

**COMMENTARY ON THE NEW BASEL CAPITAL
ACCORD FOR THE AUSTRALIAN PRUDENTIAL
REGULATION AUTHORITY**

Australia & New Zealand Banking Group Limited

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EXECUTIVE SUMMARY

ANZ welcomes the opportunity to provide constructive comment and to help shape a more risk sensitive capital framework, consistent with prudent financial institution management and the objective of ensuring a stable financial system.

We are encouraged by the considerable work undertaken to date, which has resulted in a comprehensive framework. The development of a hierarchy of capital models is more appropriate than the current “one size fits all” simple model, as it will reward those banks that move towards more sophisticated risk management techniques.

The proposed framework in its current form however, is not appropriate for implementation and still needs significant work in some areas. The development of standards that will apply to all banks around the world is a complex matter, and the Committee will need input from both the industry and supervisors in order to make them workable.

Total Capital

Our major concern is that the proposals in aggregate are likely to increase regulatory capital, as additional capital requirements have been added without sufficient reductions for the conservatism contained in many existing measures. We do not believe that changes in the Basel Accord should lead to a requirement for well-capitalised banks to hold additional minimum capital. Indeed, we maintain that these proposals could, when coupled with the possible application of banking book capital, require the Australian banking system to increase its capital levels. While we acknowledge that it is not the intention of the committee to increase overall capital requirements, the potential exists from what is presented for this to be the outcome.

The inclusion of Expected Loss (EL) in the Internal Based Rating (IRB) approach to credit risk capital and operational risk capital frameworks should be removed in banks that operate under a “dynamic provisioning” or “economic loss provisioning” frameworks. In these cases, the expected loss for credit risk is already covered by pricing at the time of origination and expected loss (i.e. dynamic) provisioning for the life of the loan. Similarly, the capital charge for operational risk should only cover unexpected losses. If expected losses are to be covered, loss deductions, provisions, and the loss absorbing capacity of current period earnings should be recognised in the calibration of regulatory capital requirements.

Credit Risk

We support the general direction taken by Basel in refining the basis of determining regulatory capital to more closely align this with risk, and in the main, the right issues are being identified and addressed in the framework. Nonetheless, we have a number of material concerns with particular aspects of the proposal, and these are discussed in greater detail in this submission. These include:

- The framework grossly over-states the capital required for home loans under the standardised approach given the observed low loss rates on this form of lending. Based on our own loss experience and external evidence such as rating agency reports, we remain of the strong belief that housing lending in Australia and New Zealand should attract a considerably lower risk weighting than 50% - statistically, less than 10% is more appropriate. We believe that the Accord should be changed, introducing a clear set of parameters under which national supervisors can set the housing risk weight to reflect local risk.

- While considerable thought has been given to treatment of corporate lending, we are disappointed that areas such as project finance and retail portfolios have not received similar detailed attention. Many internationally active banks are typically involved in project finance and retail lending (with the major banks in Australia having around half of their loan portfolios in the retail segment). In order to understand the full impact of the proposed accord, more detail is required on these sub portfolios.
- As it currently stands, the Committee's proposal adopts a more conservative approach to securitisation in comparison with exposures to corporate or other counterparties. The unnecessary conservatism will result in a disincentive for banks to utilise securitisation and potentially remove securitisation as a viable balance sheet and risk management tool.
- The treatment of major collateral types under both the Standardised approach and the foundation Internal Ratings-Based approach sends an inappropriate signal to banks. While the type of collateral that may be permitted for capital relief purposes under these approaches varies, banks get little capital relief for common collateral types. As capital is designed to protect against losses, it is logical to reward well secured portfolios or penalise unsecured portfolios. The range of permitted collateral types needs to be expanded in jurisdictions where certainty of realisation is the norm.
- Similarly, the range of permitted LGD under the foundation IRB approach should be re-designed to enable greater recognition for well-secured positions. The proposed permitted range of LGD only extends from 50% for unsecured to 40% for loans with collateral of 140% of the exposure. This also fails to reward well secured portfolios.

Throughout our submission, we have provided comment on the proposals and points of difference or corrections that must be considered. In particular, we recommend that:

- Consideration is given to either the creation of a separate risk weight for small-medium businesses, or to widening the range of eligible collateral under the standardised approach for these enterprises.
- The "w" factor should be removed from the calculation of collateral value in the standardised approach, and that the issues it seeks to address be included within the individual collateral haircut.
- The current treatment of credit derivatives is too harsh; some recognition for the "double default" effect should be permitted and the "w" remaining risk factor removed under the standardised approach or at a minimum re-calibrated.
- The conservative bias requirements for probability of default and loss given default estimates should be removed from the IRB approach (it can only lead to adverse selection and is unhealthy for the banking system in general).
- Banks should be allowed to use their own LGD estimates on a collateral-type by collateral-type basis within the IRB framework, subject to national supervisor approval and a timetable to adopt own LGD estimates for all remaining collateral types.

- When developing an implementation program for the IRB approach for internationally operating banks, national supervisors should take into account the availability of data in international operations and not delay the adoption of the IRB approach for the home markets where data is more readily accessible.
- Banks should be required to use effective maturity under either foundation or advanced IRB approach, not just the advanced approach. Maturity bands must permit exposures of less than one year.
- Real estate lending should be treated within the confines of corporate lending (as opposed to project finance).
- Further consultation is required to develop the project finance rules within the IRB approach.
- Behavioural scoring be considered for inclusion as a valid segmentation mechanism for retail portfolios.

Operational Risk

ANZ considers that *The New Capital Adequacy Framework* represents a significant step forward in recognising the importance of operational risk. The “spectrum” approach for operational risk under Pillar One is considered to be a sensible, incentive based framework, which will stimulate the further evolution of the operational risk discipline, particularly with respect to operational risk measurement. Notwithstanding this, it is also considered that the draft is lacking in specific details, which make detailed comment difficult at this time. For example, the need to collect data is strongly articulated, but there is a substantive lack of explanation in terms of the number of data points, time frame, and frequency of events that will be needed for banks to progress forward from the standardised methodology.

Most importantly, ANZ strongly believes that there is a superior alternative to the methodology proposed under Option 3 – The Internal Measurement Approach (IMA), and we understand that our concerns are shared by many other domestic and international banks. We have been working actively with the Institute of International Finance on this matter, which is working on developing a comprehensive alternative for the calculation of the operational risk regulatory capital charge.

Our primary concerns with Option 3 as it is presented relate to both the technical validity of the IMA and, perhaps more importantly, our fundamental view that operational risk management is primarily related to forward looking indicators and the quality of a bank’s internal control environment rather than historical factors. We believe that this helps to focus attention on managing operational risk, and it is important that a regulatory capital model should be as closely linked to the actual day-to-day practice of operational risk management as possible.

The alternative approach that we are working on emphasises the scope and quality of the internal control environment rather than the level of a bank’s expected losses as derived from historical loss data. In our proposed alternative, regulatory capital for operational risk would be based primarily on the size of each business line (captured through the use of exposure indicators) and regulatory-determined factors (ω) for business line/risk type combinations. A qualitative adjustment would then be applied in the form of a “Risk Score” which is derived through the assessment of internal

processes and operational controls for different risks across various business lines through the completion of a series of standardised “scorecards.”

Our other concerns are as follows:

- ANZ believes that the level 2 business lines contained in Annex 2 of the Consultative Proposal (excluding insurance) should be used in order to maximise risk sensitivity in Option 2.
- ANZ believes that operational risk should be defined for regulatory capital purposes in general terms as “the risk of loss resulting from inadequate or failed internal processes, people, and systems or from external events that are not covered by other regulatory capital charges (i.e., credit, market, and banking book interest rate risks). Business, strategic, and reputation risks are expressly excluded.” The definition as proposed in the draft Accord allows for potential overlap and subsequent additional capital imposts.
- ANZ has reservations about the proposal to calibrate the operational risk regulatory capital charge at 20% of the total minimum regulatory capital charge. We understand that proportion was developed after surveying only a few banks, and the risks they were trying to cover were greater than operational risk. This implies that the proposed calibration will be too conservative, resulting in excessive capital being required.
- The regulatory requirements for loss data collection (eg loss data thresholds, confidence levels, and minimum holding periods, minimum data point requirements, loss categorisation and loss definitions) and utilisation need to be announced shortly, as banks may need to adjust their current practices to be able to comply with the proposals.
- ANZ is of the view that operational risk is non-linear with respect to bank size or activity level. Our research so far suggests that the relationship is quite complex, and it is clear that the Committee needs to undertake further research in this area.
- ANZ is concerned about a potential requirement for joining an industry data pool in order to use Option 3.
- ANZ continues to believe in the applicability of operational risk insurance as an effective risk mitigation technique that should be recognised under Pillar One of the Accord.
- In the absence of further detail, ANZ is concerned about the proposal for Option 3 to include a “floor”. This must be clarified so that banks can assess its potential impact.

Market Risk

ANZ supports the Basel Committee’s proposals for the treatment of interest rate risk in the banking book. We disagree with the views expressed by APRA on this topic in its March 2000 submission to Basel and would be concerned about the total capital requirements and absence of a level playing field if this were introduced.

The Committee has accepted the principle that all banks have a nominal amount of interest rate risk in their banking book and that such a level generally does not represent a sufficiently large risk to warrant special attention at this time. The Committee promoted the view that only “outlier” banks should allocate capital against that risk. While defining an “outlier” bank may be subjective, in a global forum such as the Basel Committee with wide ranging consultation, ANZ is comfortable that a reasonable definition (even though it may be subjective) will emerge and gain support.

Pillar Three Disclosures

ANZ supports the premise that additional and appropriate disclosure will enhance existing supervisory and regulatory approaches to promoting sound and efficient financial systems.

However, it is critical to recognise that more disclosure does not translate to “better” disclosure. Any increase in disclosure requirements should be carefully considered in light of existing disclosures, the purpose of the disclosures and the additional value the proposed disclosures bring to the users of the information.

We agree that it is appropriate to have both binding and voluntary disclosure requirements. If the disclosure regime is to be successful and applied as envisaged then it is imperative that penalties and the ability to enforce those penalties on non-complying banks is available.

The sophistication of the users also needs to be considered when determining disclosure requirements. Providing information that only experts in other banks can understand does not add value for the general user. If disclosures are made on this basis, all that occurs is that other banks learn more about their competitors – the general user is not advantaged by such disclosures. The information disclosed should be sufficient for the general user to easily assess the risk profile and capital adequacy of a bank.

To ensure that there is as much consistency in the disclosures between non-bank and bank financial institutions, we strongly support the Committee working closely with the International Accounting Standards Board to develop their existing standards to incorporate as much of the market discipline disclosures as possible.

Further, we do not agree with the proposed disclosure requirements in respect of:

- The voluminous disclosures for banks using the IRB approach.
- The quantitative disclosures ex post performance for banks using the IRB approach.
- Additional information about credit risk mitigants.
- Actual annual operational losses by business lines rather than at the aggregate level as we currently report.

1. OVERALL CAPITAL LEVELS

From all perspectives, ANZ believes that both our Australian peers and ourselves are well capitalised banks. This is substantiated by our internal economic capital methodology, and is supported by the views of rating agencies. These assessments take into account the combined effect of the many different risks that we face, and the many different markets in which we operate. In turn of course, we are careful not to allow ourselves to be too over-capitalised.

Whilst the uncertainties in the current proposals make quantification difficult, it seems likely that minimum capital levels for Australian Banks would be materially increased and could approach current total qualifying capital, due to:

- An additional impost for operating risk capital.
- Approximately neutral to negative impact of credit risk capital changes
- The possible application of banking book capital, which we understand is being contemplated by APRA.

These elements, when taken together are excessively conservative and may result in a systematic overstatement of regulatory capital needs. Basel has stated that on average the regulatory capital for internationally active banks should be unaffected. Hence it seems unintended that a well capitalised and highly rated bank such as ourselves could have its minimum capital requirements increased such that only a small margin remains. In such an environment, without many of the issues addressed in this document being resolved, it is likely that total regulatory capital in Australia would need to increase - an outcome which is clearly unnecessary.

For instance, under the proposed standardised approach, capital for credit risk is likely to increase owing to the proposed retention of 100% risk weighting for a large portion of the banking book and the 50% risk weighting on housing, as well as new charges for commitments less than one year. To this we will be required to add the additional charge for operational risk

The internal ratings based (IRB) approach, is intended to reduce risk weighted assets for credit risk (under foundation IRB) relative to the proposed standardised approach by about 2% to 3%¹. However, this is not sufficient to compensate for the increased level of capital that will result from the additional imposts on elements such as short term commitments, let alone provide sufficient incentive to banks with less sophisticated risk management systems and processes to invest in their improvement. Even the advanced IRB approach will only allow capital reductions of 10% in the risk weighted assets calculation at inception and for two years hence (compared with the foundation approach) - again, hardly sufficient incentive to achieve this level of sophistication².

¹ Given the increased likelihood of capital requirement fluctuations that will accompany a risk weighted assets calculation based on internal ratings, it is clear that a buffer to cushion this volatility may be required, leading to an additional capital impost under IRB. This needs to be factored into the Committee's re-calibration efforts that will flow from bank submissions to the Quantitative Impact Study (QIS).

² We note that no such "floor" requirement is mentioned for Retail portfolios. Will there be a similar floor requirement for moving from standardised retail to the IRB approach for retail if significant capital reductions occur?

One of the problems evident in the IRB approach and the operational risk calculation is that capital calibrations include both expected loss and unexpected loss.

It is an unnecessary degree of conservatism to include EL in the estimation of required capital; it is contrary to every published internal modelling effort and can only be interpreted as an additional layer of in-built conservatism. From a credit perspective, we strongly object to the inclusion of EL, particularly in banks that operate under a dynamic provisioning framework, where EL is already covered by pricing at the time of origination and expected loss (i.e. dynamic) provisioning for the life of the loan.

Similarly, the capital charge for operational risk should only cover unexpected losses. If expected losses are to be covered, loss deductions, provisions, and the loss absorbing capacity of current period earnings should be recognised in the calibration of regulatory capital requirements.

In summary, we do not believe that changes in the Basel Accord under either the standardised or IRB approaches should lead to a requirement for banks in general to hold additional minimum capital and the IRB and operational risk calibrations should only reflect unexpected losses.

2. CREDIT RISK

2.1 Standardised Approach

2.1.1 Risk weighting of housing loans

Based on our own loss experience and external evidence such as rating agency reports, we remain of the strong belief that housing lending in Australia should attract a considerably lower risk weighting than 50%. We believe that the Accord should be changed, introducing a clear set of parameters under which national supervisors can set the housing risk weight to reflect local risk. Indeed, the Committee has already accepted that there are circumstances where risk weights should be more sensitive, such as by (1) proposing a 50% risk weight for high quality commercial real estate based on quite low loss rates and (2) varying risk weights for rated corporates. As part of the risk weighting re-calibration, jurisdictions where housing lending is much riskier than implied by a 50% risk weighting would be required to employ a weighting to reflect more realistic loss rates.

Publicly available information on mortgage backed securities highlight the consistently low loss rates experienced in Australia. According to Standard & Poor's February 2001 edition of "ABS Performance Watch", for the \$37 billion (approximately) of mortgage backed securities outstanding in Australia at December 2000, total losses realised were only \$63,210 (from a single vehicle) and the total claims on mortgage insurance totalled just \$8.45 million.

The proposed approach also results in a discontinuity between the standardised and IRB approaches, as under the IRB approach the capital charge is likely to be much lower. As a consequence, in the Australian market, the retention of a 50% risk weighting may lead to perverse bank behaviour. A bank operating under the standardised approach in our market would have a regulatory arbitrage incentive to securitise home loans (which may not necessarily reduce risk in economic terms), compared to the more sophisticated banks that adopt the IRB approach. The latter's choice to securitise would be based more on the true economics of securitising - clearly the preferred alternative and a more appropriate basis for the decision than regulatory arbitrage.

ANZ therefore recommends that a clear set of parameters be developed that enable determination of the risk weights for housing at the local level by national supervisors.

2.1.2 Risk weighting on the basis of external ratings

a. The need for greater granularity

ANZ welcomes the move towards the more refined risk weighting as proposed under the Standardised Approach, but believes that they need to be more granular. For example, loans to corporates rated BBB+ to BB- are grouped together at a 100% risk weight, but the changes in the probability of default of these loans (as implied by their ratings) is considerably greater than the steps between AAA to AA- (20% risk weight) and A+ to A- (50% risk weight). We also believe that it is anomalous to risk weight loans from corporates rated B+ to CCC at 150% while loans to unrated entities attract a 100% weighting. If anything, it sends a price signal to weaker corporates that they may be penalised if they are rated – such a result would not help investors or promote confidence in the banking system.

b. No distinction for Small to Medium Sized Enterprises (SMEs)

We note that for risk weighting purposes, there is no distinction for SMEs in corporate lending. Typically, lending to this segment is secured by physical collateral which is not adequately recognised as credit mitigants under the standardised approach. Moreover, as this segment is one of the greatest sources of employment and innovation, the capital charges proposed for this segment (at 100%) are set above their true risk and will have negative consequences for the economy as a whole. We therefore recommend that consideration be given to either the creation of a separate risk weight for small-medium businesses, or to widening the range of eligible collateral under the standardised approach (as discussed shortly).

c. Lending to banks

Under the standardised approach, ANZ recommends adoption of the second option for treatment of claims on banks. Under the first approach, all banks in a given country would be given the risk weight one category below that of that sovereign. In contrast, the second approach uses the banks' individual ratings and uses a lesser weight for short term maturities, which we believe more accurately reflects the risks involved. The individual bank ratings include some recognition of implied financial support from the sovereign in the event of distress, or transfer risk.

d. Local and external currency ratings

A problem remains with the treatment of corporate domestic currency loans in the standardised approach. A corporate cannot be rated better than its domicile sovereign; however, no consideration is made for comparison of local currency corporate loans with the local currency rating of the sovereign. It therefore penalises local currency lending where by definition no transfer risk is present. Both local and external currency ratings should be applied to sovereigns and applied accordingly with the currency of the transaction.

2.1.3 Collateral for credit risk mitigation

We note that real estate is not regarded as collateral for credit risk mitigation in the standardised approach. Indeed, the acceptable types of collateral are characteristic of a pure investment banking operation and thus fail to cater for the vast majority of banks operating globally. The stance presented by the Committee is unusual given the widespread use of real estate as security for corporate loans in most jurisdictions, including Australia.

We believe that failing to include common collateral types sends a poor signal to banks. For example, the current proposal would not distinguish between a bank whose corporate portfolio was secured by real estate and a bank whose identical portfolio was unsecured: clearly the former is less risky than the latter, and its regulatory capital should reflect this lower risk portfolio.

ANZ therefore recommends that greater recognition for real estate be considered as an eligible form of collateral under the standardised approach.

Furthermore, other typical forms of collateral commonly taken overseas and in Australia are similarly not eligible for capital relief purposes under the standardised approach, such as inventories, debtors, plant and equipment. Banks with large portfolios of corporate lending and leasing, where their lending is typically at least

partially secured by these types of collateral, would therefore be likely to have to hold considerably more capital than would be implied by their real loss rates. Where these forms of collateral satisfy the three minimum conditions for capital relief – legal certainty, low correlation with exposure and a robust risk management process – we believe they should be acceptable as credit risk mitigants. We therefore recommend that other forms of collateral be permitted where they meet the minimum conditions. Suitably conservative haircuts would ensure that banks receive at least some credit for a portfolio that is well secured by non-financial, non-real estate collateral.

2.1.4 The “w” factor

We note the floor factor “w” is to be used in reducing the value of the very limited range of eligible collateral under the standardised approach. This factor is designed to cover residual risks, and is to be applied after standard “haircuts” have already reduced the value of the collateral.

The “w” factor is designed to cover circumstances where a bank is unable to rely on collateral as it cannot establish title to the collateral or the collateral otherwise turns out to be effectively worthless³.

However, any concern about the realisation rates of collateral, should be factored into the LGD haircuts for each collateral type, rather than making an across the board adjustment. ANZ therefore recommends that the “w” factor be removed from the calculation of collateral value in the standardised approach.

2.1.5 Treatment of Credit Derivatives

Under both the standardised and foundation IRB approaches, there is no recognition for the “double default” effect in the allocation of risk weights (with the only difference being the ability to apply own estimates of PD and LGD for both the obligor and the credit protection provider under IRB). Given that both the underlying obligor and the credit protection provider must default before a loss is experienced, we consider this a most punitive approach and fails to encourage the active use of this growing and important form of credit mitigation.

Moreover, the setting of the “w - remaining risk factor” at 15% for credit derivatives under the standardised approach is a more punitive treatment than would result under the current BIS framework for credit derivatives from well rated banks.

2.2 Internal Ratings Approach

2.2.1 Difficulties with probability of default (PD) and loss given default (LGD) requirements

Under the current proposal, Probability of Default (PD) estimates for each rating grade should have a conservative bias – each PD estimate should be the greater of the point-in-time estimate and the long-term average (or the through-the-cycle approach). These PD estimates for each rating grade must be used consistently throughout the bank for all relevant activities including loan pricing and valuation and for risk management. Similar conditions are currently incorporated into LGD estimates, and we therefore have similar issues with the proposed LGD estimate bias.

³ Consultative Document: The Standardised Approach to Credit Risk, para 117

Banks require accurate and transparent estimates for efficient pricing and risk management. Biased estimates lead to adverse selection; overpriced loans will only attract poorer customers who cannot get a better price elsewhere and hence lead to a deterioration in the quality of the portfolio. It is clearly unhealthy for the banking system to include biases that encourage adverse selection.

A further concern about the use of excessively conservative PD and LGD estimates relates to the potential for excess capital being required. ANZ currently hold economic capital at a 99.95% confidence level (i.e. a 1 in 2000 event) calibrated to our EL. The use of the most conservative PD/LGD factors will effectively increase the calculated EL, which will require a reduction in the confidence level – otherwise we would witness a significant increase in the amount of capital required for 1 in 2000 events. This effect would be exacerbated in a cyclical downturn, when ratings migration is to be expected. Our strong preference is to use “through-the-cycle” PD/LGD estimates, with the extra capital that would be required in times of economic downturn resulting from ratings migration, which would reflect the real changes in portfolio risk.

Finally, the use of biased PD and LGD estimates will make back testing and validating risk grading frameworks and models very difficult. It will also be very difficult for the regulators to compare the efficiencies of the different banks’ risk grading systems. Accurate and transparent PD estimates will enable the measurement of the competitiveness and efficiencies of the banking system. If a built-in conservatism is required, a more transparent approach would be to adjust the capital multiplier to ensure the banks’ capital adequacy. This would enable comparability between different banks’ rating systems.

2.2.2 Calculation of LGDs under the Foundation approach

There is insufficient granularity in the LGD calculation under the foundation approach and the calculation methodology needs to be reconsidered.

We accept the starting point of 50% LGD for unsecured lending, but feel that setting an effective floor of 40% LGD fails to reward well secured positions. For example, a corporate loan secured by 150% real estate cover would attract only a 40% LGD, while an unsecured corporate loan would have a LGD of only 10% higher. Setting an unrealistic LGD cap will result in banks having to provide too much capital, with consequences for the overall cost of finance to borrowers. For example, in previous studies of our own LGD experience, we have found that where a customer with 130% or more security cover has defaulted, there was no loss in almost all cases. In this situation, a much lower floor than the proposed 40% would clearly be more appropriate.

2.2.3 “All or nothing” adoption of LGD estimates in the advanced approach

ANZ notes that the adoption of internal estimates of LGD in the advanced IRB approach is on an “all or nothing” basis, so that banks will not be able to use their LGD estimates until they have developed them for all collateral types.

ANZ recommends that banks be allowed to use their own LGD estimates on a collateral-type by collateral-type basis, subject of course to national supervisor approval and a timetable to adopt own LGD estimates for all remaining collateral types. This will act as a strong incentive to collect and validate LGD data.

2.2.4 Definition of default

ANZ is in general agreement with the definition of default, but we would prefer that the 90 day past due on any credit obligation be clarified to only include principal and/or interest payments.

Furthermore, it is important that the default events for capital purposes are in harmony with local market conditions (such as local laws governing defaults etc) so that banks do not have to work with two different concepts of default.

2.2.5 Calculation of EAD

The time series requirements to allow calculation of EAD under the advanced approach are excessive. While we support the need for seven years for LGD estimation (in order to cover an economic cycle), we see this as unnecessary for EAD estimation. Importantly, how would the requirement for such a long time period be reconciled with banking products introduced less than seven years ago?

Also, the requirement to stress test EAD is not warranted. This is an unnecessary hurdle for the adoption of unconditional long run EAD averages, which is the point of the proposal. To be able to stress test EAD requires development of predictive models of EAD, but this is in contrast to desire for unconditional long run stationary estimates.

2.2.6 Adoption of the IRB approach

ANZ notes that the proposed Accord allows some flexibility to banks in progressively implementing the IRB approach. However, we have some concerns about the speed at which we could implement the IRB approach on a global basis, and would be most concerned if delays in obtaining and back testing PD data for some of our international operations would hold us back from implementing the approach in markets where our presence and data availability can ensure a speedy implementation (eg Australia and New Zealand). Clearly, we will not be the only medium sized, internationally active bank that would be affected by this.

In some countries where we operate, our portfolios are not large enough to generate reliable loss data, and external and pooled data sources are also poor. We note that the transition arrangements for adopting PDs include a minimum of two years of data by the implementation of the Accord in 2004, but expect that there will be some countries where even this timetable will not be met.

ANZ therefore recommends that when developing an implementation program for the IRB for internationally operating banks, national supervisors should take into account the availability of data in international operations and not delay the adoption of the IRB approach for the home markets where data is more readily accessible. The standardised approach should be used for exposures in other countries as an interim measure and rolled out under an agreed timetable with the national supervisor in the bank's domicile.

2.2.7 Treatment of maturity

ANZ is concerned about the use of a blanket three year effective maturity for all exposures under the foundation IRB approach, as we see no need to differentiate this issue between the foundation and advanced approaches.

It is widely recognised that, all other things being equal, the shorter the maturity of a loan, the less its underlying credit risk. The selection of a three year maturity will have the effect of overstating risks for short term loans and understating risks for longer term loans, implying that more and less capital respectively would be required. Depending on a bank's maturity profile, this requirement may have a very significant effect on regulatory capital, which may erode some of the benefits of moving towards the IRB approach. In the case of ANZ, most of our commercial loans have an effective maturity of two years, implying that we would be disadvantaged by this approach.

Importantly, the requirement to limit the effective maturity to a minimum of one year is not supported. Credit exposures of less than one year have significantly less likelihood of default than longer dated exposures and should accord appropriate treatment for their tenor. The proposed approach makes the implicit assumption that all short dated exposures are rolled over until at least an effective one year maturity is reached, which is clearly not the case for many product lines and transactions (eg short term liquidating trade transactions).

Further, we believe that all banks that have the systems in place to be able to collect the data required to move to the IRB approach would also be able to identify effective maturities for their loan portfolios, and should therefore be permitted to use the effective maturities.

ANZ therefore recommends under either foundation or advanced IRB banks should be required to use effective maturity and these maturity bands must permit exposures of less than one year.

Further, we broadly agree with the proposed maturity multipliers proposed under the IRB approach.

Under our mark-to-market modelling, we recognise that spread volatility results in a generally linear increase of capital in proportion to the duration of loan. The Committee have assumed a zero coupon bond for their calibration which is conservative (but leads to a generally sensible result, although we believe it to be somewhat conservative due to the implicit zero-coupon bond and recovery rate assumptions which we suspect are built into its calibration). For most bank lending, we have coupon instruments that lessen the rate of increase of capital with tenor. We also believe that it is likely that Basel have calibrated assuming that recovery in event of default occurs not at the portfolio horizon but at the maturity of the loan (recovery at maturity assumption). A consequence of these two assumptions is a linear increase of capital with maturity across the rating grades.

We note that this finding is at odds with the KMV Portfolio Model which has been the main basis for industry submissions, hence the acceptance of linearly increasing capital with tenor is, we believe, unreasonably debated by the industry. Spread volatility is undeniably a source of considerable risk and remains so even for high default risk loans. Submissions made by ISDA and IIF, however, have the maturity multiplier approaching one (no tenor effect on capital) as default risk increases.

Technically this only happens as default approaches certainty, and as we are at most in the region of 20% for even the highest default rate categories, we cannot support these industry positions. Further disclosure of methodology used in calibrating is considered warranted, as well as revisiting the recovery rate assumption used in the Committee's calibrations.

2.2.8 Procedures for new products

As a general observation, the requirements for PD, LGD and EAD estimates all require relatively long observation periods, such as the minimum requirement for seven years data for EAD estimates. However, it is unclear what should be done for new products, so we seek clarification on this point. Product development is a continual process as it is a potential source of competitive advantage, so it would be highly undesirable to limit this process.

2.2.9 Collateral

As flagged earlier, ANZ has some concerns about the range of acceptable collateral that will be permitted under the foundation IRB approach. In the current draft, physical collateral is limited to commercial real estate and residential real estate, with more emphasis given to financial collateral (more commonly taken by investment banks rather than other types of banks). We are concerned that many other forms of collateral that are widely pledged in Australia and many other jurisdictions will not be eligible, such as inventories, debtors, plant and equipment. We believe that these other forms of security should also be eligible for inclusion under the foundation approach, subject to demonstrating objective valuations (such as by external valuations, demonstrated consistency in recovery rates etc).

As we recognise that recovery rates for some assets are likely to vary by jurisdiction, we therefore recommend that national supervisors should be able to specify which types of additional collateral would qualify for LGD purposes. Based on local evidence and loss experience, national supervisors would also be able to derive suitable haircuts for each collateral type.

2.2.10 Exposure distributions

While we recognise the logic behind the proposal that no risk grade should have more than 30% of gross exposures, we believe that this requirement may lead to undesirable consequences in some circumstances. For example, a bank with a large exposure to high quality borrowers may be forced to either shed some of that business or take on more lower rated debt. Similarly, we would expect that the dominance of housing lending in regional banks in Australia would lead to risk grade concentrations, as this lending would typically be portfolio graded. A requirement to take on more exposures (particularly commercial lending) in order to diversify their risk grade concentration may well be of concern to their shareholders, and act as a deterrent to moving towards the IRB approach.

Furthermore, it is unclear as to whether the 30% rule covers the entire portfolio, or whether it applies separately for each of the six sub portfolios used in the IRB approach (as intimated by the rating grade structure section for sovereign exposures)⁴. In the case of the latter (as it reads currently), we believe that the rule may cause some problems in the bank and sovereign sub portfolios, where

⁴ Consultative Document, The Internal Ratings-Based Approach, para 375

counterparties are generally clustered into a very small risk grade range based on similar PDs.

ANZ therefore recommends that the 30% rule should be dropped, or at the very least should only apply to the entire portfolio.

2.2.11 Categorisation of exposures – Project finance

a. Definitional issues

We do not agree with all the elements that the Committee wants to cover in the definition of Project Finance. Our preferred definition is provided in the consultative document to the IRB approach, which describes project finance as a special purpose vehicle with unique and large illiquid business assets and repayment measured against projected revenues.

The current definition of project finance is very broad – as even the Committee itself admits – and would capture many types of lending not generally regarded as project finance, such as passive property investments. Such broad definitions lead to areas of uncertainty, such as whether to classify a small business passive property investor (a relatively common bank customer) into the retail, corporate or project finance sub-portfolios for IRB purposes. Similarly, the classification of even large scale non-recourse projects may cause confusion or gaming, such as deciding whether to classify a project based on the obligor (potentially covering sovereigns, banks or corporates) or the project finance treatment.

Further, we strongly argue that income producing real estate lending should remain within the confines of the corporate sub-portfolio. This is appropriate given:

- the observability of LGDs and PDs
- the market depth and liquidity of the assets
- recourse to the assets and potentially other assets of the borrower

Note that we are not disputing the potential for higher correlations of PD and LGD for real estate lending, but rather that this form of largely homogenous lending can be more easily modelled under typical statistical business models than is necessary for the more complex infrastructure projects.

b. Current approaches to Project Finance

The IRB consultative document proposes a cash flow based approach for the estimation of PD, EAD and LGD on non-recourse project lending. We have in place similar models and believe it is the only adequate way to measure the risk of highly structured bespoke lending. However, standards of back testing need to be developed and will remain a central problem with these models. Typically there will be no similar ventures upon which historical actuarial estimates of default can be measured. Rather, robust procedures for simulating stochastic cash flows must be developed which is not a trivial task given that price paths must be simulated using objective measures over extended periods of time. These techniques are not normally used by banks in traded market risk fields and so must be constructed. It is also important to ensure consistency between sovereign and currency transfer treatment in project and non-project loans.

However, the major problem with the proposal at present is the little information about how the Committee intends to treat this sub portfolio. There are no capital numbers proposed for us to form an opinion. We would welcome the opportunity to participate in initiatives to develop a rigorous approach to regulatory capital allocation for this segment.

2.2.12 Retail portfolios

ANZ welcomes the separation of retail exposures from corporate, bank, and sovereign exposures under the IRB approach, and the flexibility to use a PD/LGD or EL methodology to calculate capital. Due to some unique properties of retail portfolios (i.e. a large number of customers, small individual exposures, reasonably stable default frequencies - particularly when compared to corporate portfolios), they typically contain a sufficient and reliable quantum of data to support robust statistical approaches risk measurement at sub portfolio levels.

However, while considerable thought has been given to treatment of corporate lending, we are disappointed that retail portfolios have not received similar detailed attention. ANZ, like most major banks in Australia has around half of its loan portfolio in the retail segment. In order to understand the full impact of the proposed accord, more detail is required on this portfolio.

a. Calibration of the risk weight function

Clearly the calibration of the risk weight function within the IRB retail framework is still an issue to be resolved. The Committee acknowledges this in its Internal Ratings Based Approach Consultative document, given the limited information it had available to determine the capital risk weights applicable (applying a 50% "rule of thumb" as an interim measure). It is envisaged that the Quantitative Impact Study will provide important and relevant information regarding the effects of the risk weight function and we would urge the Committee use the information from this study and seek more information where necessary to assist in determining an appropriate calibration.

We note that moving from the foundation IRB approach for corporate, bank and sovereign exposures (which is calibrated to be 2% to 3% less regulatory capital than the standardised approach) to the advanced IRB approach will be restricted by the application of a "floor" at 90% of the foundation approach. No such floor exists when moving from the standardised to the IRB treatment for retail portfolios. While we support this approach, we question whether this is an oversight in the construction of the retail IRB approach.

b. Behavioural scoring is preferable to application scoring

ANZ is also concerned about preference for application scoring over behavioural scoring in retail sub portfolios. Paragraph 337 of the Consultative Document on the Internal Ratings-Based Approach states:

Segmentation by borrower risk characteristic serves to meaningfully differentiate risk and cluster homogenous pools of loans into each segment. Thus, as a minimum requirement, a bank must segment by credit scores or equivalent. This includes segmentation based on application scoring (score based on full information in credit application). Ongoing or "behavioural" scoring (based on credit bureau data or bank's internal data) should be used as

a basis for reassessing the estimates of loss associated with each segment, rather than as a basis for segmentation.

No reason is given for the preference for application scoring over behavioural scoring. We strongly believe that this is counter-intuitive to the risk sensitive premise that underpins the proposal in that applicant scoring describes the risk associated with the credit line when it was first introduced whereas a behaviour score describes a more up-to-date view of that risk. It is clearly a better predictor of default and a more valid segmentation tool than application scoring.

Importantly, segmenting on application score can bring together credit lines taken out at very different times, which negates the effect they had the same score at that point. For example, a credit line that scored 600 five years ago and is still active is a very different risk to one that scores 600 three months ago.

With behavioural scores, segmentation can occur on bands of scores all calculated at the same time and so there is no problem of risk drift over time. Obviously the loans in a particular behavioural score segment change over time requiring the need to define the segments by the behavioural score bands at a specific time instant. Such a procedure gives a more robust homogenous segment than using application scores.

ANZ therefore recommends behavioural scoring for inclusion as a valid segmentation mechanism for retail portfolios.

c. Definition of small business

As a further issue, we are concerned about the position of lending to small-medium businesses, which as stated earlier are major sources of employment and innovation. Inappropriate capital charges for lending to this sector would therefore have wider negative effects. The difficulty with the Accord is that small business is included in the retail sub portfolio under the IRB approach, but unfortunately is not clearly defined. The Committee has proposed four tests – the loans are small business products; the loans are to or guaranteed by individuals; there is a large pool of loans managed in a comparable fashion; and that each individual loan is “small” – which still allow for ambiguity. For example, a large business could use a simple small business product (eg overdraft) with a relatively small limit, and a small business would not be restricted to using “small business” products.

However, we acknowledge that it is difficult to come up with a simple definition, even setting a dollar threshold. For example, as credit scoring becomes more widespread, it is not difficult to see that banks will try to extend scoring and mass management (as opposed to individual relationship management) to a wider range of businesses. It would be logical therefore to include these loans as part of the retail sub portfolio under the current definition.

ANZ therefore recommends that there be further consultation around the delineation of “small business lending” into the retail and corporate sub portfolios under the IRB approach.

2.2.13 Equity Exposures

The difficulty in developing capital charges for equity exposures is noted, as equity positions could typically include listed and unlisted exposures. It is also very important that there are no arbitrage opportunities in the capital treatment of debt and

equity exposures to riskier customers - as with the Accord in general, what is required is an appropriate capital framework that creates incentives for prudent risk management processes. Furthermore, we understand that some overseas banks are seeking some form of “grandfathering” for large “strategic” equity holdings. As a matter of competitive equality, we are opposed to such treatment – all equity exposures should be subject to the same rules.

ANZ is supportive of the work already in train within the Committee on this issue and concurs with the need to develop more than one approach for a risk sensitive methodology for equity capital charges. However, we are not in favour of a PD/LGD based approach. The issues of calibration due to the intensity of loss associated with an equity position would be difficult to overcome. There are practical difficulties in applying the PD/LGD framework - how do you define a default on an equity investment for the purposes of calculating PD estimates. Similarly, it is important that legal/contractual definitions of default are in harmony with regulatory capital definitions of default, or banks would have to run two separate systems. Furthermore, the probability of loss of value on an equity investment occurs well before the event of debt default, nullifying the ability to employ debt default values for these investments.

A methodology based on market risk or stress testing is desirable given its ability to incorporate more than just the credit risk associated with these exposures, but the ability to accurately price exposures in illiquid or non traded equity will be a difficult obstacle to overcome.

We believe that the Committee will need to develop more detailed proposals for further consultation before a correct and practical approach can be agreed.

3. SECURITISATION

3.1 Foundation Principles

As recognised by the Basel Committee securitisation (both traditional and synthetic) is a balance sheet management tool that can provide a number of benefits for financial institutions.

As a general statement of position, ANZ does not support the Basel Committee's proposal to adopt a more conservative approach to securitisation in comparison with exposures to corporate or other counterparties. Our position is premised on the following:

- Any facility provided to a securitisation vehicle is appropriately documented with specific limits on the bank's liability under the facility.
- Any facility provided to, or investment in, a securitisation vehicle was approved following application of credit policies consistent with approval of any other counterparty exposure.
- That the banks securitisation activities are subject to regulatory oversight and appropriate disincentives are in place to inhibit a bank from supporting a transaction beyond its legal obligation.

Provided that these "foundations" are in place, it is ANZ's view that risk exposures to securitisation vehicles should be assessed for capital attribution purposes under the standardised or IRB approach in an identical manner to exposures to any other counterparty (i.e. based purely on underlying level of risk involved).

The unnecessary adoption of a more conservative approach will result in a clear disincentive for banks to utilise securitisation and potentially remove securitisation as a viable balance sheet and portfolio management tool.

The comments that follow have been split firstly into specific comments that expand on the position outlined above and secondly comments that are more general in nature. Most of these observations are based on the Consultative Document on Securitisation, which formed the basis for the corresponding section in the main Basel proposal.

3.2 Explicit Risks in Traditional Securitisation – Standardised Approach

3.2.1 Treatment of second loss facilities

It is proposed that a second loss facility will only qualify for treatment as a direct credit substitute if it is investment grade and the first loss facility is provided by a third party. We believe that this proposal is unnecessarily restrictive as:

- There is no similar requirement that any other customer we deal must be investment grade in order to be treated as a direct credit substitute. It is more appropriate to ensure that the underlying first loss facility is sufficient to reduce the risk of loss to a level consistent with a traditional customer; and

- With appropriate documentation and regulatory oversight, there is no reason why the risks associated with one bank providing both a first and second loss facility cannot be completely quarantined.

We suggest that rather than requiring that a second loss facility is investment grade, a more appropriate position would be that a second loss facility qualifies for treatment as a direct credit substitute provided that the following conditions are satisfied:

- The first loss facility must cover a multiple of historical losses calculated by the use of models and other simulation techniques supplemented with opinions provided by reputable third parties (eg ratings agencies) concerning the adequacy of the first loss facility. Typically, the first loss facility will in fact be greater than the EL of the underlying assets and indeed may cover the entire economic capital required so the probability that the second loss facility will be called on is very low; and
- The second loss facility must only be capable of being drawn after the first loss facility has been exhausted.

Where a bank provides both first and second loss facilities, the second loss facility should still qualify for treatment as a direct credit substitute provided the above and the following conditions are satisfied:

- The facilities are separately documented and clearly function separately; and
- The second loss facility is made up of securities (or some form of marketable credit enhancement) which could be transferred at any time.

Indeed, given the conservative nature of the first loss facility, a portion could typically be considered for treatment as a direct credit substitute with the core component deducted from capital. By extension, it would be rational to treat the second loss piece as a direct credit substitute.

3.2.2 Capital requirements for investments in ABS

The proposed risk weighting schedule unfairly discriminates against securitised investments when viewed against the proposed risk weightings to be applied to corporate exposures of the same rating. This is unjustified given that a specific rating grade provided by a rating agency (eg AAA) already represents an alignment of obligors with the same relative risk. Ratings allow an investor to be indifferent from a risk exposure perspective when choosing between equivalently rated investments, be it a choice between two corporate entities, or a corporate entity versus a structured investment.

Indeed, the Committee's grouping of corporate (and securitised) investments of similar ratings categories into the same risk weighting categories shows that it accepts the "same relative risk" proposition. By extension it is therefore illogical to adopt a different risk weighting scale for investments in securitised investments from the scale adopted for corporate exposures. The clear exception to this proposition is first loss type facilities, which, as an overriding requirement would be deducted from capital. The determination of whether an exposure is first loss should be based on an analytical assessment based on sufficiency of loss coverage rather than arbitrary ratings based cut-off point.

The “look through approach” proposed in paragraph 29 of the Consultative Document is supported as it is consistent with our position that what is important is an assessment of the underlying level of risk, not arbitrary distinctions. In this light, we question the approach to subordinated debt (paragraph 30). We believe risk weightings should be applied commensurate with the applicable external rating, whether senior or subordinated. In particular, it is illogical to apply a more punitive capital allocation to a subordinated exposure of an identical rating to a senior exposure purely because it is labelled “subordinate”, as the level of risk involved is, by definition of the rating (which will incorporate some recognition of its subordinated status), the same.

Furthermore it is not uncommon for subordinated tranches of some securitisations to be more highly rated and therefore lower risk than the senior tranches of other securitisation transactions. Just as the determination of whether an exposure to a securitisation vehicle is a first loss facility cannot be decided based purely on an arbitrary ratings cut off point, it cannot be determined based purely on whether an instrument is classified as “subordinated”. We again stress that the determination of whether an exposure is a first loss exposure should be based on a more objective analytical assessment.

3.2.3 Differential treatment of second loss credit enhancements between sponsoring and originating banks

On the basis that the “foundation” principles (described in section 2.1 above) are in place, we see no justification for the proposed differential treatment for second loss enhancements between sponsoring and originating banks. In relation to capital treatment, our comments in relation to treatment of second loss facilities in section 2.2.1 are applicable.

3.2.4 Requirement to disclose in the Statutory Accounts the size and nature of its liquidity commitments to commercial paper conduits

We appreciate that there are arguments for disclosure of liquidity commitments. However, as stressed above we do not believe that there are features of liquidity commitments extended to securitisation vehicles that warrant separate disclosure to liquidity commitments extended by banks to corporate and other entities.

3.3 Internal Rating Based Approach (applied under both foundation and advanced IRB approaches)

Consistent with our comments under the standardised approach we see no justification for the differing treatment of originating banks versus sponsoring banks. For example, issuing banks deduct the full amount of retained first loss positions regardless of IRB capital requirement.

Provided that our proposed “foundation principles” are met, each facility provided to a securitisation vehicle is provided on an individual basis and should be regarded as any other third party transaction. Obligations are clearly disclosed and the risks associated with a facility are the same regardless of whether the facility provider is an originator or sponsor.

Securitisation should be included within a bank’s IRB approach (i.e. all exposures to securitisation vehicles should be allocated capital in accordance with the IRB models regardless of whether holding externally rated securities or whether providing an

unrated liquidity facility to the trust). We submit that there is no justification for treating securitisation exposures differently.

3.3.1 The Assumed 100% Loss Given Default (LGD) for an IRB Approach

The Basel Committee still proposes 'for the sake of conservatism' to apply a 100% LGD to securitisation tranches (paragraph 61). However, it will continue to look at alternative approaches.

ANZ believe that there are a range of circumstances in which the 100% LGD is clearly inappropriate - for example, when assessing a senior tranche of securities. Banks should be able to adopt approaches that offer transparent assessment of expected PD and LGD. To adopt such a punitive approach is unwarranted and disadvantageous to securitisation.

3.3.2 Responses to specific questions raised by the Committee

a. The development of a more risk-sensitive approach to securitisation in the IRB approach

Banks are being encouraged to use the IRB approach but the Basel Committee still proposes "for the sake of conservatism" to apply a 100% LGD to securitisation tranches. However, as per paragraph 64, it will continue to look at alternative approaches.

Banks should be able to apply a transparent assessment of the expected PD and LGD when assessing securitisation exposures. The differential to unsecured rated debt for example, is unwarranted and disadvantageous to securitisation.

The imposition of a 100% LGD for securitisation exposures does not align the capital requirement with the economic risk in many instances. In the case of highly rated senior securities (AAA or AA) applying a 100% LGD under the Foundation IRB approach will produce a higher risk weighting than that achieved under the Standardised model (28% vs 20%) and a risk weighting double that required for non-securitised exposures (corporates at 14%).

The adverse capital treatment is compounded for liquidity facilities provided to securitisation vehicles. These facilities typically rank pari passu with AAA rated note holders in the event of a wind up and contain restrictions on their ability to be drawn down. However, banks applying the foundation IRB approach must apply a 75% EAD and a 100% LGD. This results in a capital charge far in excess of the underlying economic risk position ($75\% \times 28\% \times 8\% = 1.7\%$). This is a significantly higher capital charge than that produced by internal economic risk capital allocation models.

We recommend allowing banks to calculate a LGD within its IRB model in the same manner as for non-securitised exposures.

b. The "two-legged" or "sliding-scale" approach

Where a bank retains a first loss position, ANZ supports the two-legged sliding scale approach. In this case it will involve determining an amount of capital held on balance sheet against the underlying assets and then assessing how much credit risk on the portfolio has been transferred to quantify the capital released. Where a

retained first loss position is less than the on balance sheet IRB capital requirement, an amount of capital should be released.

However, we do not support the concept that the total amount of capital allocated to a securitised portfolio should be in excess of the balance sheet requirement. The aggregate amount of credit risk on the underlying assets should not increase as a result of securitisation.

c. Does the differentiation in treatment on the basis of being an issuer or investor bank provide a balanced and consistent economic approach?

To ensure that securitisation is available as a risk management tool for banks, the Committee must apply a consistent approach across similar risks regardless of whether a bank is acting as originator, sponsor or investor.

Any potential concerns relating to structural or moral risk associated with securitisation are addressed adequately through the proposed operational requirements (paragraph 90) and disclosures presently made within securitisation structure documentation. We do not support any differentiation in the treatment of securitisation exposures between banks acting as originators, investors or sponsors.

ANZ endorses the effective operation of APRA's existing guidelines APS 120, requiring individual documentation, transactions to be undertaken on market terms and conditions and disclosure regarding the extent of the facility, to ensure exposures can be treated as arms length.

3.4 Synthetic Securitisation (under both Standardised and IRB approaches)

The commercial rationale for entering into a synthetic securitisation transaction includes:

1. Reducing large exposures (economic risk)
2. Reducing portfolio credit concentrations to a particular industry/region (economic risk)
3. Developing a wider investor market for participating in credit risk to promote more efficient pricing (cost of reducing economic risk)
4. Regulatory arbitrage (cost of regulatory inefficiency)

We consider that the first three goals are consistent with the objectives of regulators. Clearly there is a need to ensure that measures implemented to prevent the fourth do not make it uneconomic to carry out portfolio risk management. The overriding principle should be that the credit risk of an asset portfolio should not increase when the risk participation is divided into tranches, although a decrease in credit risk is possible through structuring and involvement of a credit enhancer.

Hence, the sum of the capital requirements for each tranche (including any first loss tranche) should be no greater than the capital required to support the portfolio had it remained on balance sheet.

3.4.1 Treatment under the Standardised Approach

In practice, the allocation method between tranches under the standardised approach is the difficult area. All externally rated tranches should attract an appropriate risk weighting (based on the generic standardised approach scale).

The balancing item should be the risk of the last to default piece (the super senior tranche) regardless of its external rating. Given that the originating bank usually retains the first loss portion the equation should balance out fairly. By way of illustration:

Size	Rating	On Balance Sheet	Risk Weighted Assets	Capital at 8%
1500	A	50%	750	60.0

Size	Rating	Post Synthetic Securitisation	Risk Weighted Assets	Capital at 8%
50	Unrated	Capital deduction		50.0
100	Subordinated BBB	100%	100	8.0
100	Senior AAA	20%	20	1.6
1250	Super Senior AAA	Preferential *	Implied	0.4

- Note Super senior cannot have a negative risk weighting.

In this example, had the originator chosen to retain all AAA rated bonds (1350) the appropriate capital required is 2.0 (such that total still equals 60).

3.4.2 Treatment under the IRB approach

If a bank chooses to retain a senior piece (because it is satisfied with the risk profile and it would be uneconomic to transfer this to a third party), the bank should simply be able to assign an appropriate PD and LGD to the restructured risk. There should be no arbitrage opportunities since the bank assigned the PD and LGD to the asset portfolio in the first instance (i.e. why arbitrage itself?)

3.4.3 Retained/repurchased senior/mezzanine risk

The regulatory requirement for a bank to transfer senior risk, even if the regulatory is comfortable with the exposure, is not justifiable (particularly given that the bank must always pay a premium to sell this to a third party).

It is generally accepted by the ratings agencies that a bank has successfully reduced its credit risk to the extent it is able to sell off debt with a lower rating than the bank's rating. For example, an AA rated bank is improving its overall credit profile by selling off an A rated subordinated tranche. From a commercial perspective, the originating bank should not be forced by regulators into transferring risk which does not improve its overall risk profile. For example, why should a AA rated bank be required to sell off AAA risk given that its shareholders are happy with the risk profile at AA level?

3.4.5 Structural Criteria

There should be no need to issue a “substantive amount of AAA rated notes or securities to the capital markets” as the issue of any rated notes (including subordinated/mezzanine) as part of the transaction will be sufficient to “subject the transaction to market discipline” (Paragraph 86 (b))

There is no rationale provided to support the requirement for two rating agency ratings. For many transactions investors require a rating from only one rating agency on the basis that the one agency is one of the top three agencies (i.e. Moody's, Standard and Poors, Fitch). On the basis that investors are happy to accept one agency, we see no reason why banks should be required to incur the additional expense of an additional rating purely for regulatory clearance. (Paragraph 86 (c))

4. OPERATIONAL RISK

4.1 ANZ's view of operational risk

ANZ has considered the proposed framework in some detail. This has included both internal analysis and participation in industry forums designed to understand and improve the draft framework as it presently stands. Primarily, this has involved contribution to the Institute of International Finance (IIF) through its Working Group on Operational Risk (WGOR).

ANZ is of the view that operational risk is primarily a product of a bank's capacity to foresee and prevent operational risk events before they occur and to detect, manage and mitigate operational risk events when they do occur. ANZ believes that there is an inextricable link between the substance and quality of a bank's internal control framework and the level of operational risk exposure that a bank faces.

ANZ approaches operational risk with a forward-looking focus whilst acknowledging that historical events provide explicit evidence of weakness in the internal control environment and hence are a primary trigger to enhance such controls.

At this early stage in the evolution of operational risk measurement, ANZ believes it premature to position historical loss data as a superior mechanism to evaluate a bank's exposure to operational risk events.

ANZ has played an active role in formulating a detailed response to the New Basel Capital Accord through the IIF and encourages APRA to review the IIF response, in addition to this response paper, when it is published in June 2001 and submitted to the Basel Committee for consideration.

A number of the views expressed regarding operational risk are similar in content and scope to those expressed in the IIF response. Likewise, where consistent, a number of these views are simply restated

4.2 Pillar One

ANZ notes that the Pillar One 'spectrum' concept presently contains three approaches for determining an operational risk regulatory capital charge:

- Basic Indicator Approach (Option 1)
- Standardised Approach (Option 2)
- Internal Measurement Approach (Option 3).

ANZ agrees with the Consultative Proposal that internationally active banks should be required to use the Standardised approach at a minimum.

ANZ also strongly supports the view that capital benefits should exist to reward banks when moving to more sophisticated options in the spectrum. These benefits should be significant enough to create incentives for banks to make the investments necessary to qualify for the more sophisticated approach.

ANZ is of the firm view that any mechanism that provides proven and effective protection against the risk of operational loss should be considered for recognition in the regulatory capital framework. In particular, the mitigation provided by risk transfer products (e.g., insurance) should be taken into account in determining the regulatory capital requirement under Pillar One.

The regulatory capital framework should also include explicit factors reflecting the quality of internal control environments in the Pillar One capital charge. Such an approach will provide appropriate incentives for banks to improve their operational risk management practices.

4.2.1 Basic Indicator Approach

A simple approach to determining an operational risk regulatory capital requirement is necessary, both for those banks where the cost of complying with the criteria necessary to qualify for more advanced options may outweigh the benefits of using these options or for non-significant legal entities in banking groups using more advanced options.

ANZ believes that a capital charge determined as a percentage of a single variable (e.g., gross income) is not truly risk sensitive. However, as the Basic Indicator Approach is not designed to be risk sensitive, such a charge is a suitable option at this stage in the spectrum.

Gross income within the Basic Indicator Approach should be defined according to the generally accepted accounting principles (GAAP) in each national jurisdiction.

4.2.2 Standardised Approach

The second option in the spectrum should provide a significant increase in risk-sensitivity when compared to Option 1. It is believed that with some modifications to the existing Option 2 methodology this increase in risk sensitivity can be achieved.

a. Business Lines

ANZ has worked with the IIF on this issue and recommends a more granular set of business lines for Option 2 than the seven business lines suggested in the Consultative Proposal. ANZ supports the IIF proposal that the Level 2 business lines contained in Annex 2 of the Consultative Proposal provide further granularity and are more appropriate for use in Option 2.

This is based on the fact that the risk sensitivity in Option 2 derives from the business line specific β values and related exposure indicators. Therefore, the most pragmatic way to enhance risk sensitivity in Option 2 is to allow for additional β values and related exposure indicators that reflect the specific risk profile of individual business lines.

b. Exposure Indicators

ANZ prefers the concept of allowing a possibly different exposure indicator to be used for each business line in Option 2, in order to make this option more risk sensitive.

We are aware that gross income is being put forward by a number of banks for use across all business lines in Option 2. The rationale for such a position is that the use of the same exposure indicator would facilitate the calibration of Option 2 vis-à-vis Option 1. Likewise, it would help simplify Option 2 without necessarily decreasing risk sensitivity because the Option 2 risk sensitivity stems from the business line specific β values. Finally, it would be beneficial because gross income is transparent, easy to document, capable of being allocated across business lines, and auditable.

Whilst we understand this position, it is also clear that it may produce some distorted results depending upon the local business arrangements employed by each bank. For example, using gross income as a measure for the wholesale payments business line may not necessarily capture the underlying level of activity occurring. It may be common practice for banks to participate in 'netting' arrangements (or other 'tailored' pricing arrangements) with large corporate customers and correspondent banks. In effect, gross income figures presented in formal accounts may not be reflective of the true size of the wholesale payments business. In general, we prefer that the exposure indicators be chosen for each business line in such a way as to best reflect the level of risk in each business.

4.2.3 Internal Measurement Approach

While ANZ acknowledges that it is important to encourage the collection, use and analysis of loss data, and ultimately to incorporate this into the Pillar One framework, the Internal Measurement Approach presents a number of fundamental concerns:

a. The appropriateness of using historical loss data to determine forward-looking capital charges.

ANZ strongly believes that operational risk cannot be effectively managed or measured simply by looking at historical events. We believe that forward-looking indicators and the quality of the internal control environment have far greater impact on the propensity for a bank to be exposed to operational loss. For this reason, and particularly at this early stage of the evolution of operational risk measurement, it is premature to position historical loss data as a superior mechanism to evaluate a bank's exposure to operational risk events.

b. The validity of using expected losses to model unexpected losses through an industry based gamma factor

ANZ questions the mathematical validity of attempting to extrapolate an estimate of "unexpected losses" through the product of expected losses and a yet to be determined industry driven "gamma" factor.

c. The availability of sufficient loss data of appropriate quality to validate the model and the potential impact of this on the stability of the resulting capital charge.

Given the views expressed above, ANZ is also concerned about the ability of the industry to supply operational loss data of sufficient quantity and quality for the model to be effectively calibrated and validated. This concern is underscored by the fact that there is currently no agreement regarding the precise definition of operational loss, or the specific characteristics regarding what qualifies as a valid loss data point (eg threshold and holding period).

d. The linear nature of the model

This issue is discussed below at Section 4.5.5.

e. The degree of risk sensitivity of the model and the insensitivity of the outcome to the standard of the current control environment

In the case of significant loss events, banks characteristically take immediate steps to improve the internal control environment and effectively mitigate the probability of a similar event recurring and / or the severity of such event should it occur.

Whilst the internal factors that failed to prevent the loss may have been remedied, under the IMA approach the loss event will continue to have a significant impact on the regulatory capital charge for a further 3 year period.

f. The lack of any direct relationship between the capital model and actual operational risk management practice.

ANZ strongly believes that the regulatory capital model should have a direct correlation with the actual day to day practice of operational risk management to the maximum extent possible. With this in mind, a direct relationship with the quality of the internal control environment is paramount in ensuring congruency between management and measurement of operational risk.

g. The lack of direct impact of the statistical model on management behaviour.

Due to the delay (or 'lag') that will occur between the improvement in operational controls and any subsequent reduction in regulatory capital charges, there will be little tangible incentive for management to make the necessary investments in enhancing the internal control environment.

An effective regulatory capital framework must, by design, provide clear and direct incentives for bank's to manage operational risk proactively (i.e. when a threat or control deficiency has been identified) rather than reactively (i.e. after a loss event actually occurs).

For these reasons, ANZ is of the firm view that alternatives to Option 3 should be developed and considered. Such alternatives should recognise that the quality of a bank's internal control environment is critical.

Loss data should continue to be paramount as qualifying criteria for Option 3 and would form the basis of progression to the next stage in the spectrum, Option 4,

where internal models based on loss data and control conditions can be developed and utilised.

In the context of the existing Internal Measurement Approach, ANZ believes that the availability of sufficient loss data both internal to a bank and across the industry will make it difficult for a bank to qualify for this approach. With this in mind, it is critical for regulators to provide formal guidelines for collection and use of loss data. Specifically, detailed guidance is required in respect of loss data thresholds, confidence levels, minimum holding periods, minimum data point requirements, loss categorisation and loss definitions.

In the absence of such guidelines, it is very difficult for banks to commence exercises converting existing data sets to regulatory requirements and to invest in appropriate loss data collection systems with confidence.

4.3 Qualitative Approaches

ANZ believes that, in addition to quantitative measurement of operational risk as determined under the spectrum, Pillar One of the regulatory capital framework should contain appropriate mechanisms for recognition of the quality of the internal control environment of banks. We believe that this can be most appropriately addressed by incorporating qualitative factors into the more sophisticated options in the spectrum. In particular, we support the development of an alternative, more qualitative approach which could be positioned as an alternative to the currently proposed option 3 formula (the IMA).

4.3.1 Qualitative Scorecard Approach

ANZ is currently leading an industry task force researching the potential to use qualitative “scorecards” in Pillar One of the regulatory capital framework. These scorecards would provide the qualitative component of a proposed alternative methodology for determining the regulatory capital charge. The “Scorecard Approach” would assess the scope and quality of the internal control environment in preference to the level of a bank’s future expected losses as determined by historical loss data under the currently proposed Option 3 formula.

ANZ believes that this approach is an advance on the current Option 2. For this reason, the Scorecard Approach could exist in addition, or serve as a possible alternative, to the proposed Option 3 formula.

The Scorecard Approach would be designed to incorporate forward looking elements into the direct calculation of the regulatory capital charge by identifying and prioritising the primary drivers of operational loss for each business line and risk category.

Under the approach, the capital charge would be based primarily on the size of each business line (captured through the use of exposure indicators) and regulatory-determined factors (ω) for business line/risk type combinations in a manner analogous to the current Option 2. A “Risk Score” would then be applied to each business line/risk type combination.

This alternative method gives a 2-dimensional matrix of charges analogous to the Standardised Approach. That is, the Standardised Approach calculates a capital charge for each business line, while the Qualitative Scorecard Approach calculates a capital charge for each business line and risk category combination which is then

adjusted by a “Risk Score”. When the “Risk Scores” are permitted to vary up or down from 1 as proposed in the methodology, they function as qualitative adjustments to the individual capital charges.

The “Risk Score” is derived through the assessment of internal processes and operational controls for different risks across various business lines through the completion of a series of standardised “scorecards.” The answers to these scorecard questions would be used to generate the “Risk Score” for each business line and risk category combination. This would be designed to not only produce a risk sensitive capital charge, but also provide targeted incentives to improve controls where specifically necessary.

The proposed formula for determining the regulatory capital charge under the Scorecard Approach is as follows:

$$\text{Capital} = \sum_{ij} EI_{ij} \times \omega_{ij} \times RS_{ij}$$

Where:

- EI** Exposure Indicator (for each Business Line/Risk Category)
Exposure indicators would be selected as the most appropriate measure for the risk drivers for the Business Line/Risk Category combination. Where appropriate, Exposure Indicators would be non-linear.
- ω** Industry weighting factor (set by the regulators for Business Line/Risk Category)
These factors would be calibrated using industry loss data and the regulatory evaluation of the required levels of minimum regulatory capital. Therefore, the factors reflect the level of capital required (for an average level of control environment) per unit of corresponding exposure indicator (eg \$1million of gross income).
- RS** Risk Score (for each Business Line/Risk Category)
These factors contribute both risk sensitivity and behavioural incentives to the framework and are calculated for each Business Line/Risk Category. The higher the quality of the control environment, the lower the risk score and vice versa (subject to a cap and a floor). Each risk score would be determined from the responses to the control-related questions on the corresponding scorecard and would be normalised to a value of 1. The strength of the embedded behavioural incentives would be determined by the permissible values for Risk Score (e.g., 0.5-1.5, 0.8-1.2, etc).
- i** Business Line
- j** Event-based Risk Category (identical to the proposed event type loss categories)

It will be important to provide assurances to regulators that the scorecard responses are accurate. This can be accomplished by requiring different levels of independent review and oversight of responses to Scorecard questions. Possible candidates for this review function include internal independent risk management functions, internal auditors, and external auditors. It is likely that appropriate levels of such independent review will minimise the need for extensive regulatory scrutiny in order to assure the quality of Scorecard responses.

The Scorecard Approach would use an individual bank's internal loss data in order to perform a validation of that bank's Risk Scores. Such a validation process would provide a direct feedback mechanism between the forward-looking assessment of the control environment and historical losses. That is, the Risk Scores calculated at the beginning of a given time period would be validated using the loss data subsequently collected from that time period.

In the event of a significant discrepancy between the level of control indicated by the risk score and the actual level of losses subsequently experienced, a number of actions could be taken such as the imposition of a capital buffer and/or a revision of the scorecard responses.

The key features of the Qualitative Scorecard Approach can be summarised as follows:

- The risk assessment is forward looking
- The method provides incentives for banks to invest in internal controls, provides a roadmap for reducing risk and allows banks to focus their investments where risk mitigation is needed
- The calculation of capital remains formulaic, transparent and risk sensitive
- The primary driver of capital calculation is the internal control environment, including assessment of operational processes and controls, and detailed internal risk drivers
- The model is calibrated using industry operational loss data; specifically, the regulator determined omegas would be set by reference to pooled industry loss data and regulatory experience/perceptions
- Banks are required to collect internal loss data in order to assist in the validation of the approach
- The approach is consistent with the actual internal operational risk management process
- All qualitative assessments are made explicit and transparent, and are subject to audit or supervisory interrogation
- The methodology attracts capital when vulnerabilities/weaknesses are revealed (i.e. when the probability is high), not after a loss, when the probability is likely to be greatly reduced.
- The approach permits easy enhancement to incorporate new operational risks as these arise (eg e-commerce security risks or other new businesses as they are initiated)
- The operational risks covered in this approach are not confined to transaction related risks only
- A large majority of banks should be able to manage this approach
- The standardised nature of the scorecard approach, and the ability to base the assessment on information that is largely objective and auditable, provides a methodology that can be implemented with limited supervisory resources. Indeed, informal discussions with several members of the global regulatory community have confirmed that regulators are likely to see the supervisory intensity required to monitor this approach as considerably less than that required under the Internal Measurement Approach, where deep and detailed supervisory review of data collection and integrity, and banks' internal controls, are likely to be required.

ANZ strongly urges APRA to consider this position and ultimately to recommend the inclusion of such an approach in the current spectrum as an additional option in its own right or as an alternative to Option 3 as currently articulated.

It is believed that the adoption of such a position would achieve two specific objectives. Firstly, it would provide an alternative to the current Internal Measurement Approach, which is yet to be validated and is subject to varying degrees of criticism by a number of banks.

Secondly, the use of a control based 'scorecard' approach acknowledges the views of a significant number of banks who firmly believe that exposure to operational risk events is best measured by analysis of forward looking indicators rather than backward looking mechanisms such as analysis of historical loss data.

4.3.2 Qualitative Factors

By failing to include a strong emphasis on qualitative control factors in the spectrum, the risk of inconsistency with sound risk management practices exists and places too large a focus on quantitative techniques. Thus, a regulatory capital framework that does not include qualitative factors would be substantially less valuable to the industry and to regulators.

4.3.3 Reasons for the Development of Qualitative Approaches

ANZ is of the view that entirely quantitative approaches to determining the operational risk regulatory capital are inappropriate for the following reasons:

a. The Drivers of Operational Risk

The ultimate operational risk level in a bank is largely determined by the adequacy of internal controls (e.g. policies, risk awareness, good quality of staff) designed to control operational risk levels. Therefore, direct actions to improve controls will lower the bank's operational risk exposure. However, under the current proposals, such reduced exposure will not directly result in a lower operational risk capital charge.

Rather, any improved operational risk profile will only be recognised after a lag period, presumably several years, once the consequences of these improvements manifest themselves in loss data. Indeed, the short term motivation will be to enhance profitability by lowering the investment in controls, and yet there would be no negative capital impact.

b. The capital charge should provide incentives to improve operational risk management

Under the proposed regulatory capital framework, there is no clear and direct benefit to management to make the investments necessary to improve internal control frameworks. The only way in which the benefits of improved operational risk management can be realised are indirectly through the likely reduced levels of operational losses that may be used to determine the capital charge under Options 3 and higher.

ANZ is of the view that this recognition is insufficient and will often be too late to provide adequate incentives to management to make the investments necessary to improve internal control environments.

Therefore, there should be a direct linkage between improvements in internal control environments and the regulatory capital charge. In this way, management can be assured that investments in strengthening operational risk controls will result in a tangible and direct benefit in the short term. A capital charge based on historical losses only will not provide the proper incentives for management to improve operational risk controls.

Given the currently developing science of operational risk measurement, one of the most important goals of the operational risk capital charge should be to provide management with incentives to improve their level of control over operational risks. This is particularly important as the environment in which a bank operates, and therefore its operational risk profile, is not stable over time.

c. New businesses

A forward-looking approach in the regulatory capital framework will assist banks in maintaining focus for managing future risk exposures. This will be critically important as banks move into new businesses or business channels (e.g., e-commerce) where loss experience will not be available. In such situations, the internal control structure and control culture surrounding these new businesses is the best predictor of future operational incidents and losses.

4.4 Loss Distribution Approach

ANZ views the inclusion of a possible Option 4 in the spectrum as a positive step and encourages the formal inclusion of this in the Accord at this time. Importantly, we believe that Option 4 should allow for regulator approved internal models, which may or may not reflect the Loss Distribution Approach. However, in the context of the brief detail provided regarding the Loss Distribution Approach, the following issues require clarification:

- What is the framework for determination of the data levels that will be needed for applying this approach?
- Will a bank be allowed to apply this approach sequentially along different lines of business as data is accrued?
- Will the transition need to be conducted across all businesses simultaneously?

4.5 Framework Issues

4.5.1 Operational Risk Definition

The Basel Committee adopted the general definition of operational risk as “the risk of direct or indirect loss resulting from inadequate or failed internal processes, people, and systems or from external events.”

ANZ has worked with the IIF on refining this definition and supports the following general definition of operational risk for regulatory capital purposes:

Operational Risk is the risk of loss resulting from inadequate or failed internal processes, people, and systems or from external events that is not covered by other regulatory capital charges (i.e., credit, market, and banking book interest rate risks). Business, strategic, and reputation risks are expressly excluded.

This work has also included the development of a series of definitions that can be used to determine the specific losses that should be covered by the operational risk regulatory capital charge.

An operational risk loss is the amount charged net of recoveries to the profit and loss account in the resolution of the operational risk event.

Amount charged net of recoveries is determined in accordance with generally accepted accounting principles (GAAP). The recording of a charge to the profit and loss accounts triggers recognition of an operational risk loss as a data point for regulatory capital purposes. The date attributed to the loss is the date on which the profit and loss account charge is first recorded. If loss amount changes in future periods (e.g., when a recovery is made), adjustments are recorded as a change to the original loss data point and do not result in a new data point.

It is anticipated that these definitions will include some losses that are currently covered under the credit risk regulatory capital framework. ANZ is in strong support of the view that further clarification regarding the inclusion of credit losses due to operational failures and inadequacies is required from the Basel Committee before the New Basel Accord is finalised. We are most concerned that definitional overlaps do not develop, so that we are not subject to “double counting” of capital for credit and operational risks.

ANZ supports the view that the definition of operational risk for regulatory capital purposes should exclude latent losses, near misses, and contingent events because of the difficulty in measuring such losses. However, this is only the case for the quantitative approaches presently detailed in the spectrum. This is a purely pragmatic view based on the belief that excluding such losses will assist to ensure consistency and comparability in the determination of a regulatory capital charge.

In contrast, ANZ is of the belief that the more qualitative approach being proposed will, by design, provide a more holistic operational risk regulatory capital charge through its assessment of the internal control environment which applies to explicit losses, latent losses, near misses and contingent events.

4.5.2 Connection with other Capital Charges

There should be no overlap in regulatory capital charges in order to avoid double counting of capital. The definition of operational risk for regulatory capital purposes should clearly state that it does not include any risk of loss already covered by market, credit, and interest rate risk regulatory capital charges. Conversely, to the extent that losses are included within the operational risk regulatory capital charge, they should not be covered elsewhere.

In order to avoid overlaps, clear definitions of the extent of the risk types in the regulatory capital framework are required.

4.5.3 Calibration of the Capital Charges

The Consultative Proposal indicates that the Committee concluded from a survey of a very limited number of institutions that banks allocate 20% of total economic capital for other risks. Therefore, the Committee used a figure equal to 20% of minimum regulatory capital to estimate a provisional multiplier for the Basic Indicator Approach

(Option 1) and to generate initial calibrations of some of the beta values in the Standardised Approach (Option 2).

ANZ believes that the 20% of current minimum regulatory capital figure suggested for calibrating Options 1 and 2 is potentially not appropriate and requires further work. According to the Consultative Document, this figure was based on a sample of institutions where only a small number provided complete data sets. More importantly, many of the banks providing this data may have provided a figure for the amount of economic capital allocated to cover all “other risks,” a much broader term than operational risk.

ANZ is presently participating in the Basel Committee QIS and suggests that the results of this survey be used in order to determine an appropriate calibration of both Option 2 and the entire regulatory capital framework.

4.5.4 Non-linearity of Operational Risk

The proposed formula for determining the regulatory capital charge in Options 1, 2 and 3 generate a regulatory capital charge that is linearly proportional to the exposure indicator used in the formulae. At a basic level, this suggests that operational risk is expected to double as the size of the bank doubles. ANZ supports industry analysis, which indicates that this relationship is not intuitively correct and is not supported by the research conducted to date.

While ANZ is yet to form a view on the precise mathematical relationship between scale and operational risk, our internal analysis leads us to conclude that

- There is a highly complex relationship between scale and regulatory capital requirements for operational risk.
- The relationship varies by the type of operational risk being considered: for some (eg political risks) it may be linear; for others (eg cheque processing) it will be much less than linear.
- In some cases, the relationship also depends on decisions taken by the Bank (eg to centralise or devolve its IT systems).
- In others (eg large-scale fraud / rogue trading) the relationship is not particularly clear, and arguable in many directions.

On balance, there is likely to be a less-than-linear scaling of operational risk regulatory capital requirements with the size of bank, creating an economy of scale. Thus, ANZ strongly recommends that further industry analysis be undertaken to examine the relationship between scale and operational risk and that, based on this analysis, a non-linear function be incorporated into each of the options in the spectrum.

4.6 Operational Risk: Pillar Two

ANZ agrees with the Consultative Proposal that regulators should assess the adequacy of the control environment in each institution. However, as indicated, it believes that control environment analysis should be included in Pillar One. In addition, ANZ concurs that where the environment is deemed inadequate or the capital allocation insufficient, regulators should expect banks to take prompt action to correct the situation.

ANZ believes that Pillar One should contain all elements necessary to determine the regulatory capital charge. This includes the criteria that each bank must meet in order to qualify to use a particular option to calculate the regulatory capital charge. ANZ acknowledges that the actual approval of a particular bank to use a particular option for determining its regulatory capital charge is a Pillar Two determination. However, ANZ believes that all methods used to determine the actual capital charge should be specified under Pillar One.

ANZ believes that all Pillar Two actions should be executed in a consistent and transparent fashion on the basis of published guidelines.

4.7 Data pooling

A major challenge for developing the operational risk regulatory capital framework is the collection of loss data. Industry-wide loss data may be needed not only for the calibration of the operational risk capital charge but also may be necessary to supplement internal data for at least some business line/loss type combinations.

ANZ shares a number of bank's concerns about the possibility that regulators might require banks to join an external (i.e. industry) data pool in order to qualify to use certain approaches in the spectrum.

ANZ has a number of concerns regarding any data pools. However, ANZ does not believe these concerns to be insurmountable if managed appropriately. In this regard, ANZ shares the following concerns relating to data pools that have been articulated by a number of member banks of the IIF.

a. Repelling plaintiff's interrogatories

Pre-trial discovery capabilities in many legal systems may allow plaintiffs to obtain data contained in any part of a legal entity irrespective of the geographic location of the data. For example, a writ of discovery served on a branch in Melbourne may enable plaintiffs to obtain data held outside Australia. This is an issue for each individual bank, regardless of whether it joins a data pool. However, ANZ is concerned that, even if an individual bank has taken steps to protect itself against such discovery, data pools may not. Thus, ANZ believes that data pools should provide the capability for individual members of a data pool to provide resources – funds and expertise – to repel plaintiffs' interrogatories.

b. Regulatory protection from civil litigation

In order to strengthen the protection for banks contributing to data pools with respect to civil litigation, ANZ believes that national regulators should extend the protection from civil litigation currently given to auditors' notes to include internal operational risk data and data pools. This should be done on a uniform basis across all supervisory jurisdictions in order to avoid a situation where the combining of information from various jurisdictions would result in the loss of the protection provided by the particular jurisdiction from which any data originates.

c. Confidential or privileged loss information

In some circumstances (such as the result of a lawsuit settled without formal legal judgment), there may be confidentiality agreements or privilege requirements that govern operational loss information. If these agreements or requirements tend to

occur more frequently with low frequency/high severity events, then there may be implications for determining the true shape of the operational risk loss distribution.

ANZ is aware that some banks have consulted legal counsel and have been advised that the legal challenges presented by sharing confidential or privileged loss information could be managed by changes in legal practices. Specifically, assuming that an individual cannot be identified directly or indirectly from the raw loss data, settlements subject to non-disclosure agreements may be able to be included in data pools. However, ANZ is yet to obtain specific advice regarding these matters from its own counsel.

5. MARKET RISK

5.1 Risk control and audit

Consistent with the principles included in the consultative document, ANZ ensures the integrity of its risk control system through regular independent audits and reviews. We separate risk control and risk oversight functions. The risk control unit retains primary responsibility for day-to-day administration of the risk measurement system, while risk oversight unit is responsible for auditing, reviewing assumptions, models, analysis and reporting. This includes representation of product and customer contract information in the risk system.

5.2 Standardised interest rate shock

The calculation process proposed for non-G10 currencies would be cumbersome and subjective as 5 years of daily interest rate observations for all term buckets is often not available. This is particularly the case for small and developing countries that do not have active wholesale markets. In these markets, it would not be possible to establish the size of the parallel rate shock necessary to be consistent with the 1st and 99th percentiles of observed interest rate changes.

It is recognised that from ANZ's perspective, these countries do not represent a significant interest rate risk exposure. This, however, may not be the case with other internationally operating banks where such exposures could represent a significantly larger proportion of their risk.

5.3 Calculation process for the standardised framework

Step four of the calculation process suggests directly summing the net short and long weighted positions for different currencies to derive the total interest rate risk of the banking book. Summing positions without accounting for the portfolio benefits of holding different currencies is likely to overstate the true risk position of the bank where two net positive or negative positions are held. Conversely the risk position will be understated with opposing positions. To more accurately reflect the total interest rate risk position of the bank, ANZ believes that the calculation should include some allowances for correlation effects (whether positive or negative) between currencies.

5.4 Capital for interest rate risk in the banking book

ANZ supports the Basel Committee's proposals for the treatment of interest rate risk in the banking book, and notes that the proposal differs from the views APRA expressed in its March 2000 *Submission to the Basel Committee on Banking Supervision: A New Capital Adequacy Framework*. We would be concerned if APRA were to introduce treatment for Australian banks that differed from the Basel approach.

The Committee accepted the principle that all banks have a nominal amount of interest rate risk in their banking book and that such a level generally does not represent a sufficiently large risk to warrant special attention at this time. Instead, the Committee promoted the view that only "outlier" banks, (i.e. those that maintain unusually large levels of interest rate risk in their banking books) should allocate capital against that risk. ANZ notes that defining an "outlier" bank will be subjective, however, in a global forum such as the Basel Committee with wide ranging

consultation, ANZ feels comfortable that a reasonable definition (even though it may be subjective) will emerge and gain support.

ANZ is supportive of the Basel proposal that a capital charge would only be levied on “outlier” banks for the following reasons:

- The banking market is developing into a competitive global market in which Australia is increasingly being forced to compete. The generally accepted view is that additional capital is not required for normal levels of interest rate risk in the banking book. To deviate from this view would disadvantage Australian banks and promote the developing theme that Australian companies should follow the emerging trend of moving their head offices to a suitable offshore location.
- Identifying “outlier” banks is an important role for a regulator to perform. This then allows the regulator to focus its audit and compliance efforts to those institutions posing the greatest risk and deserving the highest attention.
- The allocation of interest rate risk capital against the banking book will increase the cost of providing banking products. Such costs will ultimately be borne by customers, many who have relatively simple banking products.
- Most banks have developed proprietary models and frameworks for measuring and understanding the various types of interest rate risk embedded within their individual banking books. As each bank's business and mix are unique, so too is their product risk and the way in which they manage it. Such frameworks can be, and are, regularly reviewed by the various regulators thus giving support to the view that an additional capital charge is not necessary. Development of an industry standard may not be in the best interests of prudent risk management.
- It is generally accepted that the interest rate risks in the trading book and banking book are not strictly additive, as they are different with unique accounting and management processes. Hence, it does not follow that capital rules for the trading book should be applied to the banking book. While it has been suggested that there may be an incentive to transfer risk between such books should the capital allocation processes differ, in practice the operating procedures and accounting principles for each book are radically different (i.e. each business has unique drivers). Trading books are generally managed around flows of customer business, with short-term proprietary positions being taken and reported on. Market value accounting is used and generates an immediate earnings impact. On the other hand, the banking book is focussed on longer-term management of cash flows generated through lending and deposit business. Cash flows are managed using various techniques, with market value changes not being recognised in current earnings.

Until broad based international standards can be developed that can be applied to a varying range of banking businesses, ANZ believes the current proposals by the Basel Committee for treatment of “outlier” banks is appropriate. Any additional regulatory issues can be adequately addressed by APRA through its normal process of review of internal models, policies and operating procedures. This will ensure adequate prudential standards are maintained without compromising the competitive position of Australian banks.

6. THIRD PILLAR - DISCLOSURE

6.1 General Considerations

6.1.1 The Rationale for Disclosure

ANZ agrees that information that assists users to understand and assess the level of capital held by a bank and its risks should be publicly available. We also believe that constant review of disclosures is part of, and intrinsic to, good financial reporting. Furthermore, as the complexity and variety of methodologies to apply the capital requirement increases, it is appropriate to review and update the current disclosures. On this basis we support the underlying thrust of Pillar Three.

However, the key to the success of Pillar Three will be the quality and informative value of the additional disclosures implemented. It is important to distinguish between information that is useful for decision making, and data that does not assist the user to assess relevant risks. Assessment of the relevance of the information provided is necessary to ensure that users are aided, rather than confused, by the reporting of the institution.

Indeed, greater disclosure does not always translate to 'better' disclosure. Any increase in disclosure requirements should be carefully considered in light of existing disclosures, the purpose of the disclosures and the additional value the proposed disclosures bring to the users of the information.

6.1.2 Implementation of Pillar Three

A key characteristic of financial disclosures is comparability. Users need to be able to compare aspects of one bank with those of another, and to compare the performance of banks over time

We agree that in a regulatory regime that allows banks to use their own internal models, comparability is best achieved by both binding and voluntary disclosure requirements. There should be core disclosures that all banks are required to make no matter which methodology is used. These disclosures will be comparable across different banks.

We also agree that a successful disclosure regime should be supported by penalties for non-compliance. The mechanism for enforcing disclosure regimes already exists in many jurisdictions, and we suggest that Basel consider adoption of existing mechanisms in these jurisdictions.

Many countries have a well developed framework for monitoring compliance with accounting standards, and for taking action against banks which do not meet the required standards. In these jurisdictions, compliance with standards or otherwise must be attested to by the directors, and we believe that incorporating additional disclosure standards within accounting standards would be the most effective way of achieving compliance.

ANZ notes that the international standard on disclosures by financial institutions (IAS 30: Disclosures in the Financial Statements of Banks and Similar Financial Institutions) has been adopted, either in whole or largely, by a significant number of countries. The disclosures provided to meet the requirements of this (or equivalent

standards) allows the reader to compare risk positions of international banks, for example those in Europe, much of South East Asia and Australia.

The widespread acceptance of international accounting standards make these a ready vehicle for actioning increased bank disclosure.

We also agree that the information disclosed should be verified. The appropriate mechanism is an audit, and ANZ suggests that the market would expect and prefer that the information disclosed is subject to audit.

Finally, we believe that any additional disclosures should be subject to a cost benefit analysis. The preparation of financial reports is a significant cost for all banks, and we believe that it would be inappropriate to supply more data, without assessment of the additional cost versus the additional benefit. For example, it may be more useful to the reader – and more efficient for the bank – if the bank provides an explanation of how risks are categorised, and the level of capital and amount of business held for broad categories, rather than pages of detailed tables of risk categories.

6.1.3 Characteristics of the Disclosures

We believe that key core information should be published on a semi-annual basis and supplementary information on an annual basis. A bank should be able to disclose the supplementary information on a more regular basis, at their discretion.

We do not believe that any more regular disclosure is required, unless there is a significant change that results in the previously released information becoming materially false or misleading. In the event of such a change, each bank would be required to meet the regulatory requirements of its home country, for example, disclosure outside half yearly reporting may be required in continuous disclosure regimes.

6.2 Disclosure Recommendations

6.2.1 Risk Exposure and Assessment

Effective disclosure is achieved when the information presented enables the users to make optimal decisions about the organisation concerned. The quality of information disclosed is therefore of critical importance.

If the proposals of Pillar Three are to be effective, the disclosure requirements must focus on providing the users with quality information. Greater quantities of disclosure does not of itself translate into added value for the users. If too much information is provided, critical facts can be lost amongst unimportant and trivial matters. The level of information disclosed is also important, so data dumps of detailed facts and figures should be avoided. Too much data can confuse and mislead users.

The sophistication of the users also needs to be considered when determining disclosure requirements. Providing information that only experts in other banks can understand does not add value for the general user. It does however provide information of use to competitors. The information disclosed should be sufficient for the general user to easily assess the risk profile and capital adequacy of a bank.

We are not aware of any research that addresses the issue of recent bank (or other financial institutions) failure, and the extent to which such failures could have been avoided by increased disclosure. Nor are we aware of research which investigates

whether regulators who have access to more detailed information on banks than is publicly disclosed, have been better placed to predict and prevent bank failures.

We suggest that both these issues should be addressed while consideration is given to increasing the amount of bank disclosure.

We would also be interested in the opinions of banking analysts. These analysts have a detailed understanding of the industry, which has been built up through review of existing disclosures. We would be interested to know the extent that analysts seek additional information. We suggest that analysts must meet time and cost constraints in their assessment of the information provided, and therefore would probably seek only information that filled existing gaps in knowledge.

As noted previously, we believe that comparability is an important factor for the proposed disclosure requirements. In order to achieve comparability, the disclosures need to provide information that is prepared within a set framework and disclosed in a manner that makes comparison easy. Comparability is maximised when information is disclosed at a level that allows the information to be compared without any manipulation. When information is presented that requires manipulation due to inconsistent definitions or different methodologies it not only reduces comparability it also can lead to wrong assessments being made.

To ensure that there is as much consistency in the disclosures between non-bank and bank financial institutions, we strongly support the Committee working closely with the International Accounting Standards Board to developing their existing standards to incorporate as much of the market discipline disclosures as possible. If the disclosures already exist in IAS standards then Pillar Three should refer to their requirements. Where Pillar Three is recommending new value-added disclosures, we believe that the Committee should look to have these disclosures incorporated into a revised IAS 39 or IAS 30. As accounting standard disclosures are focused on achieving the same outcomes as the Committee under Pillar Three, it is appropriate to have all the disclosures in accounting standards.

On the basis of the above we believe that the disclosure requirements for Pillar Three should focus on providing high level quantitative disclosures and detailed qualitative information about the methodology and key inputs. Our specific comments in respect of the proposed disclosures detailed in the Document are as follows.

6.2.2 Credit Risk in the Banking Book

We agree with the proposed credit risk disclosure requirements in respect of:

The core quantitative and qualitative disclosures that are applicable to all institutions. We note that some of these disclosures are already required under existing International Standards.

- The required quantitative and qualitative disclosures proposed for those banks using the Standardised approach. We believe the recommendations should be treated as supplementary disclosures and therefore at the discretion of the bank.
- The proposed qualitative disclosures in regard to general information on methodology and key inputs for those banks using the IRB approach.

We do not agree with the proposed disclosure requirements in respect of:

- The voluminous disclosures for banks using the IRB approach. While we recognise that providing the information listed at the sub-portfolio level rather than at the portfolio level may provide investors with useful data, we are greatly concerned that disclosing at this level would result in banks being at a competitive disadvantage compared to non-banks. For example, niche players that are not regulated under the banking framework – such as credit card operators or mortgage originators – would gain detailed insights into the equivalent portfolios operated by banks. The information that is proposed for disclosure under the IRB approach – such as rating migration data – would be of great interest to our competitors.
- We do not agree that the disclosures proposed for banks using the IRB approach provide relevant information. The proposals cover an extraordinary amount of detail. For example, disclosure of the methods of estimation and validation could result in publication of a text book – hardly what external reporting seeks to achieve. We believe that the more useful disclosures have been covered in the quantitative disclosures.
- The quantitative disclosures ex post performance for banks using the IRB approach. We believe an appropriate level of information is already provided about credit risk – past and present via these proposals and existing disclosure requirements (for example, impaired assets). Users of the information can compare historical information to easily identify trends about the quality and reliability of the credit risk assessment.
- Additional information about credit risk mitigants under the IRB approach. We believe sufficient quantitative information about credit risk mitigants is required as part of the core information requirements and should not need significant expansion for IRB purposes.

6.2.3 Market Risk in the Trading Book

For market risk, we support the core quantitative and qualitative disclosures for both the Standardised and Internal Models approaches. We believe that the supplementary disclosures should be left to the discretion of the bank.

ANZ has some concerns about the extent and basis of disclosure envisaged by the principles of interest rate risk in the banking book. Firstly, it should be noted that modelling skills in this area are a source of competitive advantage among banks. For example, a bank with a better understanding such issues as customer option-exercise and prepayment behaviour can use this understanding to feed into its pricing. ANZ is concerned that too much disclosure in this area could serve to assist rival banks.

Secondly, the disclosures imply that the all banking-book positions have short-term realisable economic values; this is not the case for most consumer deposit products. Income measures provide a more realistic indicator of the realisable value inherent in these products.

Third, the market disclosure principles do not consider the differences between economic risk management principles and accounting reporting standards. Public

reporting against these two diverging standards will generate inconsistencies that many investors will be unable to reconcile.

On balance therefore, we believe that the information disclosed would be of limited use for investors, and may erode a source of competitive advantage.

6.2.4 Operational Risk and Interest Rate Risk in the Banking Book

For operational risk and interest rate risk, we support the core quantitative and qualitative disclosures. We believe that the supplementary disclosures should be left to the discretion of the bank as much of the proposed disclosure would be of limited value to general users and may in fact increase the risk of misinterpretation. For example, stress testing interest rate risk in the banking book is a complex area, and disclosing results would be more likely to lead to confusion among general users.

7. CONCLUDING REMARKS

ANZ believes that the Basel proposal and the opportunity afforded to industry to have input into its refinement/improvement are productive and prudent steps in progressing the development of a more risk sensitive capital framework and the promotion of a more stable financial system. There are clearly areas that require further work, with many technical and conceptual issues still to be improved or further developed, but overall the moves toward a risk based capital framework are to be applauded.

We are happy to discuss any aspect of this document and elaborate on its content. Please contact Morris Batty, Head of Policy and Portfolio Management (telephone +61 3 9273 5790 or email battym@anz.com) or Tom Appleby, Manager Portfolio Strategy and Industry Analysis (telephone +61 3 9273 6860 or email appleyt@anz.com) for further clarification on the issues raised.