the Foundation Approach were to be adopted. ***Furthermore, the new capital requirement against operational risk (OR) will create an additional burden in terms of supervisory capital, whose consistency with the actual operational risk undertaken would require a thorough empirical inquiry*** (precluded by the short deadline for responding to the authorities).

The consequences of the approach that the supervisory authorities have adopted, for now, could be especially severe not only for the banks' traditional function of sustaining economic growth (because it would lower the ratio of loan assets to own funds) but also in curbing the development of new segments of the financial market stemming from new techniques in asset management (such as securitization) or new instruments for handling credit risk (such as credit derivatives).

As to ***credit risk***, a first criticism bears on the determination of capital requirements both in respect of unexpected losses and in respect of expected losses (the latter being normally covered through the earnings on banking business).

Against expected losses, banks generally already follow prudential policies of setting aside provisions, or else they implicitly factor such losses into their pricing (higher interest rates when the probability of default is higher). Hence, given the Basel Committee's new proposal, the present definition of capital for supervisory purposes is not consistent; it needs revision and broadening (despite the difficulties stemming from the international differences in accounting rules and standards). Specifically, supervisory capital should include all those components that represent a "cushion" for unexpected losses, such as allocations to risk provisions (the current rules, under the 1988 Capital Adequacy Accord permit inclusion of the loan risk provisions as supplementary capital only up to 1.25 percent of risk-weighted assets as computed for purposes of the solvency ratio) as well, possibly, as a portion of net interest earnings.

Further aspects open to criticism are the following:

a) identification of counterparties at risk (a ***definition of default*** that is excessively wide reaching in terms of days overdue);

b) the introduction, in the Standardised Approach, of the ***150% weight*** for higher risk loans (the present weight is 100%);

c) the adoption in the Internal Ratings Based Approaches (Foundation and Advanced) of a ***single curve for all corporate counterparties, (regardless of size***) and for both sovereign and bank exposures for determining the risk weight coefficient in respect of the borrower's probability of default;

d) ***inadequate treatment of credit risk mitigation techniques*** (CRMT).

More in detail:

a) Among the various events giving rise to a default, that of ***90 days' overdue payment*** creates major problems for Italian banks, including:

- probable inability to use the time series available, in which a 90-day failure to pay event does not require classing a loan as in default;
- lack of clarity in determining the requirements in respect of (a) the frequent cases of restoration of performing status not long after the expiration of the 90-day limit, (b) factoring transaction, in which episodic failure to pay or late payment does not indicate a state of default.

We accordingly request the application of a less stringent definition of default in terms of the time frame, considering among other things the characteristics of relevant credit exposure (e.g., we suggest a 180-day period for medium- and long-term loans). Alternatively, we would call for a lower value of the Loss Given Default than the 50% envisaged under the Internal Rating Foundation Approach.

b) As for higher risk loans in the Standardised Approach, ABI asks that the authorities ***not introduce the 150% weight for payments over 90 days late*** or else that they ***lengthen the period*** to at least 180 days for medium- and long-term loans.

c) The risk weight function proposed for non-retail exposures, based on empirical evidence from the large corporate segment using a portfolio model, is not at all suitable to the real situation of commercial banks in continental Europe and especially in Italy, whose loan portfolios are largely composed of assets with small and middle market businesses.[1]

ABI accordingly requests the introduction of a new risk weighting curve for small business and middle market borrowers. Alternatively, there should be explicit provision for the

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[1] Consider, for instance, the very sharp rise in the risk weighting for even very modest deteriorations in the probability of default -- which are quite common among small firms -- owing to the very steep slope of the curve. This fact, in turn, depends primarily on an estimate of the asset correlation by the Committee (20%) drawn from empirical data from the large corporate sector and utterly inapplicable to the kind of loan portfolio we are considering here (estimates for the Italian national market indicate a much lower asset correlation level of between 2% and 10%).

possibility of treating most of these positions, and ***all positions relating to small businesses, as part of the retail portfolio.***

d) As for guarantees, there needs to be fuller recognition of the banks' ability to mitigate losses by acquiring appropriate guarantees and collateral. For if developing a rating system is in a sense a new chapter in the banks' experience, which could thus justify excessive prudence on the part of the supervisory authorities in setting the risk weights (though one may not fully agree), the possession of suitable guarantees in respect of a loan asset unquestionably represents an established ability to conduct banking business. Specifically, three aspects appear to entail undue penalties for banks:

- the presence of the ***w factor for financial collateral***, guarantees and credit derivatives, which means nothing less than a sort of duplication of the capital required against other risk factors (e.g., legal risk), which are already contemplated as part of operational risk;

- the reduced benefit -- compared with the general rule of the Foundation Approach setting LGD at 50% -- assigned to physical collateral (the 40% floor for the LGD);

- the lack of specific, adequate treatment of the guarantees intrinsically present in ***leasing*** and ***factoring transactions***.

The failure to fully acknowledge the effects of the aforementioned credit risk mitigation techniques does not incentivate banks to evolve from the Standardised Approach to the Foundation Approach; indeed, it makes it more advantageous to leap straight to the Advanced Approach, under which banks do have the possibility of evaluating the impact of such techniques in estimating the LGD.

The request, therefore, is for fuller recognition of the capital benefits of financial and physical collaterals and explicit treatment, not limited to the Advanced IRB Approach, of personal guarantees, especially those provided by entrepreneurs on behalf of their own companies, as it is quite common in Italy.

As for ***asset securitization***, in our view it is excessive, and severely penalising for the development of this technique, to envisage in future an additional minimum capital requirement in respect of implicit or residual risks, considering among other things that the treatment of explicit risks on ABS is already less favourable than that of other assets with equivalent ratings.

Turning to ***operational risk***, the Committee's intention to introduce a specific requirement in respect of this third class of banking risk is certainly one of the main innovations and one of the areas that could contribute most substantially to an ***increase in the overall capital requirement for supervisory purposes on the international banking and financial system***. It is essential, in this regard, to ***recognise insurance coverage*** as a means of reducing the requirement against operational risk, at least for the most commonly insured types of operation in Europe (against fraud, theft, etc.). Further, we ask for some changes in the Basic Approach in order to allow for ***gradual transition to the Standardised Approach***, making it possible to apply such method to selected rather than all lines of business.

Finally, ABI is currently studying the possibility to establish an ***Italian Data Base on Operational Losses***. The purpose is to quantify operational risk more accurately.

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It is our sincere hope that the dialogue between the supervisory authorities and the banking industry on the issues raised in this Position Paper can continue beyond the formal termination of the consultation procedure.

1. CREDIT RISK - THE STANDARDISED APPROACH

Within the Standardised Approach for calculating the capital requirement in respect of credit risk, the Italian banking system submits that:

- the introduction of the ***150%*** risk weight (instead of the current 100% ratio) in the case of higher risk loans (***those with payments overdue by more than 90 days***) significantly aggravates the capital requirement. ***We accordingly request the elimination of this provision in the definitive capital adequacy agreement;***

- ***alternatively the 150% risk weight should be introduced in the case of a longer overdue period (e.g., to 180 days) or only when the manifestation of insolvency is observed to be the continuous or recurrent missing of payments*** (this is particularly relevant to factoring);

- in the framework ***of the first*** of the two options suggested ***for interbank positions***, which we deem to be ***the more appropriate***, there is no provision for privileged treatment of ***short-term claims***, as there is under the second option. ***We request that this possibility be allowed for, and that the definition of short-term be extended to items with residual maturity of up to 12 months***;

- ***we do not agree with the application to supervised financial counterparties of the weights used for the corporate exposure.***

2. CREDIT RISK - INTERNAL RATINGS

2.1 General

The new proposal allows for the possibility of using a ***simplified Internal Ratings Based Approach*** (the IRB Foundation Approach whereby the bank estimates only the probability of default). This would appear to give many banks an opportunity to avoid having to resort to the Standardised Approach. Yet, a priori, ***this may not necessarily imply a benefit*** (at least, applicable credit risk mitigation measures being equal).

The first analyses performed, for instance, indicate that ***the weighting ratios*** corresponding to the various classes of probability of default (PD) ***entail weights of more than 100% for a fairly substantial number of positions*** (the dividing line between the 100% risk class and a higher one falls between Standard & Poor's BB+ and BB). At present, any more precise valuation is quite complicated, especially given the imperfect definition of the treatment of risk mitigation and the treatment of small business borrowers. Some simulations run on corporate loan portfolios indicated very considerable increases in capital requirements. Thus even in what we consider the improbable event that the capital requirement in respect of credit risk does not change, ***the overall capitalisation required by the new regulations will certainly be higher*** than the present one, given the introduction of the requirement in respect of operational risk.

Moreover the Basel Committee's rule that short-term loan ratings must be ignored when a long-term rating is present appears over-prudent.

The ***definition of default***, which in IRB Approaches affects the value of PD for various classes of borrowers, and hence the weights used to calculated the capital requirement, ***appears to be more stringent from the standpoint of time than the present Italian definition***. The new document defines as a default event ***failure to pay for more than 90 days***. This represents a major difference from standard Italian accounting practices and Italian supervisory regulations (definitions of bad loans, non-performing loans, restructured loans and loans in course of restructuring).

The definition of 90 days' overdue as a default event, in particular, causes considerable concern, for two key reasons:

- ***diminished ability of banks to use the time series available***, in which such an event does not trigger reclassification of a loan as in default (which is also in conformity with Italian supervisory regulations);

- ***lack of clarity in determining the requirements*** in respect of the frequent cases of restoration of performing status not long after the expiration of the 90-day limit and in respect of factoring, in which episodic repayment or late payment does not indicate a state of insolvency.

Italian banks accordingly request the application of a less stringent definition of default in terms of the time frame, considering among other things the characteristics of credit exposure (e.g., we suggest a 180-day period for medium and long-term loans) and to avoid inclusion among defaulted positions of those overdue exposure which reach again a performing status.

2.2 The calibration of the risk weight function for corporate exposures

In generating the ***risk weights*** for the corporate loan portfolio, the Committee has used a ***portfolio model***. As the supervisory authorities themselves have noted in some comments upon the proposal, ***the results of this estimate have been revised from the prudential standpoint***, a revision which we consider excessive. For example, in order to take account of systematic underestimation of risk in the internal rating models[2] or because of reduced effective capacity of the bank's capital to absorb losses, very substantial increments of the risk weights have been applied (20 percent and 30 percent, respectively, in these two events).

Furthermore, there is a good deal of perplexity over some aspects of the portfolio model adopted, such as the ***asset correlation level of 20%.*** This is open to ***serious criticism*** (see Annex 1) in that:

1. as the model is unifactorial (the sole systematic factor is, in fact, precisely the asset correlation), its outputs vary most substantially with changes in the asset correlation postulated;

2. ***the 20% asset correlation***, probably taken from empirical studies of the large corporate market,[3] ***is much higher than*** that observed in small business portfolios and generates anomalies in the loss curve estimated.

Consider, for instance, the very sharp rise in the risk weighting for even very modest deteriorations in the probability of default -- which are quite common among ***small firms*** -- owing to the very steep slope of the curve.

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[2] A possibility that the Committee does not contemplate in the case of external ratings.

[3] Although the annex to this position paper shows that this value may not be fully appropriate even for that segment.

These choices on the part of the supervisory authorities, which have an adverse impact above all on the banks' small business loan portfolio, represent the main source of the considerable aggravation of the capital requirement instituted by the IRB proposal.

Therefore it would be more appropriated to introduce a third curve for setting the specific risk weights for small business loans. This appears to be the only practicable approach, from the methodological viewpoint as well, to fair treatment of the typical loan portfolios of continental European commercial banks, and in particular Italian banks. Fair treatment could not be obtained by adapting the curve envisaged.

In the event that the request for a third curve cannot be granted, the Italian banking system considers it utterly necessary to revise the parameters defining the curve now foreseen by the Committee, and especially the intercept.

Apart from the problem of small business loan assets, respondents continue to doubt the possibility of using a single curve to calibrate such highly differentiated portfolios as corporate and sovereign exposures.

2.3 Retail loan portfolios

The risk weighting of retail exposures is lower than that for corporate exposures.

It must be observed that it is possible, with the approval of the supervisory authorities, ***to include within the retail class loans to small businesses*** that are not exposures to physical persons and/or guaranteed by physical persons. And the authorities may elect to set a ceiling above which loans cannot be treated as retail.

As for the criteria to be used in creating an ***objective*** definition of the borrowers to be treated as retail customers, we think it would be preferable to adopt a standard ***based on the borrower's sales volume***. We should like to recall that one possible definition could come from the criteria adopted by the European Community to define Small and Medium-sized Enterprises.

2.4 Incentives for evolution towards more sophisticated approaches

Our members point out that given the limited incentives for the use of the simplified IRB Approach, ***small banks in particular will be unlikely to develop rating systems based on assessment of the borrower's creditworthiness, in view of the substantial costs of setting up such a system and the lesser benefits***, as well as in consideration of the small size of single portfolios, meaning a small number of defaults and consequent problems of statistical significance at the level of the single bank.

Moreover, future transition to more sophisticated methods is regulated by the supervisory authorities via minimum qualitative requirements that make transit through the Foundation Approach virtually unavoidable.

One of the incentives introduced is that of ***maturity.*** In this regard, Italian banks request that the Advanced Approach eliminate the minimum maturity level; ***that is, that specific reductions be envisaged even for maturities of less than a year*** (including revocable facilities).

Now, while we understand that the ability to calculate the LGD internally forms part of a more sophisticated method of gauging risk by the bank that can be identified with the advanced level, it is not entirely clear why some influence of the maturity of the various portfolio assets on capital requirements cannot be comprised even in the Foundation Approach (this would make the approach more risk-sensitive).

Accordingly, Italian banks request that the Advanced IRB treatment of maturity be applicable in the Foundation IRB as well. They also ask that the disparity between the Credit Conversion Factor in the two approaches be eliminated and that the 75% factor provided for in the Foundation IRB be adjusted to those envisaged in the advanced model.

2.5 Loss Given Default

The first observation here is that an LGD of 50%, as in Basel's Foundation Approach, would be justified if the definition of "default" corresponded exactly to that of "bad loan" currently used in Italian banking. But with a broad definition of default like that of the Committee proposal, the measure of LGD should be much lower.

Failing revision of the definition of default, it would be advisable to use the Advanced Approach from the outset, because this permits internal estimates both of LGD and of Exposure at Default (EAD). Yet the stringent requirements for adoption of the Advanced Approach greatly restrict the possibility that it can quickly come into widespread use. The end result would be an overall disincentive to the adoption of Internal Rating Systems. To repeat, we feel that the reference definition of default should be revised, extending the time horizon for measuring overdue payments and also taking into account the characteristics of the exposure.

Moreover, the LGD estimate should begin with direct consideration of credit risk mitigation techniques calculating the recovery rate on value of hedge separately. This would take due account both of the specificity of the CRMT and of the effective value it can be expected to cover. This would also avoid the rise of moral hazard, which could occur if the LGD were estimated according to exposure categories. For example, it could happen that the historical estimate of LGD based on at least seven years' data results in values that make it in the bank's interest to diminish the collateral on the individual exposure, since in any case it can apply the estimated LGD for a substantial period of time before the effects of the new policy feed back onto the LGD, which in fact is a long-run average.

Finally, Italian banks call for making the LGD estimation period the same as that for the PD (5 years rather than 7) in order to assure the existence of necessary track records at the date of implementation of the New Accord.

3. SOVEREIGN RISK

3.1 The Standardised Approach

For the Standardised Approach, the proposal is to use the ratings supplied by national Export Credit Agencies (ECA). But it is not clearly indicated when local currency ratings are to be used and when foreign currency valuations are in order. In fact, risk weights are more favourable for sovereign loans paid and funded in local currency, thus implicitly recognising the lesser risk of operations not subject to transfer risk. However, there is no comparable explicit provision for exposures to the private sector.

It would seem correct to apply to all the loans disbursed and funded in local currency, including those to private sector borrowers, better risk weights, in keeping with the local currency rating approach. In any case, more detailed rules would be useful to avoid problems of interpretation[4].

3.2 The Internal Rating Based Approach

Unlike corporate borrowers, sovereign borrowers default extremely rarely, so that it is not easy to get significant estimates of PD for single rating classes. To overcome this difficulty and ensure equal competitive treatment, preventing individual banks from adopting excessively diversified PD estimates on sovereign exposures, it would be advisable as a second best option for the banks using the IRB Approach also to apply to their sovereign portfolio the weights provided under the Standardised Approach, i.e. the range from 0 to 150%.

In any case, as the Basel Committee requires internal consistency between the rating scales and PDs used in the various portfolios, the PD typical of the corporate exposures associated with the corresponding rating classes cannot be applied to sovereign exposures of countries assigned equivalent sovereign ratings.[5]

For equal default probabilities, the proposal would use the same benchmark risk weights for the sovereign, bank and corporate exposures. This approach requires further study, in that it fails to take account of the inherent differences between sovereign, bank and corporate exposures and could engender distortions in credit allocation. We suggest that the Committee should develop specific coefficients for the three segments.

The Committee's definition of insolvency also contemplates as a default event a late payment that is more than 90 days overdue. It is important, in considering country risk as well, that this definition be as clear as possible. The annotation that in the case of sovereign risk one should treat as a default also a debt restructuring or any alteration in the original repayment schedule that results in a capital loss suggests that restructuring and renegotiation without capital losses are not to be classed as default. Moreover, as the definition of default for corporate exposures appears to be more stringent (including as it does postponement of capital/interest payments), Italian banks think a specific statement in this regard would be helpful (especially for the proper interpretation of bank and corporate defaults owing to country risk, such as those discussed above).

[4] Consider the case of a Latin American country whose supervisory authorities have taken Option 1 for the treatment of loans to banks under the Standardised Approach. Can a loan from Bank A in that country to Bank B in the same country in local currency be weighted according to the local currency rating? And is it therefore proper for that bank to have a competitive edge over a foreign bank that seeks to lend to Bank B?

[5] Because S&P's multiyear statistics indicate that on average a corporate rating of B+ has a PD of 3 percent over a one-year period, we have to avoid a situation in which a sovereign borrower with a B+ rating is assigned a PD of 3 percent, which would result in having a weight of 246% under the IRB approach, rather than the 100% envisaged under the Standardised Approach.

4. RISK MITIGATION TECHNIQUES

4.1 General

The Italian banking system concurs with the decision to broaden the range of eligible CRMT for the reduction of capital requirements. However, there is very considerable perplexity over the procedures for recognising the capital requirement attenuation deriving from ***collateral*** (financial and physical collateral), ***credit derivatives***, and ***guarantees***, especially with reference to the ***w*** factor, either in the Standardised or in the IRB Foundation Approach. We should like to see a specific treatment of factoring and leasing transactions – in particular those affecting real estate – that recognises their intrinsically lower risk. It should be noted, furthermore, that in some European countries (including Italy), leasing and factoring companies are subject to supervision.

4.2 Financial Collateral: cash, securities, gold, etc.

As regards collateral eligibility, we need to define the cases in which there is a low correlation between the PD of the guarantor and that of the principal debtor.

Another problem is the failure to consider the correlation between the risk of the activity guaranteed and that of the guarantor, the so-called double default effect. Our proposal is accordingly to take account of the possibility of using data on the correlation between default rates if reliable data in this field become available in the future.

Italian banks would also like to have further, more detailed clarifications concerning:

1) the treatment of convertible bonds;

2) the "main market indices" to use for valuing securities recognised as eligible;

3) the possible recognition of capital benefits in respect of collateral consisting of unit-linked policies or commodities.

In general we do ***not agree with*** the Basel Committee's ***approach to haircuts***[6] to apply to the value of collateral and of the underlying exposure:

- ***the method proposed to calculate the haircut*** on debt securities for collateral as a function of the issuer's rating ***is too disadvantageous***, especially as regards investment fund units. For the latter, Italian banks propose applying the average haircut on the securities in the fund's portfolio. We should also like to point out that the column of sovereign issuers should add Multilateral Development Banks;

- the fixed surcharge of 8 percent in respect of exchange risk fails to take account of the differing volatility of different currencies. Moreover, the surcharge is not justified when the foreign exchange exposure has already been hedged;

- the method for calculating the discount on collateral that is not marked to market daily is excessively burdensome, given the costs and difficulty of implementation. We suggest a simplification to make it less burdensome for banks;

[6] As required by the Committee, the haircuts result in a reduction of coverage to take account of the volatility of the value of the collateral and of the underlying exposure, as well as of any exchange risk.

- finally, the use of the haircut to account for the volatility of the underlying asset is not justified when the asset itself is entered in the accounts at cost rather than market price.

4.3 Physical collateral (residential and commercial real estate)

The Basel Committee document provides for different treatment of mortgage loan assets as between the Standardised and the Internal Ratings Approaches. In the Standardised Approach, mortgages do not appear to be recognised as collateral (as they are under the IRB Approach), in that mortgage loans (both residential and commercial) are considered as ***claims*** secured by residential or commercial property . ***This assumption is inconsistent and excessively burdensome in the case of default***, because mortgage loans are subject to the same risk weight as all other non-collateralized credit claims, namely 150%.

The Italian banking system would appreciate further explanation of the proper weight to apply to mortgage loans when a default event occurs.

A further suggestion is for more favourable prudential treatment of loans secured by ***mortgages on commercial property***, irrespective of the restrictive requirements laid down by Basel. It is hard to understand, in fact, why such loans should be treated in the same way as unsecured loans.

The 40% floor on LGD under the Internal Rating System – when the property's value is more than 140% of the loan exposure – seems too high, because it ***fails to take into account the actual recovery rate for this type of collateral; it should be substantially lowered***.

Doubts are also voiced on the different criteria adopted in the Standardised and IRB Approaches for recognising commercial real estate (CRE) and residential real estate (RRE) as eligible physical collateral. In the Standardised Approach the definition of residential and commercial mortgage loans comprises loans secured by rented properties, a case that the IRB Foundation Approach explicitly excludes. This difference could work against the transition from the Standardised to the IRB Approach; moreover, it does not appear to be warranted in view of historical recovery rates on this type of collateral.

The definitions of RRE and CRE proposed exclude from the preferential treatment under the IRB Approach building credit forming part of project financing. But the definition of project financing itself is not clear; it is so broad as to include many real estate lending operations, which should really be classed together with RRE. It should also be recalled that the requirement for frequent monitoring and revaluation of the mortgaged property – whether it is classed as RRE or CRE – is excessively costly. Italian banks would suggest redefining the frequency, such as by determining the intervals for revaluation as a function of the percentage of residual debt on the property, setting a percentage threshold below which revaluation is no longer necessary, or at least could be effected by automatic procedures.

Finally, Italian banks consider that eligible physical collateral should also comprise special collateral such as liens on ships and aircraft.

4.4 Guarantees and credit derivatives

Both the Standardised and the IRB Foundation Approaches institute more restrictive requirements for recognising corporate guarantees than bank guarantees. Our own proposal would

be to treat bank guarantees in the same fashion as those provided by enterprises or other persons of comparable standing.

With specific reference to guarantees under the Foundation Approach, our respondents voice considerable criticism of the decision to consider them under probability of default rather than under loss given default, as such guarantees can be collected only once default has occurred. In a sense, while there are obviously differences, the risk in the case of guarantees can be assimilated to that of issuer risk in the case of an exposure covered by collateral in the form of securities. Once default occurs, the guarantee or the collateral comes into play. Thus it is proper for such guarantees to be treated under LGD[7].

Finally, let us note that in the case of ***personal guarantees on the part of entrepreneurs on behalf of their own enterprises***, some banks believe that risk mitigation will only be recognised if the loan is in the retail loan portfolio, not the corporate portfolio. It follows that personal guarantees in the corporate segment do not give rise to a reduction in supervisory capital requirements except under the Advanced Approach.

The request is accordingly that the Foundation Approach recognise such guarantees in the corporate loan segment as well.

The same reasoning applies to ***factoring and advances against the transfer of credits and/or bill discounting*** (with a second co-guarantor). These should be considered as technical forms with mitigated risk, because the legally significant presence of a third party protects the bank in case of default by the original debtor. This is confirmed by the fact that as a consequence of this lower risk it is the established practice of banks to apply a clearly lower price to such operations than to unsecured risks. Our request is thus to ***define less restrictive criteria for recognising guarantees*** in the Foundation Approach.

Turning to credit derivatives, the minimum operational criteria for their recognition are reductive in some cases and not appropriate to the specific type of protection afforded.

More specifically:

- Aside from failure to pay, the credit event that Basel says must be specified in the contract is "the restructuring event", which should reasonably be considered a choice and not an obligation for the buyer or seller of protection. Further, the inclusion of this credit event is significant essentially for the protection seller alone, and thus raises the price of the derivative instrument. In conclusion, consistently with the provisions on guarantees, the trigger event that must be considered should only be "failure to pay event".

- The valuation of the recovery value of an asset should not depend on a 30-day limit. A longer period (which appears to be the market norm) would benefit the protection buyer. This time limit should thus be extended (at least to 90 days).

Moreover, despite these minimum requisites, the prudential treatment of credit derivatives is more unfavourable than that of personal guarantees. For whereas the floor factor (w)[8] can be equal

[7] The ideal would be joint evaluation of the PD of debtor and of guarantor.

[8] See section 4.5 for more specific discussion of the floor factor itself.

to zero for guarantees by sovereign states or banks, it is also equal to 0.15 in the case of credit derivatives. There is thus disparity of treatment of instruments whose economic rationale is similar.

Nor should one underestimate the importance of the fact that: a) the protection afforded by a credit derivative is broader in scope than that of a guarantee, in that it may cover a broad range of "events," not all involving failure to pay (e.g. restructuring, etc.); b) with a single contract one gets protection for a whole set of assets; c) some types of credit derivatives (TRORS, for instance) afford protection both against credit risk and against market risk.

The proposal is to review the treatment of credit derivatives and bring it into line with that of guarantees.

Finally, with reference to the ***trading book***, the Committee proposal is to offset only 80 percent of the specific risk in any given transaction. Our member banks' opinion is that it is unjustified to limit the compensation to 80 percent of the specific risk when the hedge consists in a credit default swap, especially if the reference asset is identical in issuer, currency, duration and coupon. Regardless of the features of the two assets, note that in such cases as bonds hedged by credit default swaps, a decline in the value of the bond generally corresponds to a rise in the value of the hedge. It is thus overdoing it to apply a fixed factor that fails to take account of the actual misalignment (which could prove to be minimal).

The request is therefore to abolish the 80 percent limit on offsetting specific risk. It would also be appropriate to provide for partial offsets given a maturity mismatch, weighting the specific risk according to the un-hedged duration as a specific forward risk.

4.5 W factor

The Basel Committee applies a coefficient, w, to the prudential treatment of loans secured by financial collateral, guarantees and credit derivatives, with the following aims:

(a) encouraging banks to continuously review the creditworthiness of their counterparties;

(b) taking counterparty risk into account as well as collateralization of the risk asset (joint risk default);

(c) hedging against legal and document risks (including those stemming from any cash settlement clauses), especially for guarantees and credit derivatives.

However, in the view of Italian banks these motivations are not valid, given that:

- valuation and monitoring of loan security is already an integral part of banking activity aimed at proper, constant risk measurement. Provision for a special additional capital charge would not appear to provide any incentive for activating such processes;
- the value of the guarantees is already discounted by the haircut, whose function is prudent calibration of the risk mitigation obtained;
- for joint risk default, recall that the collateral eligibility requirements already provide that there be a low correlation between the PD of the guarantor and that of the primary debtor;
- the Basel document itself already provides for a series of minimum requisites in respect of legal and document risks. Note that with specific reference to the eligible credit derivatives (credit default swaps and TRORS), the availability, and hence the use, of standard documentation recognised and accepted by the market (e.g., ISDA master) backed by specific legal opinions –

updated at regular intervals, at least yearly – have precisely the purpose of eliminating legal uncertainty[9];
- finally, the Committee already handles these residual risks by instituting a specific capital charge in respect of operational risk.

The conclusion must be that the institution of w factor creates a series of inconsistencies:

- it does not prompt banks to monitor the quality of the guarantee attentively. It is certainly open to criticism to think that a valid valuation process can be replaced and/or penalised by indiscriminately applying a fixed factor; and such a practice certainly represents a disincentive to diligent risk control policies by banks. Nor is it comprehensible to maintain that the imposition of factor w may induce banks to focus on changes in their counterparties' creditworthiness, since the same factor would apply to diligent and non-diligent banks alike;
- it entails a capital charge even in the event of overcollateralization;
- it generates a useless increase in capital requirements by comparison with the present situation; this could represent an obstacle to the acquisition of the hedge and in particular could penalise the development of the credit derivative market.

On the basis of the foregoing considerations, the Italian banking systems asks for the abolition of w factor.

4.6 Maturity mismatches

The prudential treatment of maturity mismatches under the Foundation Approach is excessively severe. Our members would suggest partial recognition of risk mitigation also when the residual maturity of the hedge is less than a year.

4.7 Netting

Our members would request that the meaning of the expression "netting on an individual basis" be better specified and that "the specific legal principles and specific risk control procedures" necessary to recognition of netting agreements be spelled out in more detail.

They further think consideration should be given to the possibility of allowing netting even for maturities of less than a year in cases of maturity mismatching, given that the money market generally involves operations shorter than 12 months.

5. ASSET SECURITIZATION

5.1 Treatment of risks assumed by the originating or servicing bank

The proposal is insufficiently clear in several points concerning the treatment of risks taken on by the originating or servicing bank, engendering possible doubts as to interpretation and a danger of differing application at national level. In particular, the document should better specify the minimum conditions on which the originating bank may be authorised to take the securitized assets off its balance sheet, especially as regards the notion of Special Purpose Vehicle and its ownership. In substance, the request is to specify the examples of "holders of beneficiary interests,"

[9] For the risks of cash settlement clauses, recall that minimum requisites are already in place in respect of such clauses. Moreover, they are no longer in use in the markets, *de facto*.

an ambiguous wording that may refer to the bearers of the securities issued by the SPV or to the latter's shareholders.

Another point requiring clarification is the treatment of the instruments used to improve the credit rating of the securities generated by securitization. First of all, there should be better specification of "first loss" and "second loss" credit enhancement (perhaps in terms of percentages of loss allocation). Second, the final version of the Committee proposal should specify: (i) the existence of caps (equal to the capital requirement that would be applied to the assets underlying the securitization) for first level credit enhancement; (ii) whether such a cap is also envisaged for the second loss tranche, and if so, the capital requirement in the event that a third party has provided a first level credit enhancement; that is, (iii) whether in determining this requirement one must take into account the amounts already allocated by the third party in relation to the first loss tranche.

Greater clarity is also needed as regards treatment of lines of credit granted by the bank to the SPV and drawn on by the latter.

As to revolving credit operations with early repayment clauses, our members observe that it would be a good idea to indicate the weighting criterion to apply to the total securitized assets, on the basis of the conversion factor. Moreover, given that in case of early repayment the main risk for the originator bank is liquidity risk, the national supervisory authorities should allow a reduction of the conversion factor when the bank itself shows that it has taken appropriate measures to safeguard against liquidity risk.

5.2 The investing bank

In terms of risk management, there is little justification for the disparity of treatment -- with equal ratings below BBB- -- between ABS and corporate securities. Further, it is hard to agree with the provision that mezzanine tranches of unrated securitization operations should be weighted at 100%, while the BB+ tranches are at 150%.

For unrated securitization operations with inhomogeneous underlying assets, to which the look-through approach is applicable, we propose that the referent for weighting the ABS be the risk factor for the predominant type of asset within the securitized pool or else the weighted average of their asset weights; it would be excessively burdensome to apply the highest risk weight, considering that in an extreme case, for instance, for the existence of just one default all senior ABS would have to be assigned the 150% weight.

5.3 The sponsoring bank

As for liquidity facilities drawn on, we find uncertainties of interpretation analogous to those regarding the originating or servicing bank. Moreover, in the event that the liquidity facility should fail to meet the criteria laid down by Basel and thus have to be treated as a credit exposure, the criteria as to how it should be treated are not specified. That is to say, when application of the principle of credit substitute is required and when instead a capital deduction is proper. And when the liquidity facility is treated as a credit enhancement, the capital charge should be differentiated depending on whether it is on a first or a second loss.

5.4 The valuation of securitization operations via internal ratings

For consistency with the Standardised Approach, it would be advisable if, for the IRB Approach as well, the capital deduction against credit enhancements provided by the originating

bank should be limited by a similar cap equal to the capital requirement -- calculated under the IRB Approach -- in respect of the pool of underlying assets.

As for the risks assumed by the investing bank, the estimate of LGD as 100% is excessively prudent considering that the Foundation Approach provides for a ceiling of 75% on the LGD for non-collateralized subordinated loans. The Italian proposal is to scale the LGD according to actual risk on the securitized loans. In the Advanced Approach, it would be advisable to leave the bank the possibility of setting the LGD percentage autonomously.

5.5 Implicit and residual risks

For asset securitization it is going too far, and certainly constitutes a severe impediment to the development of this technique, to consider an additional capital charge on implicit/residual risks, in view among other things of the fact that the treatment of explicit risks on ABS is already less favourable than that of other assets with equivalent rating.

6. OPERATIONAL RISK

6.1 General and definitions

The Committee's desire to introduce a specific capital requirement in respect of this third category of banking risk is certainly one of the main innovations. This is also one of the areas that could contribute significantly to increasing the overall supervisory capital requirement for the international banking and financial system[10]. Though there is full recognition of the importance of careful management of operational risk (OR), and despite the rapid evolution of methodologies in this field, Italian banks feel that the introduction of a capital requirement under the first pillar necessitates resolution of several problems of definition.

For example, tracing the boundary between the various types of direct and indirect losses, as cited in the Committee's definition, is highly problematic and could jeopardise an homogeneous determination of the impact of operational risk among intermediaries.

An ***interbank study*** now being conducted by ABI on problems of implementation, feeding and utilisation of data bases on operational losses[11], has opted to cast off from the definition of direct and indirect losses. The principal domain chosen for data collection from the individual banks is harmful events that have entailed ***actual losses***, i.e. objective, measurable losses, ***in that their impact on the profit and loss account can be traced***[12]. The value entered is the cost to resolve the event net of the costs incurred to "improve controls", preventive measures and investment in new systems, but gross of the amounts recovered from insurance.

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[10] Chiefly because of the Basel Committee's assumption that this requirement should represent 20 percent of total supervisory capital. This hypothesis should be studied more carefully, with a new analysis of the data supplied by some international intermediaries, whose internal capital allocation models have rightly allocated capital parts to OR that from a supervisory perspective should not fall under the OR requirement (e.g., business and strategic risk). Furthermore, the estimates of the banks surveyed, furnished in the logic of their internal models, could also refer to components of OR such as possible errors in the model for estimating market risk, which the authorities, through the coefficient still applicable to internal estimates, include in the requirement in respect of market risk.

[11] Drafted by an interbanking special working group, the study will be available shortly.

[12] An example, though not the sole one, is extraordinary losses.

In the medium run effective losses, which are considered to be reasonably ***objective and uniform between different banks***, should ***constitute the basis for estimating expected and unexpected losses, hence the capital requirement***.

Consistent with this approach, for purposes of reporting to the Italian database on operational losses, which is in course of definition, there is agreement that the banks belonging to the consortium must report ***only events that have entailed effective losses*** greater than zero, or perhaps greater than some threshold yet to be set.

The position is that the domain of estimation of expected and unexpected losses, hence supervisory capital requirements, should not include ***lost profits*** (though this is an indicator that bears very careful watching) or, above all, ***potential losses***, which from the logical standpoint should be considered as a gauge of the solidity of the organisational safeguards designed to mitigate the effects of adverse events.

6.2 The quality adjustment factor

Owing to the difficulty of defining the field of measurement of OR, a capital requirement under the first pillar based exclusively on quantitative estimates would be incomplete. For example, our respondents do not feel that the new Basel proposal attributes sufficient influence on the capital requirement to the degree of effectiveness of a bank's internal control system. The degree of sophistication of the internal control system is only considered as one of the requisites for advancing to more sophisticated methods that are less burdensome in terms of capital charges.

On the contrary, we believe that a bank having a highly developed, efficient system for internal control of operational risk will have a lower OR profile and could thus be subjected to a lower capital requirement compared with other ***banks using the same approach for determining their capital requirement, but less sophisticated in term of internal control on the OR***.

We accordingly request that the Committee consider the possibility of ***including under the first pillar a quality adjustment factor***. This could envisage various degrees of reduction of the capital requirement and should be applied to banks so requesting that demonstrate, say, that they have gone above the ***minimum qualifying criteria*** for the control framework for their method of computing capital requirements; the margin by which their quality exceeds the minimum would have to increase with the size of capital reduction allowed.

6.3 The Basic Approach

Within the Basic Approach, it is hard to understand the choice of ***gross income*** as the indicator to which the capital requirement in respect of OR should be proportional[13]. The doubts bear on the suitability of this indicator as ***a proxy for the bank's size*** (to which, the Committee maintains, exposure is proportional) and on its ***neutrality with respect to the structure of the profit-and-loss account*** in different countries.

While the identification of truly risk-sensitive indicators is still in progress, it would seem preferable to proxy risk with indicators reflecting volumes and/or income components ***in absolute***

[13] The working hypothesis, as we know, is that OR should have a weight of 20 percent of the capital funds for some international banks. In terms of capital requirements, this amounts to a percentage of 1.6% (i.e., 8% times 0.2) of risk-weighted assets.

value of assets rather than income margins[14]. If it is easy to intuit the direct correlation between volumes or components and the probability of operational risk, this is not at all the case of income. In this case, it would be better to proxy risk with the volatility of income. ***Nor are measures based on administrative*** expenditure preferable, owing to the danger that banks might seek to reduce their capital requirement by cutting spending on controls.

In particular, we find decidedly too high the percentage mentioned (30%) for the alpha factor in the event that gross income is retained as the risk indicator under the Basic Approach. Considering that the Basic Approach should be used by a large number of banks and that it could take a substantial amount of time to qualify in terms of requisite characteristics and data to move on to the Standardised Approach for *all* the lines of business, our members request -- as for the passage from the standardised to the internal measurement approach -- ***that a specific path from the Basic to the Standardised also be traced out***.

To this end, for example, ***the alpha factor could be subdivided*** into a number of addends equal to the number of lines of business to be considered in the Standardised Approach; the value could be determined by subdividing alpha itself ***in proportion to the beta factors.*** Accordingly a bank could be authorised to apply the beta factor to one area of operations and alpha factors to the others.

6.4 The standardised and internal measurement approaches

An important element that the supervisory authorities, at present, have yet to definitively provide is a specific definition of the ***various lines of business*** into which banking is subdivided in the standardised and internal measurement approaches, as well as the criteria for mapping banks into these different areas of operations.

In the course of this definitional work, ***Italian banks request the Committee to take into account that on the basis of the decisions taken*** many medium-sized banks could be obliged to ***make investments to disaggregate***, for example, the gross income of the entire bank into the gross income of the retail segment, the payment and settlement area, and so on; these data may not necessarily be available as of the present.

Conversely, for banking groups the ***determination of the capital requirement by line of business would appear to imply the generation of data flows*** that cut across the group members, with organisational costs that in this case too can be expected to be substantial.

As the previous points make clear, the movement to increasingly more sophisticated methods will entail growing costs that need to be offset by a reduction in capital charges. Thus the presence of a ***floor*** where the switch to IMA entails a substantial reduction in capital requirements could act as a disincentive to banks' adopting that approach, which in fact entails substantial investment both in account and in control systems.

As for determining the gamma factor, the Committee intends to identify a distribution function for losses for the entire industry. The document speaks of a ***range*** of confidence comprising 99 percent of all losses. This could prove excessively costly.

[14] This holds not only for the Basic Approach but also for the other two approaches in all instances in which indicators such as Gross Income are postulated.

6.5 Linearity

The linear method that the various approaches use can be seen to be an approximation in excess. ***Linear correlation of the bank's size*** (or of variables relating to its operations in various lines of business) with the ***capital requirement*** fails to take account of ***economies of scale*** in the ***control infrastructures***, hence in the prevention of operational losses.

We accordingly request that the Committee consider the possibility of including risk indicators in a ***non-linear, continuous or step function*** that attenuates the proportional rise in the capital charge with the rise in these indicators.

6.6 Allocations to provisions and insurance

Another problem area is ***expected and unexpected losses***. In contrast to what is generally done at the operational level, the minimum capital requirement in respect of operational risk is considered explicitly as protection against expected losses over and above unexpected losses. The Basel Committee's argument for this thesis is based on the differing treatment of provisions in different national legal systems and the non-explicit consideration of expected losses in product pricing.

We feel that in the case of estimates of expected losses whereby the individual bank makes an explicit ***allocation to provisions*** in the profit-and-loss account, it should be possible to use such allocations to reduce the capital charge (as, for that matter, is already partially allowed in the case of allocations to loan risk provisions).

Further, by similar logic, Italian banks would like to see the ***recognition of insurance*** as a partial reduction of the charge on OR, at least for the most commonly insurable types of operational risk (fraud, theft, etc.). ***Counterparty risk***, which the Committee defines as a risk that in these cases supplants operational risk and justifies the non-recognition of insurance coverage, could be made explicit in the rating assigned to the insurance company, adopting the same criteria as for credit risk. If, for instance, the insurance company is rated between A- and AAA, the weight of the impact of the activities insured could range from 0% to 20% of the capital charge, and so forth.

7. MARKET DISCIPLINE

On disclosure, considering that the supervisory authorities (acting through their inspection functions) can gather all the data desired from the banks under their supervision, the quantity and detail of the data to be supplied must not in any case be such as to distort competition. Furthermore, the emphasis must be on qualitative and quantitative characteristics of the data such as to permit correct interpretation on the part of institutional users.

It is the Italian banking industry's view that in the area of disclosure the Basel Committee must in any case proceed in concertation with standard setters in accounting. In particular, this work should be done within the framework of the ongoing revision of international accounting standard IAS30 concerning disclosures in the financial statements of banks and similar institutions.