Austrian Banking Industry

Response to the second Basel Consultative Document (The New Basel Capital Accord)

General position

- ***General opinion***

  We are in principle in favour of the system proposed in the Basel Consultative Document, under which the relationship between credit risk weights and economic risk would be strengthened, regulatory capital requirements would be refined and risk mitigation techniques would receive greater recognition. However, sufficient allowance must be made for small- and medium-enterprise structures in Austria.

- ***We welcome the proposal that internal ratings should be recognized both simultaneously and as being of equal value for supervisory purposes***

  Although we would in principle welcome a more refined means of capturing and setting capital charges for credit risks, we must point out that Austria, too, is not sufficiently equipped with the external ratings needed to implement such a system and that the situation is unlikely to change in the foreseeable future.
  We therefore welcome the proposal that banks' internal ratings should also be recognised as a basis for assessment when setting capital charges so long as it is ensured that external ratings and the internal measurement of risks are recognised both **simultaneously and as being of equal value** for supervisory purposes. The **conditions for recognition must be such that they can be satisfied by a broad section of the industry.**

- ***Creating a level playing field***

  It must be ensured that neither individual groups of market participants nor individual instruments suffer competitive disadvantages at either national or international level. In other words, a level playing field must be guaranteed. In that connection, we are also concerned about the options that

will remain open to national supervisory authorities and the associated risk of supervisory arbitrage.
The new framework must not put banks at a disadvantage vis-à-vis other providers of financial services.

- ***The goal of not increasing the overall capital charge imposed on the banking system must be adhered to***

  In-depth discussion of the results of the *Impact Study* will be needed to ensure that the overall framework does not cause any increases in capital charges (above all because of haircuts and deductions in connection with risk mitigation such as *"floor" factor w*).
  We have reason to believe that the reduction in minimum capital requirements foreseen by the model will not be achieved. Consequently, this issue needs to be re-addressed when the results of the *Impact Study* become available.

- ***The definition of retail exposure***

  Wording needs to be found that, as far as possible, includes small and medium enterprises.

- ***Partial use of partial models must be recognised***

  Partial use of partial models must be generally recognized within the scope of the IRB (internal ratings based) approach, in the treatment of collateral (comprehensive or simple approach) and during the measurement of operational risk.

- ***Retention of the principle that regulatory capital can be drawn upon to cushion unexpected losses***

  One of our key requirements in this context is the retention of the principle that regulatory capital can be drawn upon to cover unexpected and unsecured losses.

- ***Longer-maturity finance should not be disadvantaged***

  We cannot understand the notion contained in the Basel Consultative Document that longer loan periods should be seen as a significant risk factor during the measurement of credit risks.
  The established longer-term finance variants (e.g. mortgage-backed and yielding a fixed interest rate) should not under any circumstances be less favourably treated.

- ***Operational risk – inadequate risk sensitivity***

  In the absence of suitable standards, inclusion in Pillar 1 currently seems inappropriate. A shift to Pillar 2 therefore seems necessary during Stage 1.

The suggested volume-based indicators would not guarantee sufficient risk sensitivity.

- ***Supervisory review – adequate standards and limits are needed***

  It must be ensured
  - that supervisors do not assume any management functions,
  - that competitive distortions are avoided, and
  - that adequate standards for and limits to supervision are set.

- ***Market discipline – disclosure requirements must reflect market conditions***

  The excessive scope and level of detail implied by the proposal regarding disclosure requirements would obscure the essentials and harbour the risk of inadvertently disclosing sensitive data.

- ***Adequate transition period once the framework has been finalized***

  We wish to put on record that many parts of the Consultative Document use vague terms and wording, making it very difficult to assess its contents and implement it. Not least for that reason, it will be important to offer banks sufficient transition periods from the time the framework is finalized to the time of changeover to the new system of regulatory capital charges.

Part 1: Scope of Application

The Austrian banking industry welcomes the Basel Committee’s efforts to give greater international homogeneity to the scope of application of the Capital Accord. However, we have observed that in addition to general statements regarding the scope of consolidation, national authorities are being left with extensive discretion (e.g. in defining the terms *holding company*, *banking group* and *securities firm*, the treatment of minority interests, recognizing the surplus capital of insurance entities, assessing the importance of minority interests, defining the threshold for significant investments in material interests). That will further erode the scope of application of the Basel Capital Accord as an instrument for supervising consolidated entities.

We reject the proposal of mandatory sub-consolidation at every level and the proposal that minority-owned stakes should be deducted (especially in the proposal’s present form, which is

both simplistic and open to differing interpretations at national level).

We also reject the proposal that investments in insurance subsidiaries should be deducted at this stage (too simplistic, too much elbow-room for other national variants).

Part 2: The First Pillar – Minimum Capital Requirements

I Credit risk – the standardised approach/general rules

The Consultative Document names three possible approaches to measuring risk, whereby the complexity of the advanced IRB approach and the lack of transitional arrangements means that it will in practice only be capable of implementation in a number of years' time. We have reason to fear that the standardised approach will only reduce capital charges for credit risks if external ratings are in place. However, the setting of additional capital charges for operational risk makes such a reduction necessary if one is not to increase the aggregate capital charge burden on the banking industry.

We wholeheartedly welcome the proposal that it should be permissible to develop internal rating models for two or more banks on a pooled basis. That possibility would provide crucial support to smaller banks (e.g. within decentralised banking groups). However, the prerequisites must not be such as to create excessive work and expense.

The implementation and control of rating classifications should be carried out by an independent agent. The necessary organizational measures should be taken to create a firewall between those responsible for granting loans and the auditing echelon.

We expressly welcome the proposal of for small loans to absorb the shock of the disadvantages imposed on small and medium enterprises. However, it still remains to be stated explicitly that retail business will be taken to include not just consumer loans but also, as far as possible, borrowing by SMEs.

Other collateral must be recognized within the scope of the standardised approach, as it is within the scope of the IRB (internal ratings-based) approach. We therefore see it as necessary to regulate mortgage security in the section on collateral and not separately within the scope of the standardised approach. (For detailed reasons, please see our comments on Point 61.)

II Credit risk mitigation in the standardised approach

Although additional forms of collateral are to be recognised, the associated administrative hurdles are such that they cannot ultimately be employed.

It is therefore essential for other collateral for which market values (in a broader sense) do not exist (e.g. mortgages and bank guarantees) to be treated separately and in a appropriate manner.

The subdivision of credit exposures into the probability of default on the part of the borrower and collateral as a separate item may seem necessary from a mathematical point of view. However, if the borrower’s actual credit standing is only taken into account when assessing the probability of default, important and reliable forms of security are not recognised, and the EAD and LGD are fixed by the supervisors within the scope of the foundation IRB approach, an asset that is for instance secured by chattel pledges, hypothecation/restrictions of transferability by insurers or (collateral) assignments will be treated as an unsecured asset for regulatory purposes.

Given that the intention is to set capital charges that are appropriate to the risks concerned, a number of other forms of collateral should therefore also be recognised as risk-mitigating within the scope of the standardised approach.

III Credit Risk – the internal ratings based approach

In general, we would welcome the adoption of the IRB approach as being of equal value.

We therefore agree that banks’ internal ratings should also be recognised as a basis for assessment when setting capital charges subject to the proviso that external ratings and the internal assessment of risks must be recognised both **simultaneously and as being of equal value** for supervisory purposes. The associated conditions must be such that they are capable of being satisfied by a broad section of the industry.

In addition, we must insist that here too, sufficient transition periods are provided from the time of the framework’s finalisation.

IV Asset securitisation

In general, we welcome the present proposal regarding the regulatory treatment of asset securitisations in that it would permit the creation of a level playing field.

We must however point out that the use of vague terminology could create unwanted leeway during the framework’s incorporation into national law.

V Operational risk

The Austrian Banks concur in general with Basel's opinion that the entire banking industry should pay more attention to the problem of operational risk in the future, especially in the light of the industry's experience of losses caused by operational risks.

However, we regard the inclusion of operational risk in Pillar 1 of the Capital Adequacy Framework as far too premature and therefore propose that operational risk be moved to Pillar 2. Our principle reasons for believing that operational risk should be relocated to Pillar 2 are stated in detail in our comments regarding operational risk.

The proposed volume-based indicators would not guarantee sufficient risk sensitivity.

Part 3: The Second Pillar – Supervisory Review Process

We generally concur with the desire to support banks in the implementation of risk management processes and to increase dialogue between banks and supervisors. It is also in every bank's own interests to comply with the goals of supervisory review (e.g. improving mechanisms for measuring and controlling risks, matching economic capital held to the bank's risk profile, ensuring that even under future circumstances capital does not fall below required minima).

However, the decisive issue will be the way in which supervisory review is to be implemented in practice. The following factors will be particularly important:

- The level playing field
  Insofar as Principles 3 and 4 imply obligations or empowerments to translate qualitative shortfalls into quantitative capital charges (individualised capital charges), they necessitate the definition of binding conditions by the Basel Committee if a level international playing field is to be ensured.
  Differing methods of incorporating the Capital Adequacy Framework into national law (for instance because of Austria's constitutional *Legalitätsprinzip*, which requires that executive action be based solely on legislation) must not be allowed to lead to competitive inequities.

Although we see it as progress that a number of passages in the Consultative Document (in particular Footnote 3 to Point 47 of the Annex) acknowledge the fact that the incorporation of the framework into the legal systems of a number of different countries will lead to difficulties and suggest that supervisors could use other ways of encouraging banks to hold more than their required capital minima, our objections regarding competitive equality still stand.

The introduction of the IRB approach to setting regulatory capital charges would also create new challenges for supervisors. Supervision is not only responsible for ensuring a banking system’s soundness. Supervision frameworks must also ensure a level playing field both nationally and internationally. At the same time, limits must be set to supervision before it hampers day-to-day processes.

- Costs
  With all due respect for the goals of the new framework, the associated effort and expense must remain in proportion to its objectives.

- Legal certainty and transparency
  The Consultative Document uses a whole number of vague terms that need to be defined more precisely.
  Banks require clear and unambiguous conditions, procedures and standards regarding the scope of supervision. “Locked-in” quantities need to be defined.
  It is also important to have clear rules regarding the imposition of sanctions by supervisory authorities. It must be stated precisely which authority can impose which of the available sanctions under which circumstances and which legal means of appeal are available to the bank.

- Regulatory procedures
  Measures taken within the scope of the supervisory review process must be designed in such as way that they do not encroach upon management’s responsibility for risk management and risk control (e.g. specification of control and analysis models, laying down assumptions and setting measurement parameters).

Interest rate risk (IRR) in the banking book

There have been repeated attempts to develop regulatory standards for interest rate risk in the banking book, and ultimately they have all been abandoned. If Basel intends to make another attempt to calculate a capital requirement for interest rate risk in the banking book, we welcome the fact that that is now being done within the scope of Pillar 2 of the Capital Adequacy Framework

and not under the heading of minimum capital requirements under Pillar 1, where the topic was still to be found in the first Consultative Paper.

We are also of the view that such an approach must leave sufficient leeway to ensure that further developments in this area are not hampered. In this connection, we would above all insist on the recognition of internal models and on far-reaching freedom of choice in the treatment of products with indefinite maturities.

We do in any event welcome the fact that Basel’s revised recommendations regarding interest rate risk recognise banks’ internal control systems as the principal tool for measuring interest rate risk in the banking book.

Even if the relevance of each methodology for controlling interest rate risk in the banking book will vary depending on volumes, complexity and business segment, and given that differently structured banks will apply different emphases when implementing their means of controlling interest rate risk in the banking book, we must stress that much of the new Basel paper entitled *Principles for the Management and Supervision of Interest Rate Risk* is written from a general point of view (“This paper is intended to set out principles of more general application for the management of interest rate risk, independent of whether the positions are part of the trading book or reflect banks’ non-trading activities.”).

The differing methods of measurement are also an increasingly unsatisfactory justification for the unequal treatment of interest rate risks associated with trading and non-trading activities (IAS 39).

Part 4: The Third Pillar – Market Discipline

We are seriously concerned that excessively sweeping disclosure requirements could prove counter-productive:

The proposed core disclosures go far beyond what would be justified by the materiality principle and therefore require fundamental reconsideration. The Consultative Document assumes a highly informed general public that is capable of correctly interpreting the risk indicators. Allowance has not been made for the needs of other audiences (e.g. brevity, readability). Much of the information that is being proposed as mandatory (e.g. methods for estimation and validation within the scope of the IRB approach) goes far beyond what is currently being

disclosed in the risk management sections of even the most exemplary annual reports.

Moreover, much of the information described is either information that is of no relevance to the market, information that discloses business secrets or information that could cause serious difficulties for individual banks.
We therefore believe that reporting should be subdivided into the following categories:

- **Regulatory information**
  Information that is only disclosed to supervisory authorities within the scope of regular reports and which should therefore be included in Pillar 2.

- **Information requiring publication**
  - core information;
  - supplementary information (not mandatory).

Since Basel primarily addresses internationally active banks (most of which use international accounting standards such as IAS and US GAAP) that exert a significant influence on financial markets, smaller banks of purely regional dimensions that cannot therefore exert an influence on international financial markets should at least receive special treatment within the scope of EU regulations. Their duties of disclosure should be reduced to an extent that is appropriate to their size and impact on national and international financial markets.

The effort needed to satisfy disclosure requirements on the scale that is currently being proposed would be an unreasonable imposition on all institutions, and especially on smaller banks. We point out that the proposals for Pillar 3 in particular would cause huge costs (audit costs, staff costs associated with preparing reports, possibly the costs of preparing condensed versions of annual reports). Moreover, the requirements outlined in the proposal would also impose substantial demands in the fields of data collection, data auditing and IT implementation, many of which would be out of all proportion to the information obtained.

In addition, the new requirements must conform to the pertinent legal provisions. Sanctions without a firm legal basis will not be acceptable. Moreover, disclosure requirements must be harmonised internationally and available sanctions must be imposed equally in different countries if competitive inequities are to be avoided.

Harmonisation between the Basel and IAS disclosure frameworks (and the resulting increase in quality of information for the reader) must not only take place at a formal level. There must

also be harmonisation of content. However, harmonisation of content will only exist if the measurement parameters and methods applicable to identical subject-matter are also identical in both frameworks. Basel is currently constructed on the basis of existing EU directives (which also provide the basis for current Austrian law).
As regards the system changeover to EU accounting standards (i.e. away from prior EU directives to IAS), it has not yet been made clear whether differences between (future) IAS standards and Basel's current measurement criteria will have an effect and if so, what that effect will be. In the absence of such clarity, the application of the Basel framework could lead to the publication of differing data, depending on one's choice of IAS reporting and valuation criteria. That would be unacceptable.

Clear rules are needed in this area (in particular in view of plans to rapidly develop the IAS standards into a fair value accounting system), among other things to ensure that "non-IAS" reporters employ identical methods of measurement within the scope of the Basel framework. Consequently, it will be essential to achieve the greatest possible consistency between different capital measurement and valuation methodologies.

OUR COMMENTARY IN DETAIL:

Part 1: Scope of Application

We refer you to our “General remarks”.

Regarding individual points in this section:

Para. 2 We welcome the proposal that the Accord’s scope of application should be enlarged to include holding companies. However, the definition of a *banking group* as being a group that engages “predominantly” in banking activities is ambiguous, creating latitude for discretion on the part of national supervisors. A precise definition of the term *banking group* is needed to achieve a uniform *scope of consolidation* of the kind contained, for example, in *Article 1 (21)* of *EU Directive 2000/12* and *§ 2 Zi 25 lit. c Bankwesengesetz* (Austrian banking act).

Para. 3 The Basel Committee regards it as necessary for consolidation to take place at every tier within a group (sub-consolidation) to ensure adequate capitalisation. In addition, according to Basel, sub-consolidation should only not be a requirement if a subsidiary institution (itself a sub-group) deducts the book values of any investments in deconsolidated financial institutions and banks from its capital.
We are not in agreement with the proposed requirement of sub-consolidation because it would not serve any additional regulatory purpose. Basel’s alternative proposal that, as an alternative to sub-consolidation, investments could be deducted at the level of the subsidiary institution, would imply massively more stringent requirements than contained in current regulations (EU). If for no other reason, that method of proceeding would be unacceptable because the consolidation of all group members undertaken by the parent company already fully captures all risks within its group. It would therefore be proper to exempt a downstream subsidiary that is itself a parent company.

Para. 4 Whether individual banks should also be adequately capitalised on a stand-alone basis is a competition-related issue that should not be left to the discretion of national supervisors.

B. SECURITIES AND OTHER FINANCIAL SUBSIDIARIES

Para. 5 To ensure a level international playing field, it will be essential to include not just banks but also securities entities and other financial institutions in the scope of consolidation of financial holding groups. To that extent, we welcome Para. 5. However, Para. 5 also contains an exception in that securities entities are only to be included in the scope of consolidation to the extent that they are "subject to broadly similar regulation or where securities activities are deemed banking activities". This of itself weak wording would enable national supervisors to take securities institutions back out of the scope of consolidation. That would not be acceptable to the EU financial sector because it would be inconsistent with EU regulations.

We at least need a uniform international definition of the countries in which the requirements (above all, similar standards for the supervision of banking activities) are deemed to be satisfied.

Para. 6 Basel intends to leave it up to national supervisors to assess the appropriateness of recognising third-party minority interests in consolidated capital.

Our general view is that consolidation also includes all assets and contingent claims and therefore that all minority interests held by third parties should also be recognised as part of the consolidating entity’s regulatory capital. Since the proposal would also require the consolidation or deduction of investments and recommends the maintenance of capital adequacy at the level of the stand-alone entity (Para. 4), uneven distribution of capital within a group is virtually impossible, and there must be no double-counting of capital if the holder of a minority is itself subject to capital regulations and capital charges.

Furthermore, in the event of the adjustment of minority interests held by third parties, there needs to be a special arrangement for “special purpose vehicles” (*SPV*s) for the issue of hybrid capital, which Basel would then recognise under certain circumstances and to a certain extent.

Finally, we cannot concur with Basel's proposal that the inclusion or non-inclusion of minority interests in group capital should be left to national supervisors. National discretion of that kind would make a level international playing field impossible.

Para. 7 The Basel Committee has conceded that there may be instances where it is not feasible or desirable to consolidate certain securities or other regulated financial entities. This wording too is very vague, leaving open a large number of national options, and would therefore be unacceptable. Exemptions from consolidation should be limited to cases that are precisely defined on an *ex ante* basis. (See also Article 52 of Directive 2000/12.)

C. INSURANCE SUBSIDIARIES

Paras. 9 & 10 The Basel Committee believes that it is "in principle appropriate" to deduct banks' investments in insurance subsidiaries.

1. We cannot accept the wording "in principle appropriate" because it is not sufficiently precise.

2. The deduction of investments in insurance subsidiaries from banks' capital would not be generally acceptable because insurance risks are fundamentally different from other financial institutions' credit and market risks. In addition, an asymmetrical arrangement of that kind would burden banks with the deduction, whereas insurers would not have to deduct investments in banks. That would create the danger of supervisory arbitrage between insurance firms as parent entities and banks as parent entities. Given the fundamental difference in risk profiles between insurance risks and banking risks, the biggest risk associated with an investment in an insurance subsidiary is that of losing the investment itself – and the risk inherent in the investment itself is already covered by an 8 percent capital charge under present regulations. The higher capital charge for risky investments as proposed in the Basel Consultative Document would set a charge for this risk of up to 12% (150% weighting), rather than the 1,250% that would be implied by their deduction in full.

3. We cannot concur with the application of alternative approaches or leaving risk aggregation to the discretion of national supervisors because that would make it impossible to ensure a level playing field.

4. The danger of competitive inequalities would be aggravated by the fact that the “alternative approaches” and the methodology for risk aggregation have not even been defined in detail.

5. All things considered, it is clear that the specific and cross-sector issues created by financial conglomerates cannot be settled unilaterally within the scope of regulations pertaining to bank supervision.

Paras. 11 & 12 — We assume that the treatment of investments in insurance subsidiaries and their recognition within the scope of consolidated capital will be addressed by the EU in its Financial Conglomerates Directive. Since neither Basel nor the European Union’s own funds regulations currently make it possible to predict the effects those new regulations will have on banks’ capital, we believe that the whole issue of financial conglomerates’ regulatory capital should not be addressed until after the new own funds regulations are in force and that they should then be addressed at an international level.

At the current stage of the discussion, we therefore reject the proposal for the reasons stated above (see our “General comments").

Para. 13 — As for an insurance subsidiary’s adherence to capital requirements on a stand-alone basis, one must ask which capital requirements are to apply.

D. SIGNIFICANT MINORITY-OWNED EQUITY INVESTMENTS IN NON-INSURANCE FINANCIAL ENTITIES

Para. 14 — According to the Basel proposals, the threshold above which minority-owned investments are to be deemed significant is to be left to national supervisors. But this is another area in which the level playing field demands the definitive adoption of a homogeneous international methodology. We therefore suggest that here too, the arrangements that already exist within the European Union should be adopted, and the same applies to the *pro rata* consolidation of joint ventures that is mandatory within the EU.

Para. 15 We are assuming that the European Union’s *de minimis* arrangement will remain in place (Art. 34 Paras. 12 & 13 of Directive 12/2000)

E. SIGNIFICANT INVESTMENTS IN COMMERCIAL ENTITIES

Para. 16 Our comments on Para. 14 apply analogously to the definition of the term “significant interest".

As regards the materiality thresholds of 15% and 60%, it must be made clear that deductions will only take place in respect of components that lie above the pertinent threshold.

Para. 17 We do not understand why investments in significant commercial entities below the stated materiality levels should be risk weighted at **no lower than** 100%.

We insist that such investments should, like insignificant investments, be risk-weighted on a rating-dependent basis (within the scope of the IRB approach, ownership interests will be given special treatment, as yet undefined, within a category of their own).

F. DEDUCTION OF INVESTMENTS IN DECONSOLIDATED ENTITIES

Para. 18 Deducting investments equally from Tier I and Tier II would imply economically more stringent deductions for minority interests on both a stand-alone and a consolidated basis and would therefore be unacceptable.

Part 2: The First Pillar – Minimum Capital Requirements

I Credit Risk – Standardized Approach / General Rules

See also our general considerations.

1. CLAIMS

(i) Claims on sovereigns

Para. 24 Under paragraph 24, a lower risk weight may be applied, at national discretion, to banks' exposures to the sovereign or central bank of incorporation if such exposures are denominated in domestic currency and funded in that currency. such discretionary decisions should be published and the application of these risk weights to institutions domiciled in another country should be subject to the same terms (i.e. automatic mutual recognition of national discretionary decisions), without any further authorization of the respective supervisory authority being needed.

Para. 25 For the supervisory recognition of the country risk scores assigned by Export Credit Agencies, the OECD 1999 methodology should not constitute the only criterion. Rather, the same criteria as for external credit assessment agencies should apply (at least as far as methodology is concerned).

(ii) Claims on non-central government public sector entities

Para. 27 As far as the publication of national decisions and the mutual recognition of these decisions is concerned, the same applies as in the case of paragraph 24.

As regards the categorization of spin-off undertakings under public law, the Supporting Document focuses primarily on potential revenue-raising powers of these entities. As was common practice until now, guarantees of the respective regional or local authorities should also be taken into account and the same weighting as in the case of claims on banks should be possible.

(iii) Claims on banks

Paras. 29 et seq. Two options continue to apply to claims on banks. Under the first option, the bank is assigned a risk weight one category less favorable than that assigned to claims on the sovereign. The second option bases the risk weighting on the external credit assessment of the bank itself (moreover, the second option provides for additional preferential treatment of claims with an original maturity of three months or less.

According to the Basel Accord, the national supervisors are free to choose the option they want to apply. Free choice of the supervisory authorities is rejected in view of the risk of regulatory arbitrage.

Example:

Credit assessments of banks	Credit assessments of sovereigns	Option	Risk weight
BBB-	B-	1	100%
		2	50 (20)%
BB+	AAA	1	20%
		2	100 (50)%

Due to the possibility of massive regulatory arbitrage demonstrated by the example, a harmonized international arrangement is preferable.

Based on the current assumptions made in the Consultative Document, we prefer Option 1 (in this context, please see also our comment in paragraph 33).

Para. 32 Existing technical arrangements applying to sectoral central institutions should remain unaffected by the new regulations.

Para. 33 The lower risk weight applying to claims with an original maturity of three months or less (Option 2) should also be applicable to Option 1. Moreover, we would consider it necessary to define short-term claims as claims with a maturity of six months. The generally lower weight applying to short-term claims under Option 1 is necessary because the exception made in paragraph 33 also applies to both options (i.e. the preferential treatment for claims on the sovereign under paragraph 24 is extended to

bank claims which are assigned a risk weight that is one category less favorable than that assigned to claims on the sovereign).

Moreover, the maturity of claims should be calculated on the basis of their residual maturity rather than on their original maturity.

Para. 35 The 50% weighting should also apply to corporates rated BBB, as the historical default rates of BBB bonds are only insignificantly higher than those of A-rated bonds, whereas the gap to sub-investment grade is considerable.
This comment also applies to paragraph 32.

(vi) Claims on corporates

Para. 36 A higher risk weighting for unrated claims – subject to the discretion of national supervisory authorities – is considered problematic, as this would inevitably lead to competitive distortions.

(vii) and (viii) Claims secured by residential property and commercial real estate

Paras. 37/ 38 We are strongly in favor of the decision to provide for a lower risk weighting for lending secured by mortgages on residential property and commercial real estate.

However, we hold the opinion that mortgages should be treated in the section on asset securitization. This would make it possible to explicitly subsume mortgages under the so-called eligible collateral in the Basel Accord.

(ix) Higher risk-categories

Para. 39 The unsecured portion of any asset that is past due for more than 90 days (net of specific provisions) is to be risk weighted at 150%. In our view, there is no point in applying higher risk weights to assets with provisions, as this would point to inadequate provisioning. If the provisions are sufficient, a higher weighting is not needed, if the provisions were inadequate, however, a deduction would instead be called for. (Precautionary action should not be “punished“ from the supervisory viewpoint.)

Para. 40 We object to an extension of the 150% risk weight category to other assets (which moreover are not specified).

(x) Other assets

Para 41 Under the applicable capital requirements, the standard risk weight for buildings and facilities as well as other tangible fixed assets is 100%. In line with the Basel Document and the definition of operational risk (i.e. the risk of direct or indirect loss resulting from inadequate or failed internal processes, people and systems or from external events), risks associated with tangible fixed assets are to be considered operational risks. Since operational risk will be subject to special supervisory treatment, such assets would have to be treated separately from credit risk. Risks associated with them would be covered by the capital charges applicable to operational risk.

(xi) Off-balance sheet items

Para. 43 Paragraph 43 of the Basel Capital Accord Document reads: "The credit conversion factor for business commitments with an original maturity up to one year will be 20%." It must be ensured that the CCF of 20% applies to longer maturities.

2. External credit assessments

(i) The recognition process

Para. 45 According to the Basel proposals, the external credit assessment institutions (ECAIs) are to be recognized by the national supervisors and the supervisory process for recognizing ECAIs should be made public. Any mutual recognition of nationally recognized rating agencies could only be endorsed, however, if there were stringent international eligibility criteria that meet at least the requirements applicable to banks using the IRB approach (including disclosure requirements).

(ii) Eligibility criteria

Para. 46 The Basel Documents stipulates that the ECAIs satisfy six criteria in order to be recognized by the national authorities. To ensure comparability between external ratings and IRB measures, it should be ensured that the methods of the ECAIs

fulfill the same requirements as those of the internal rating systems. To this end, clear and internationally comparable definitions of the six Basel criteria must be specified in order to reduce national leeways and to ensure effectively that the same criteria are applied as in the case of internal rating systems.

3. Implementation consicerations

(i) The mapping process

Para. 47 In line with the Basel Committee‘s proposal, national supervisors will be responsible for mapping ECAIs‘ assessments into the standardized risk weighting framework. In order to ensure first of all an internationally comparable procedure and moreover the comparability with the IRB approach, each type of claim – depending on its rating (sovereign, banks, corporates) - should be slotted on the basis of probability of default. This “master scale“ should be uniform for all countries, with the assessments of officially recognized ECAIs classified according to the default probability determined by the agencies.

Para. 49 It is plausible that the Basel Document calls for banks to use the chosen ECAIs and their ratings consistently, i.e. for both risk weighting and risk management purposes. “Consistent use“ must not mean, however, that specific types of claims always require the same rating agencies. This would not only be a competitive drawback for new rating agencies but would also significantly hamper the applicability of external ratings under the standardized approach.

(ii) Issuer versus issues assessment

Paras. 54 et seq. The solutions put forward for issuer and issues assessments in paragraphs 54 and 55 will very likely not lead to homogeneous application and must therefore be reviewed. The principles to be observed would be as follows:

Issues assessments are to be used only for certain issues (otherwise, issuer assessments should be used). Using issues assessments for issuer assessments leads not only to top-down distortions with regard to the risk weightings, but also involves a disproportionately big supervisory

burden and should be subject to detailed regulation.

(iii) Short-term/long-term assessments

Paras. 56 et seq. We are strongly in favor of applying assessments at matching maturities, i.e. short-term assessments should be used for short-term claims even if a long-term assessment is available.

(vi) Unsolicited ratings

Para. 60 We object to the provision that national supervisory authorities may allow banks to use unsolicited ratings in the same way as solicited ratings.

II Credit Risk Mitigation in the Standardized Approach

See also our general considerations.

1. Scope

Para. 61 The exhaustive listing of collateral does not include mortgage-backed collateralization, which is treated – apart from the other types of collateral - under the standardized approach. Mortgage-backed collateral denotes customary bank collateral, which would therefore have to be treated in this section. In some sections, which suggest special treatment of collateral, mortgage-backed collateralization are not taken into account.

Furthermore, we propose adding other types of risk-mitigating collateral to the list, which would include:

- Assignments of receivables
- Pledging of movables
- Pledged cash on deposit with other banks
- Pledging / Restriction of transferability of insurance contracts etc.

Moreover, we propose to include as collateral commodities (except for gold) that are subject to market risk and need to be taken into account in calculating the capital requirements of the trading book.

2. Collateral

Para. 65 If the bank, however, really acts as a mere agent without assuming the risk for the counterparty to the repo-type transaction, we object to the imposition of a capital requirement for this transaction. The obligation to calculate capital requirements for fiduciary transactions is rejected as this involves operational risk.

(i) Minimum conditions

(a) Legal certainty

Paras. 68 et seq. The obligation to obtain legal opinions confirming the enforceability of the collateral arrangements can practically only refer to such collateral whose legal enforceability or realization is uncertain due to the novelty of the arrangement (incidentally, such collateral must not be taken into account under the terms of this document).

Para 69 This corresponds to the status quo. It must be added, however, that registration is usually not required. Instead, securities deposit accounts subject to a specific power of disposal (pledge, retention, compensation etc.) are blocked. Furthermore, we are in favor of considering the recognition of collateral deposited with a third bank.

Para. 70 In our view, updating of legal opinions at certain intervals is necessary only as a result of new legislation or case law. We therefore object to annual updating of legal opinions.

Para. 71 The term “timely“ is not clearly defined. Moreover, any decision on the date of liquidation should be left to the credit institution concerned. In this case, the collateral will replace the claim on the client as an asset (and has to be taken into account appropriately with regard to capital requirements). If anything, an assessment of the collateral should occur in a timely manner.

(c) Robust risk management process

Para. 73 Other risks (in particular operational and legal risks) are already subject to other types of capital requirements, which would mean a double burden. Consequently, we object to this additional capital requirement (or suggest an appropriate set-

off against the requirements applicable to operational risk).

Para. 74 In this context, we draw your attention to our comments on paragraph 149.

(ii) The methodologies

Para. 75 Here again, a possibility should be provided for combining both approaches, on condition that business units are defined accurately and one approach is used consistently in each business unit.

Insistence on this provision would seriously hinder the acquisition of new companies. In particular as far as privatizations are concerned, the application of the comprehensive approach in the newly acquired subsidiaries is impossible.

(a) Eligible collateral

Para. 76 We are strongly in favor of recognizing the following additional collateral types customary in banking:

- Merchandise inventory subject to a specific power of disposal and provided as security, in particular commodities already taken into account in today’s trading book,
- other assets subject to a specific power of disposal that meet the aforementioned conditions (e.g. pledged claims),
- collateral provided on condition of retention of ownership (car financing),
- cash on deposit with other banks serving as collateral.

The term “main index“ is not defined.
A definition should, at any rate, focus on sufficiently broad indices, because otherwise the use of broadly diversified – and consequently market-risk mitigating - portfolios and investment funds is either unnecessarily strongly limited or made impossible altogether in the simple approach.

Para. 78 Item (c) should point to the pari passu status of the issue (i.e. “no other issue“ should be replaced by “no other pari passu issue“). Item (d) in particular must be defined more clearly. Item (e) is not feasible and should therefore be deleted.

In our opinion, as regards the simple approach to the treatment of collateral under the standardized

approach, unrated bank bonds should constitute full collateral even if they are not listed on a recognized exchange.

Para. 79 Since basically only the composition of banks' own investment management companies is known (with other investment management companies publishing information only once a year), the administration of these requirements is not viable. Investment management companies would also have to disclose which of their funds are eligible for recognition or not.

Above all in view of this fact, it is necessary to recognize cash on deposit with other banks serving as collateral (see paragraph 76), because otherwise no fund would fulfill the conditions of paragraph 79.

Paras. 79 and 89 Moreover, exceptions should be made with regard to hedging transactions, but also generally for small-scale derivative positions that have no marked influence on the risk profile of UCITS and mutual funds, because primarily the former are able to mitigate the market risk of collateral. Exceptions with respect to the latter, by contrast, keep administrative costs for funds within reasonable bounds, as the obligation to justify the hedging purpose on a case-by-case basis would be eliminated.

(b) The comprehensive approach

Para. 80 Haircuts should only be applicable to the market risk. Other risks (e.g. operational risks) are already covered by other capital-related measures. Additional capital requirements are therefore, in our opinion, unwarranted (an alternative being the set-off with capital requirements applicable to operational risks).

Para. 81 Market practices should be the guiding principle here. The requirements laid down in the Document, by contrast, constitute a major tampering with market practices.

Para. 82 These requirements do not seem to tie in with daily mark to market and remargining. Moreover, it will be necessary to recognize "pegged currencies" – i.e. currencies that, based on statistical experience, show a strong positive correlation (see definition in paragraph 94) – and take into consideration a maturity factor.

Para. 84 We object to the inclusion of an additional factor (“w“), because the risks to which it applies have already been taken into account.

- In accordance with the First Pillar, the capital requirements applying to the exposure depend on the borrower risk weight (or the internal rating),
- for collateralization purposes, this exposure requires an additional haircut,
- the collateral involves another haircut,
- currency mismatch is subject to another haircut,
- an additional upward/downward adjustment of the risk-weighted assets based on granularity is envisaged in order to provide for adequate diversification,
- operational risk is subject to additional capital requirements,
- in specific cases, supervisory authorities may stipulate a higher capital ratio,
- moreover, there will be a need for banks to hold capital beyond the regulatory minimum capital requirements in order to provide for risks not covered by the First Pillar,
- a floor factor for exposure is required in those cases where the value of the collateral exceeds the value of the exposure,
- moreover, a factor “w“ is introduced for undefined risks.

In conclusion, the additional factor “w“ results in double counting of risk and is therefore rejected.

Para. 85 We are against taking the “volatility“ of the exposure into consideration. Claims in the banking book (mostly loans) are generally not valued at market rates, with the book value constituting the maximum loss. An additional haircut for this book value does not make sense. Moreover, if the market value is used, it also serves as the basis for the calculation of capital requirements, i.e. the “volatility“ of the exposure is implicitly taken into account in calculating the minimum capital.

In addition, the floor factor is unjustified. If, e.g., collateral in the form of government securities significantly exceeds the exposure, a floor factor is unacceptable.

The planned procedure will also entail tremendous administrative and computer-related costs going far beyond the goal of integrating collateral.

The Consultative Document gives the impression of recognizing additional claims, albeit on the basis of overly complicated calculation methods, which make application virtually impossible or involve excessively high costs.
The other impression is that the Document applies a mathematical approach to risk problems, relying on highly conservative assumptions (see also operational risk) that do not adequately reflect real-life conditions.

Para. 87 The last sentence provides for the extension of internal haircut estimates to the banking group as a whole. As in the case of other calculation methods, the recognition of partial use is a vital necessity. Rigorous application of this principle would hinder the acquisition of new subsidiaries considerably, because haircuts may not be applicable to the group as a whole, the proposed complex calculation method might be applied to parts of the group and the application of banks' own estimates to the key companies of a group would consequently be prevented.

Para. 88 Since the Austrian banking sector is strongly in favor of the inclusion of mortgage-backed collateral in the chapter on collateral (its treatment being, however, completely different from that of marketable collateral), an explicit restriction is to be made to tradable collateral such as securities, gold or commodities. In particular the haircuts for longer maturities of sovereign exposures seem to be much too high.

Para. 89 Here a qualification seems advisable to the effect that only in cases where the individual claims in the funds are unknown the highest haircut is applicable according to the investment strategy. Moreover, the chosen investment strategy should be reflected in the haircuts based on its products (in the case of mixed equity-bond funds, e.g., haircuts for equity and bonds are applied – i.e. capital requirements according to the maximum requirements in line with the investment strategy).

Para. 91 Here again it is necessary to deal with "pegged currencies" separately (as mentioned in paragraph 94 of the Consultative Document). Moreover, the haircut should be consistent with maturities (i.e. in line with remargining). We object to a haircut of 8 percentage points for overnight transactions or in daily remargining.

Para. 92 We object to establishing a link between the application of own haircuts and substantial securities trading, as the scope of the latter is much greater than the calculation of haircuts for certain products.

Para. 94 The Consultative Document does not provide any precise definition of “lower-quality assets“ or “illiquidity“. These terms should be defined clearly and moreover linked to the corresponding holding periods.

Para. 98 Haircuts rise disproportionately, depending on the frequency of remargining. As far as secured loans are concerned, it is not quite clear which haircuts should be applied to the exposures. They are essentially unrated / non-rated borrowers.
As already pointed out in the introduction, the requirements set out suggest that Basel is ready to recognize additional types of collateral, but defines the criteria for eligible collateral in such a way that a practical implementation is almost impossible. The level of the standard haircuts for unrated claims should be defined clearly.

Para. 99 It is not quite clear in this context why a holding period of twenty business days is required with daily marking to market, considering that remargining applies at all times. This provision of the Consultative Document does not fit into the general context and should therefore be deleted.

Para. 100 In the German translation, the term “ermittelt“ (“determined“ in the context of mark to market) seems to refer to the market pricing rather than to the internal assessment, as the latter is subject to a period of six months as set out in paragraph 99. This matter should be clarified.

Para. 101 The factor “w“ was already discussed in paragraph 84.

Para. 104 It should be made clear that the category “core market participants“ includes all banks and that no differentiation is made in terms of size or market share.

(c) The simple approach

Para. 106 We object to a revaluation of collateral with a minimum frequency of six months. This should refer only to marketable or tradable securities, but not to other collateralization such as mortgage-backed collateral which is to be recognized as collateral.

In this context, collateral should receive a more differentiated treatment. Moreover, the term “pledged“ should be replaced by “subject to a specific power of disposal.“

Para. 108 As regards letter (b), daily marking to market of loans and securities of the investment portfolio is not provided for under the current national and international accounting standards and is therefore rejected.

3. On-Balance Sheet Netting

Para. 112 Since the netting option refers exclusively to on-balance sheet products, a set-off with off-balance sheet products is prohibited. However, netting should be made possible for all other products (derivatives) so that the effective net position with the same counterparty can be taken into account.

Para. 113 In this context, we draw your attention to our comments on paragraph 149.

Para. 114 The Document stipulates that a portfolio subject to netting and consisting of a number of loans and deposits be decomposed and netted on an individual basis. This provision is generally untenable and should therefore be deleted.

Para. 115 The cited haircuts have already been discussed above.

Para. 116 Here again, a simplified method should be applied. Netting arrangements with identical maturity in identical currency (e.g. money market accounts) should not lead to any deduction of collateral and should therefore not take haircuts into account.

Only maturity and currency mismatches are to be taken into consideration. In addition, we are in favor of an extension to assets/collateral of counterparties (corporates, banks, sovereigns) rated BBB.

4. Guarantees and Credit derivatives

(i) Minimum conditions

Para. 117 A (bank) guarantee taken is independent of risk management processes.

Para. 118 In this context, we again draw your attention to our comments on paragraph 149.

(a) Requirements common to guarantees and credit derivatives

Para. 120 These are essentially risks that are already taken account of elsewhere. A renewed inclusion through deductions would lead to double counting of risk and is therefore unacceptable.

Para. 122 Protection should focus not only on credits, but also on other claims (guarantees related to leasing transactions, securities etc.). Instead of "credit", the term "claim" should be used. Moreover, the protection of future claims should also be taken into account.

Para. 124 "Timely manner" should be defined more clearly in this context.

(b) Operational requirements for guarantees

Para. 125 Again, the term "timely manner" should be defined more clearly in this context.

(c) Operational requirements for credit derivatives

Para. 126 Guarantees and credit derivatives must meet operational requirements to be recognized. The requirements cited must not lead to impractical "over-regulation" and have to be checked thoroughly for their suitability. International master agreements and the conditions set out therein should have a benchmark function.
As regards (a): Recognition should also occur if only the principal is covered by this credit derivative.
As regards (d): "Any material event" would have to be defined in more detail, with the customary market contracts being taken into consideration.
It should be clarified whether contracts with cash delivery can be subsumed thereunder.

Para. 128 Recognition should not be restricted to certain products, i.e. other types of credit derivatives offering protection (e.g. options) should be

recognized. At any rate, a flexible solution is called for, as the development of financial markets would otherwise be severely hampered. We therefore suggest a definition of criteria instead of products.

(ii) Range of eligible guarantors / protection providers

Para. 129 The Consultative Document does not recognize credit protection given by corporates rated BBB, which contradicts other sections. We therefore suggest that protection provided by corporates rated BBB be also recognized.

(iii) Risk weights

Para. 130 Taking the risk weight of the obligor into account for the covered portion of the exposure does not make sense and should therefore be deleted.

Para. 131 The provision on materiality thresholds below which – in the event of loss – no payment will be made and which therefore must be deducted from the bank's capital does not make sense, because they should be treated like the underlying loan. Basically, they do not constitute first loss positions. We are therefore in favor of capital requirements in line with the approach used (standardized, foundation IRB or advanced IRB).

Para. 132 We generally object to the factor "w", as it constitutes a factor for the operational risk and would result in double counting of risk.
Moreover, the effect of risk mitigation through the so-called double default effect (simultaneous default of obligor and guarantor) is completely disregarded. Taking this factor into account – in particular with respect to the other correlation calculation criteria, as stipulated in the Consultative Document - will be essential.

(b) Tranched cover

Para. 138 This across-the-board deduction is unacceptable. At least the rating of the obligor should play a substantial role.

Para. 139 As already pointed out above, we object to the calculation of a "weighted" average of the risk weight of the obligor and the protection provider (the deduction from capital is also rejected). To ensure consistency with the Consultative Document

as a whole, the applicable rating must be taken into account.

Para. 140 This means that capital must be held only for the senior tranche. A calculation of the full amount is therefore not necessary.

(iv) Currency mismatches

Para. 141 For a discussion of the haircuts, see above.

(vi) W: Remaining risks

Para. 144 As already pointed out, the inclusion of a factor “w“ leads to double counting of the operational risk. This would actually boil down to the establishment of the principle hitherto applied (except for the other haircuts), as currently only federal or bank collateral is recognized (exception: cash collateral, which, however, remains also at zero).

Para. 145 Here, too, a zero “w“ should apply to banks.

Para. 148 Maturity-mismatched collateral with a residual maturity of less than one year is not recognized.

Otherwise the following applies:

$$R^{**} = (1 - t/T) \times r + (t/T) \times r^*$$

where:
R^{**} is the risk weight of the maturity-mismatched position
r is the risk weight on the unhedged position
r^* is the risk weight if the position has been hedged without a maturity mismatch
t is the residual maturity of the hedge
T is the residual maturity of the exposure

In principle, the recognition of maturity-mismatched hedging meets with our approval. It is not quite clear, however, why hedgings with a residual maturity of less than one year are not recognized.

The method used for calculating the recognition of hedges seems practicable due to the simplified approach, but at the same time somewhat arbitrary.

6. Disclosure

Para. 149 Disclosure has no causal connection with credit risk mitigation. Making the fulfillment of disclosure requirements a precondition for the recognition of collateral is therefore unacceptable. Disclosure-related information should only be submitted to the competent supervisory authority within the framework of the supervisory reporting system.

III Credit Risk – The Internal Ratings Based Approach (IRB Approach)

Please also see our general considerations.

A MECHANICS OF THE IRB-APPROACH

1. Categorization of exposures

(iv) Definition of retail exposures

Para. 156 (Supporting Document 266-270):
Definition of retail exposures:
Besides retail customers per se, i.e. natural persons, it is basically possible to include small businesses in the retail treatment. However, this requires the explicit approval of national supervisory authorities. The differentiation between traditional corporate customers and small businesses should be based on several components since a one-dimensional differentiation (e.g. via a maximum loan amount for an exposure) may lead to extreme distortions; for example, for large corporations that borrow from one main and several additional banks and thus take out accordingly lower exposures from the additional banks.

In view of the Austrian small and medium-sized corporate structure, the wording should be such that as many small and medium-sized companies as well as freelancers as possible fall under this definition.

The right of the national supervisors to set a minimum number of exposures has to be restricted insofar as the minimum number must not be determined in a way that makes it impossible for small banks to apply the IRB approach. Unless this

right is restricted, under the current proposals (incorporation of all 6 partial portfolios into the IRBA) national supervisors will be practically free to generally exclude single banks from the adoption of the IRBA by applying this regulation.

(v) Definition of project finance exposures (para 157)

Para. 157 It has to be clarified whether the project finance definition includes Bauträgerfinanzierung (property development lending), i.e. financing of companies that build and sell completed residential properties (e.g. social housing).

2. Adoption of the IRB approach across all exposures

Para 159 and 160 Banks that use the IRB approach for some of their exposures must agree to an aggressive, articulated plan with the supervisor to adopt the IRB approach "within a reasonably short period of time" across (a) all exposure classes and (b) across all significant business units.

A "partial use of partial models" option should be included in the Basel and Brussels papers, allowing banks to apply the standardized approach and the IRB approach to single portfolios and units at the same time. This is necessary because in case of, for instance, acquisitions and new business units, the development and implementation of internal processes requires lead time (historical time series covering at least five years) and is not always effective, a case in point being business units of minor importance (at present, although planned, it is "subject to national discretion").

3. Adoption of elements of the advanced approach for IRB

Para 161 and 162 Here, too, banks should – for the stated reasons – be entitled to opt for "partial use". For banks that use the advanced IRB approach, double counting must be avoided or restricted to the two-year transition period.

4. Transition period for data requirements

Para 163-166 During a transition period of three years from the date of implementation of the new Capital

Accord , the requirements for the length of the underlying historical observation period for the estimation of probability of default (five years) can be shortened (subject to the discretion of the national supervisory authorities) so that banks can start with a two-year history and reach the required five-year history only by the end of the transition period. This shall apply to corporate, bank and sovereign exposures as well as retail exposures.
The passage according to which the stated relaxations are subject to discretion of the national supervisor should be deleted.
The length of the transition period is too short. In order to be able to meet the mentioned requirements, the implementation of the internal rating systems in the banks has to be finished by the end of 2001. From 2002 onwards, the data for the estimation of the probability of default of the borrowers have to be collected and documented in order to meet the minimum requirement of two years of data by the time of implementation of the new provisions in 2004. However, the implementation cannot be finished by the end of 2001 for the simple reason that all requirements will probably not be known until the publication of the new Accord. The supervisors will be working on many items of the Accord during the whole of 2001 in order to make the wording of the requirements – which is currently often vague – more concrete; for example, in the case of retail exposures or project finance exposures the Accord points out that the detailed wording will only be completed in the course of this year after the banks' feedback has been received.
The draft also provides that banks will have to demonstrate from 2004 onwards that they have been using for at least three years a rating system that is broadly in line with the minimum requirements articulated in the draft. On the one hand, this is inconsistent with the requirement for a historical observation period of two years and, on the other hand, these minimum requirements are partly still unknown, as mentioned above.
For all banks that do not adopt the foundation IRB approach as of January 1, 2004, time series of at least five years are obligatory. This period is too long; a historical observation period of three years should be sufficient.

For the advanced IRB approach, too, shorter time series and corresponding transition periods are to be planned, in particular since "decreases" in the

credit risk necessary for the additional capital requirements of the operational risk will only take effect when the advanced IRB approach is adopted.

B RULES FOR CORPORATE EXPOSURES

1. Risk weighted assets for corporate exposures

(i) Formula for derivation of risk weights

Para 171-177 In general it has to be noted that, according to some initial comparisons, the proposed calibration does not reflect the actual situation in the European banking industry. Accordingly, there would be a clearly higher risk weight on the basis of the defined standard exposure for the standard exposure described in the consultative document (0.7% PD, 50% LGD, M 3 years).

Therefore, it is imperative that calibration be adjusted accordingly!

The use of credit risk models in case of calibration by the supervisory authorities is also contradictory (para 164 Supporting Document). Adequate calibration requires the use of *valid credit risk models*. However, the supervisory viewpoint differs from that. Otherwise, corresponding models could also be used for the calculation of the capital requirements.
Therefore, it is urgent that credit risk models be recognized.

If they are used for regulatory calibration, they should also be recognized by the supervisory authorities.

Neither paper reveals whether it is planned to set capital requirements both for the expected and the unexpected loss. Both rather favor the view that capital should be held for the expected loss, too.

However, this is inconsistent for several reasons:

Banks account for the expected loss by factoring in a risk premium (markup) and by setting aside loan loss provisions (value adjustments).

The relationship of these two measures is, on the one hand, subject to market pressure and, on the

other hand, mainly the responsibility of the bank’s management.

If capital requirements were to be set for the expected loss, too, and thus more equity capital were to be held in case of higher expected loss, this would mean that supervisory action impacts on a company's business policy. However, this cannot – and must not – be the aim of supervision. Therefore, the statement in the Basel Accord to the effect that “banks misprice their loans ” is utterly questionable.

Therefore, we demand that only unexpected loss be subject to capital backing.

(ii) Inputs to the risk-weight function (para 178-234)

(a) Probability of Default (PD)

Para 179-193 PD is defined as follows: “The PD of an exposure is the greater of the one-year PD associated with the internal borrower grade to which that exposure is assigned, or 0.03%.” In the Supporting Document, the “average PD per grade” is preferred to the individual PD of the borrower for regulatory purposes.

The following has to be noted:
A floor of 0.03% does not seem generally justified. For some borrowers, the observed PD is actually lower, which should also be considered from a regulatory point of view.

Furthermore, preference for the “average PD per grade” means that the PDs of the borrowers of one rating class are all the same. This may be too broad a classification for internal purposes, particularly in case of borrowers with large exposures. In banks’ internal models, these are often modeled as a separate cluster with the individual PD. Banks should be permitted to use thisdivergent approach internally.

If a transaction is collateralized by a guarantee or by credit derivatives, the substitution principle is kept in all approaches, as previously.

Under the foundation approach, the recognition is contingent on the borrower having a rating of at least “A” or an equivalent internal rating. In this case, we demand that the rating of the borrower be

changed to at least "BBB" or an internal PD rating equivalent to "BBB".

Furthermore, we object to w=0.15 in this case too, for the reasons already given.

(b) Loss Given Default (LGD)

Para 194-224 Loss Given Default – basically the amount of the loss – is determined by the supervisor under the foundation IRB approach. Under the advanced approach, each bank calculates the LGD itself.

Under the foundation IRB approach, the following applies:

50% LGD for unsecured claims and claims without recognized collateral. 75% LGD for subordinated claims.

It is up to the national supervisors to set a "broader" definition of subordination. In this case, too, *uniform* regulatory criteria should be determined in order to prevent national differences.

In general, the LGDs should be determined in a more sophisticated way, namely according to the type of transaction.

Commercial real estate, residential real estate:
At present, the LGD – subject to adherence to certain minimum requirements, which are very strict – is between 40% and 50% for these mortgage loans, depending on the ratio of the collateral value to the exposure. The determination of the effective LGDs is based on the various intervals of the quotients of C (collateral) and E (exposure):

Case	Condition	Effective LGD	Treatment
Case 1	$C/E \leq 30\%$	50%	Same as unsecured
Case 2	$C/E > 140\% \Leftrightarrow E/C < 100/140 = 71\%$	40%	Floor LGD
Case 3	$30\% < C/E \leq 140\%$	$\{1-[0.2 \times (C/E)/140\%]\} \times 50\%$	Weighted average of secured and unsecured LGD

Thus, this type of collateral is at a strong disadvantage because an LGD of 40% is assigned only to that part of the exposure that does not exceed 60% of the loan value or 50% of the market value of

the real estate. The exceeding part of the exposure is assigned an LGD of 50%. In view of the stringent and detailed regulatory minimum requirements, the LGD should be lowered further.

(c) Maturity (M)

Para 225-228 Since generally longer-term financing forms prevail in Europe (contrary to the Anglo-American context), **the assessment of maturity should once again be closely reconsidered**.

It remains unclear why the maturity of the instrument has to be considered at all for risk measurement purposes in case of an observation period of one year.

(d) Measurement of exposure amounts (Exposure at Default – EAD)

Para 229-234 Comment on the off-balance sheet positions: It is planned to lift the CCF for loan commitments of 20% (original maturity up to one year) or 50% (original maturity more than one year) in the standardized approach to 75% in the IRB-FA, irrespective of the original maturity. All CCFs are independent of the creditworthiness of the borrower in question.

The reasons why the CCF was raised for the IRB approach should be stated as this could be regarded as downgrading the IRB approach vis-à-vis the standardized approach. Here, the the standardized approach provisions should also be adopted: 20% irrespective of the maturity; the residual maturity rather than the original maturity should be the basis.

2. Minimum requirements for corporate exposures

The predictive power and the power of the statistical procedures used should be at the core of these quality requirements. The evaluation of the power of forecast should, therefore, be given express top priority.

(i) Composition of minimum requirements

Para 235, 236 Minimum requirements are defined which have to be met by the banks if they want to qualify for the IRB approach.

In this context, it is important to pay attention to the interests of smaller banks and take a pragmatic approach.

(ii) Criteria to ensure meaningful differentiation of risk

Para 237-243 It has to be clarified why a given minimum number of rating grades is still considered appropriate against the backdrop of the use of a continuous function for the risk weights. The problem of mapping internal rating grades to those determined by the supervisory authorities is no longer an issue. Setting a certain minimum number of rating grades fails to guarantee the predictive power of a rating system. The proposal that no more than 30% of gross exposures should fall in any one borrower grade is not appropriate and cannot be met by banks that want to tap special customer segments.

We take objection to the limitation to 30% exposures per rating grade, as this does not seem appropriate in particular with respect to high credit assessments.

As to the granularity factor, see below.

(iii) Completeness and integrity of rating assignments

Para 244-247 Further definition is necessary concerning the “independent unit," whose remuneration must not be dependent on the rating assigned, and which must not gain any other advantages from the rating assigned. If interpreted in a narrow sense, this means that the review of the ratings must be done by a unit that is independent of sales and operative risk management.

At present, these requirements with respect to organizational structures within the credit risk area are in part *not* customary practice. Sweeping organizational changes will be necessary if these requirements are to be implemented.

(iv) Oversight over the rating system and processes (para 248-257)

(a) Oversight by the board of directors and senior management

Para 248-252 The requirements imposed on the management are often grossly exaggerated (e.g. a *continuous* dialogue between the management and the credit risk control unit or internal audit).

Here, the following should apply: the rating processes, and possibly any changes to these processes, are to be approved by the management. The management has to ensure the implementation, application and documentation of the models. Furthermore, the management has to be informed *regularly* about the results, the predictive power of the models and the limitations of the instruments. It would be appropriate to summarize the details concerning the items "documentation, statistical models" in a separate paragraph.

(b), (c), (d) Internal and external audit, credit review function, quality of staff

Para 257 Quality of staff: the staff members responsible for the rating process should be adequately qualified and trained. The bank's management must allocate sufficient and skilled resources. The qualification and training of the staff should, however, be in line with the complexity of the business undertaken as well as the business volume.

The requirements spelled by the supervisors lean strongly towards the principles guiding commercial transactions. What has been stated before holds true here, too: these requirementswith respect to organizational structures within the credit risk area are partly *not* customary practice at present. Sweeping organizational changes will be necessary if these requirements are to be implemented.

(v) Criteria and orientation of the rating system (para 258-269)

(c) Assessment horizon

Para 262-263 The characteristics of future risk factors need to be considered as well ("conservative view of projected information"). For risk quantification (the process of assigning PDs to individual grades) a one-year horizon is to be used. In contrast, for the assignment of rating grades a longer observation horizon (maturity) is advisable.

(f) Exceptions to rating criteria

Para 268-269 Besides quantitative elements based on information obtained from annual statements, rating systems also include qualitative elements (e.g. market position or management quality).
The demand that *all* relevant variables/factors (as listed) must be considered should be dropped. More

risk factors do not necessarily improve the statistical predictive power. Models that contain only 3-4 variables can also show a good predictive power, without considering all “relevant risk factors.”

(vi) Minimum requirements for estimation of PD

(a) Estimation using reference definition of default

Para 271-273 For reasons of consistency, the Accord demands that a regulatory reference definition be established.

A definition of default, as proposed in the consultative document, is rejected for reasons of practicability.

The main problem in the definition of default in paragraph 146 (Supporting document) is that the banks have to document and store *all* listed default events.

For the bank, default means a probable financial loss.

From a regulatory point of view, default could be defined as in paragraph 146 (Supporting document), with the following limitation:

Each bank has to internally determine *one* of the above-mentioned events as point of reference for the probability of a financial loss event.

The given points of reference differ only in terms of time time. This difference can be counterbalanced either by considering the “recovery rate” or the amount of the LGD.

The amount of the LGDs should therefore also be adjusted to the definition of default, which the banks determined internally.

In this context it has to be noted that the inclusion of an event where the obligor is past due more than 90 days in the definition of default is by no means common European banking practice.

The risk weights should therefore be calibrated according to the banks’ individual definitions of default. A uniform definition of default in the sense of a uniform point of reference for all banks set by the supervisors would, in many cases, not

correspond to banks' individual practices. This would deeply interfere with the risk management of the banks. In addition, individual default data that already exist could no longer be used.

(b-g) Minimum requirements

Para 274-283 Apart from quantitative techniques, qualitative subjective elements should also be included "applying a conservative bias" (judgmental considerations). However, it is not quite clear why quantitative results have to be adjusted "applying a conservative bias" only. It might also be possible that quantitative results seem too high to the assessor and that "downward" adjustments are made, for instance due to a very favorable forecast of the future prospects of the market considered and the expected market position of the borrower.

As to the mapping to external data, banks are faced with a problem when trying to to prove the comparability of external and internal rating criteria because rating agencies are seldom prepared to provide detailed information about their rating methods. In this context, it is necessary to make sure that the requirements for external rating agencies equal those for internal rating models.

We have already commented on the length of the historical observation periods .

(vii) Data collection and IT systems

Para 284-288 All data collected over time must be stored and form the basis for prudential reports and the public disclosure requirements under Pillar 3. Retention periods should be established.

(viii) Use of internal ratings

Para 289-301 The new Accord provides that internal rating systems are also to be used internally in the banks, which is reasonable in principle. The requirement that this information should be used as a factor in the pricing of the exposure is, however, going too far since this interferes with the business policy of banks. This decision must remain the autonomous sphere of the banks.

It is unclear what is meant by the requirement of "daily credit risk measurement." Paragraph 249 stipulates that reporting should be on a monthly

basis. Therefore, credit risk measurement should also be conducted monthly. Shorter periods do not make sense. Instead of using the term "daily," "current" should be used.

While we appreciate the requirement that banks using credit risk models have to use the internal ratings as input for the model, the question remains why the models are not recognized by the supervisors.

This non-recognition inevitably means that internal and external capital calculations will diverge since only part of the internal risk management processes, namely the internal rating systems, are recognized by the supervisory authorities.

The requirements for stress tests are partly defined in a very vague manner (e.g. liquidity conditions). It has to be clarified in particular how such tests are to be conducted in the exposure portfolio without using credit risk models. Furthermore, the requirement that "appropriate action must be taken in cases where the results exceed the agreed tolerances" is also unclear.

If an internal credit risk model is used monthly for internal capital allocation, it is sufficient to conduct stress tests every twelve months since the portfolio is regularly "tested" for its economic dependencies.

(ix) Internal validation

Para 302-308 The validation requirements – in particular the obligatory assessment of the model by means of statistical tests – can become a significant obstacle to the implementation of the foundation approach. In case of audits, this area will take center-stage ("receive significant supervisory attention prior to allowing a bank to adopt the IRB approach").

It is unclear what is meant by "statistical testing of the dynamic stability of the model and its key coefficients." How can this be done in expert systems?

The requirements for internal validation are currently vaguely defined. Here, talks between the supervisory authorities and the banks still need to be held in order to jointly define these criteria.

(x) Disclosure requirements

Para 309 The disclosure requirements that banks must meet for the foundation IRB approach are minimum requirements for all banks that choose to adopt such an approach.

In general, we think that the extremely extensive disclosure regulations lead to highly complex administration and additional cost for the banks, which will ultimately result in an enormous flood of information.

Therefore, for the moment, we regard it necessary to noticeably reduce these disclosure regulations.

In order to be able to interpret such complex information correctly, a profound insight into risks and models is required. Such disclosures should, therefore, not be stipulated. However, such analyses should obviously be made available to the national supervisory authorities.

Moreover, the requirements described make high demands on data collection, data assessment and IT, which, to a great extent, are out of all proportion to the information gained through it.

Generally, we point to our comments on Pillar 3.

(xi) Minimum requirements for supervisory estimates of LGD and EAD (para 310-323, 233-235 Supporting Document)

(a) Overall minimum requirements

Para 311 An internationally binding recommendation should be elaborated on how national supervisors, at their discretion, may choose to employ a wider definition of subordination.

Para 321 In addition, it needs to be clarified what is meant by containing collateral management within a "distinct operational unit."

3. Minimum requirements for the advanced IRB approach

General notes:

For the application of the foundation IRB approach, in particular for the application of the advanced IRB approach, credit risk models should be recognized. If correlation and

diversification effects are not considered, risk-adjusted capital requirements accounting for portfolio effects will become impossible and efficient risk management will be counteracted. Consequently, concentration effects will not be considered in credit risk measurement, rather benefiting banks with poor diversification.

On condition that a rating system has to be capable of differentiating between borrower-specific and transaction-specific risk, the assumption of an LGD of 50% for unsecured and 75% for subordinated claims, the annual minimum default probability of 0.03% (except for sovereign exposures) as well as the use of a granularity index of 30% does not seem to be effective. On the contrary, we assume that a riskless rating grade is to be seen as benchmark both in the area of PD and LGD and, as far as the LGD is concerned, a detailed gradation at least according to type and maturity of the transaction is carried out.

(i) Own estimates of loss given default

Para 326 The minimum requirements here fall into a number of categories. They cover the structure of the rating system, the estimation of LGD for both secured and unsecured loans, as well as certain operational requirements related to collateral. LGD is defined as the expected loss given default, expressed as a percentage of exposure.

The debt outstanding is defined taking account of the deduction of eligible collateral as well as the assessment according to type and risk of the transaction.

(d) Criteria and orientation of LGD estimates

Para 333-334 **Since the new Accord is based on the definition "LGD = 1 – recovery rate" and generally the criterion of a low correlation between exposure and collateral is to be fulfilled, key characteristics of both the borrower and the product or transaction type have no impact on the LGD estimate. On the contrary, the LGD estimate should focus exclusively on the enforceability and the liquidation of the collateral, as described in paragraph 334.**

(e) Minimum requirements for the estimation of LGD

Para 337 **Since the regulations proposed in the Basel Accord are based on the assumption that estimations of LGD are made by experienced staff that is independent of operational areas, subjective or judgmental**

considerations are to be allowed; particularly due to the fact that

- **estimates should be forward-looking;**
- **they should be validated by backtesting;**
- **sufficient market information is not available for all types of collateral.**

(f) Estimation using reference definition of default and loss

Para 338 Consistent with the estimation of PD in the foundation approach, banks must use the reference definition of default set out in paragraphs 271 and 272 in estimating LGD and collecting loss and recovery date.

Para 339 The definition of loss used in estimating LGD is economic loss. This should include discount effects, funding costs, and direct and indirect costs associated with collecting on the instrument in the determination of loss. Banks should not simply measure the loss recorded in accounting records, although they should be able to compare the two.

In this context, the reference definition of default is again rejected, above all regarding the regulation of events where the obligor is past due more than 90 days, since existing collateral is not considered. In addition, we would like to point out that when interpreting loss as economic loss, it cannot be assumed that every type of collateral can be liquidated within 90 days.

We object to such a far-reaching definition of loss since this definition includes fixed costs of banks, which are in any case already incorporated in the calculation.

(h) Internal validation

Para 360-361 Banks must undertake plausibility tests on their LGD estimates through a comparison with external data sources.

We support the requirement that all data used for the LGD estimationshould be consistent in their definition. Accordingly, internal data sources are to be preferred to external ones. In this context, we do not understand the demand for plausibility tests based on external data sources. Consequently, this passage would have to be deleted.

Banks must have in place sound stress testing processes for evaluating their estimates of LGD. An independent unit must carry out stress testsat least every six months.

In case of IRB models that have been set up in a decentralized manner, stress tests have to be conducted in the same manner.

Stress testing must involve identifying possible events or future changes in economic conditions that could have unfavorable effects on banks' LGD estimates and the effect these might have on their overall capital adequacy. Three areas that banks might examine are: (i) economic or industrial sector downturns; (ii) market-risk events; and (iii) correlations in estimates of PD and LGD across exposures.

As the requirement for semi-annual stress testing is exaggerated, the frequency should be reduced.

(i) Public disclosure of LGD and related data

Para 363 Banks must meet the minimum requirements for disclosure under the advanced approach to LGD set out in paragraph 652 and paragraphs 653 and 658 as applicable.

Disclosure is in no way related to the result obtained from LGD estimation. Linking the recognition of an LGD estimate to disclosure is, therefore, rejected. At most, the LGD estimate should be disclosed within the prudential reporting framework.

(i) Use of EAD estimates

Para 388 The EAD estimates must be considered in the setting of internal (portfolio or sub-portfolio) limits.

As mentioned above, detailed setting of internal limits, particularly at the portfolio level, requires the consideration of correlation and diversification effects and, consequently, the recognition of credit risk models.

Para 400 Banks must have in place sound stress testing processes for evaluating their estimates of EAD. An independent unit must carry out stress tests at least every six months. Stress testing must involve identifying possible events or future changes in economic conditions that could have unfavorable

effects on their EAD estimates and the effect these might have on its overall capital adequacy. Three areas that banks might usefully examine are: (i) economic or industrial sector downturns; (ii) market-risk events; and (iii) correlations in estimates of PD and EAD across exposures.

The frequency of stress testing should be reduced.

(j) Public disclosure of EAD and related data

Para 402 Banks must meet the minimum requirements for disclosure under the advanced approach to EAD set out in paragraph 652 and 653 to 658 as applicable.

In this context, we refer to our comments on paragraph 363.

C RULES FOR RETAIL EXPOSURES

As the provisions for retail exposures are basically embodied in the IRB approach, all general provisions apply accordingly. Therefore, the related comments concerning IRB (general notes) apply as well.

1. Risk-weighted assets for retail exposures

(i) Formula for derivation of risk weights

Para 426 The approach of calibrating the retail benchmark risk weight to an LGD of 50% of corporates seems somewhat high. Experience has shown that risk in the retail segment is by far lower than in the corporate segment. Therefore, an approach of approximately 25% for the retail segment would be appropriate.

(ii) Risk inputs

Para 434 Risk components: in our view, the expected loss approach has to be put in question (the related “minimum requirements” necessitate the determination of historical default data and thus an alternative PD/LGD approach).

2. Minimum requirements for retail exposures

(ii) Criteria to ensure a meaningful differentiation of risk

Para 446 Delinquency status: the new Accord calls for at least two categories for pools of loans that are in arrears. However, it is not specified which steps are to be taken if a bank adopts a rating system for retail exposures. Is the bank free to choose in such a case? In principle, it is not necessary to provide two rating grades for delinquent retail loans; one rating grade should suffice.

Para 447 Effects of “seasoning”: it has to be clarified what is meant in concrete terms by effects of “seasoning”. It is postulated that portfolios with a high seasonal component may experience a change in the loss distribution function during the year. In this context, what does capital buffer mean? In practice, this could be a risk markup in the sense of the granularity scaling factor. We generally reject this capital buffer; a definition of seasonal business areas or possible seasonal products would be necessary in this case. This seasonal component is reflected in the GSF anyway, thus having its impact on risk weighting.

(vi) Requirements for estimation of EAD and either (a) PD/LGD or (b) EL

Para 466 In this context, we refer to our comments on paragraph 272.
The contrary statement in the Supporting Document is counterproductive.

Only Supporting Document 302

The assumption of a correlation of 10% in the retail segment seems to denote a maximum ceiling, it should rather tend towards zero. However, it needs to be pointed out that correlations are reserved for risk models, but these risk models have not yet been recognized in the consultative document, contrary to our demand.

D RULES FOR SOVEREIGN EXPOSURES

Para 479-494 In line with the new Accord, the provisions for incorporating sovereign exposures into the internal ratings based approach should largely correspond to those of corporate exposures. Differences should arise only as regards the following points:

When it comes to assigning an internal rating, banks must monitor the economic and political

developments of the rated countries on an ongoing basis. The political dimension must include the possibility that a sovereign may be unable or unwilling to repay its obligations, or may not have access to foreign currency. In the internal rating assignment, key macroeconomic variables (e.g. GDP growth, exports, imports, external debt, fiscal balance) must be taken into account. Forecasts should be made for these indicators.

Banks should use information on spreads of traded securities.

For the LGD estimate in the advanced IRB approach, banks should differentiate between foreign currency loansand loans denominated in their own currency.

Note: it has to be analyzed whether spreads are always an appropriate indicator for PD, particularly in case of less liquid positions.

E RULES FOR BANK EXPOSURE

Para 495-502 The comments on corporate exposures apply here as well.

Incorporation of equity into the IRB:

As regards the incorporation of equity (definition in para 158) into the internal ratings based approach, the Supporting Document contains only drafts and merely outlines the problems . At present, the Basel Committee seemingly plans to develop two approaches toward treating different equity positions.
A proposal has yet to be made.

Incorporation of project finance into the IRB

The Basel Committee has only started to develop plans for incorporating project finance. Therefore, it mainly identifies problems that result from the incorporation of project finance into the internal ratings based approach. Here, too, a proposal remains to be made.

F CALCULATION OF IRB GRANULARITY ADJUSTMENT TO CAPITAL

Para 503-515 According to the Basel Committee’s proposals, the weighted exposures that are not incorporated in the

retail approach should be increased or decreased by a granularity component according to the granularity of the entire portfolio. The Basel Committee explains this by stating that the risk weights for a portfolio were calibrated with a granularity typical of a large bank. Accordingly, banks that have an above-average (below-average) single-borrower risk concentration should be subject to a higher (lower) capital requirement.

The adjustment calculations proposed in the Accord lead to the fundamental question why internal credit risk models are not recognized since, on the one hand, the problem of adequate risk weighting and, on the other hand, the granularity factor would be resolved in a consistent way. The underlying approaches of approximation (MTM model, DM model) between risk weights and granularity factor are based on different assumptions, which are modeled on a number of estimates. In particular parameter and correlation assumptions are made, which can be measured in greater detail because they are internal and portfolio-specific. As a further consequence, this leads to a more exact estimate of the capital requirement.

Calculations have shown that the granularity scaling factor cannot – as announced in the Accord – result in upward and downward adjustments, but results EXCLUSIVELY in upward adjustments. Furthermore, due to the formula, this could result in certain portfolios requiring capital backing for individual exposures which exceeds the amount of the exposure.

Since each bank is obliged to spread risks accordingly and an extreme concentration of exposures is impossible due to other supervisory regulations (large investments), this upward adjustment should be **deleted without replacement.**

IV Asset Securitization

See also our general considerations.

I. Explicit Risks Associated with Conventional Securitizations

A Standardized Approach

1. Originating Banks

a) Minimum operational requirements for achieving a clean break

Para 518 and para 9 and 13 Annex:

The requirement set forth by the consultative paper to achieve a clean break (especially with regard to the true sale provisions under paragraph 13 lit a and c of the Annex) should be made consistent with the true sale provisions of US-GAAP and IAS (see also the proposed U.S. regulations on securitization accounting according to FASB 140). Unfortunately, US-GAAP and IAS at present leave plenty of room for interpretation and accountants' opinions differ widely. Discussion of this topic should continue in the future, since the paper for the first time dealt with asset securitization in greater detail.

In defining an SPV, the paper refers to a concept for which at present only the US-GAAP framework offers a comprehensive definition. The footnote to paragraph 13 in the Annex spells out that it is up to the national accounting standards to provide a definition for SPV. We suggest that the Basel Capital Accord contain such a definition, which would account equally for IAS and US-GAAP regulations.

b) Minimum requirements for credit enhancements

Para 521 and para 15 and 16 Annex:

We propose that equal treatment be generally applied to subordinated (mezzanine and junior) tranches, irrespective of whether they are retained by the originator or sold to a third party.
We support the deduction of capital for first loss enhancements. Second loss enhancements should be treated according to the ratings (this is consistent with the respective U.S. proposals).

Paragraph 15 of the Annex should point out that in case capital is deducted from a tranche, the capital charge must not be higher than if the underlying assets had not been securitized. The U.S. proposal of March 2000 also makes this point. At present, such equal treatment is not guaranteed by the paper.

Para 522 and para 17 Annex:

The Accord should spell out that the criteria cited for liquidity facilities under paragraph 54 of the Annex also apply to liquidity facilities under paragraph 17 of the Annex (cash advances) to ensure uniform treatment of this instrument.

Para 522 and 534 and para 17 and 55 Annex, weighting of liquidity facilities:

While the 20% on-balance sheet credit equivalent proposed by the paper is justified, a flat risk weight of 100% cannot be deemed justified as this aims at eliminating any credit risk in liquidity facilities, which is not consistent with the stringent criteria formulated in paragraph 54 of the Annex. We consider it adequate to risk weight liquidity facilities in line with the rating of the underlying asset pool.

c) Minimum requirements for revolving securitizations with early amortization features

Para 523 and para 24 Annex:

We object to the flat conversion factor, since the stringent eligibility criteria for off-balance treatment (clean break etc.) should be sufficient.

2. Investing Banks

a) Minimum capital requirements for investments in ABS

Para 525 and para 26 Annex:

The capital charge for investments in ABS should – according to the standardized approach - be calculated using external ratings.

The Accord in the document on asset securitization refers not only to general requirements for rating agencies (Supporting Technical Document on the Standardised Approach), but also to additional requirements in connection with the valuation of securitizations. The paper merely describes the additional qualifications in very vague terms ("… the external credit assessment institutions deemed eligible in the area of securitisation must demonstrate their expertise in this field, as may be evidenced in particular by a strong market acceptance"). We fear that only the three rating agencies currently active in the field of securitization (S&P, Moody's and FitchIBCA) will be eligible and that other external credit assessment institutions will de facto be barred from entering this market.

Para 526 and para 27 Annex:

Different risk weights are envisaged for corporates (see paragraph 35) and ABS which have the same ratings. This applies to ratings below BBB- and unrated tranches.

It is not clear why diverging risk weights are applied to corporates and ABS whose ratings have the same PD.

Asset securitization with investing banks rated BB+ to BB- is accorded the same 150% risk weight as riskier assets; this does not capture risk properly since, for one thing, corporates rated up to BB- are risk weighted at 100% and, for another, securitization is about investing in a well diversified portfolio, which results in reduced default risk. Furthermore, securitizations comprise also subordinated tranches which cover first losses. To treat securitizations in the same way as commercial credits better corresponds to the risk situation.

Capital deduction (investing banks) for tranches rated B+ and lower or unrated tranches:

Counterparty		Standardized approach						
		AAA to AA-	**A+ to A-**	**BBB+ to BBB-**	**BB+ to BB-**	**B+ to B-**	**below B-**	**unrated**
ABS	Proposed rating	20%	50%	100%	**150%**	**capital deducti**	**capital deducti**	**catpial deducti**
Corporate	Proposed rating	20%	50%	100%	100%	150%	150%	100%

Comparable corporates rated B+ show a probability of default of close to 3% for one year. In line with the IRB approach this corresponds to a risk weight of 246%. A deduction from capital equals a risk weight of 1250%.

Therefore we object to drawing the line for a deduction from capital for investing banks at a rating of B+. Compared to corporates, capital deductions would start from a CCC rating. For strategic reasons, a deduction from capital could, if necessary, apply to unrated tranches. If a capital deduction applies to tranches rated higher than CCC, the default risk of the asset-backed portfolio will be covered several times; this will, by extension, be inconsistent with the objective of maintaining the overall level of regulatory capital held in the entire system.

b) Treatment of unrated securitizations

Para 527 and 529 and para 29 and 31 Annex:

In line with the look-through approach outlined in the Accord, senior tranches which are part of unrated securitization structures are viewed as indirect holdings of the underlying asset pools and should be risk weighted at the higher percentage applicable to the underlying asset. This treatment is not justified. For an asset pool with an exceptionally high rating and few outliers, this treatment will result in a distinct overestimation of the associated default risk (e.g. given a very high share of assets rated AAA and just one asset rated A+, the asset pool would have to be risk weighted at 50%). Therefore we propose that the weighted average of the risk weights applicable to the invidual assets be used instead.

B IRB Approach

Para 541 and para 61 Annex:

Banks employing the IRB approach may use either one of two methods to determine probability of default (PD); these methods essentially comply with the general proposals for the IRB approach:

1. PD according to long-term default rates measured by the rating agencies for each rating category

2. internal PD estimates for "comparable" rating categories approved by the national supervisors

As a large number of the securitizations traded on the market have an external rating, it should be possible to rely on externally measured PDs. For unrated tranches, banks should – as opposed to the capital deduction proposed by the Accord – have the option to evaluate such issues using internal estimates (PD measures based on experience or statistical default models) or pooled data. Such treatment would comply with the minimum requirements for PD estimation (paragraph 274 et seq.), which also envisages a combination of various measurement techniques.

At present a flat 100% weight applies to loss given default (LGD). This treatment is certainly not justified. Given the conservative structuring of ABS, a recovery rate similar to a secured loan should be considered when determining LGDs.

II. Synthetic Securitizations

Para 68 et seq. Annex:

The proposals on the treatment of synthetic securitizations may at the present juncture be regarded as a mere presentation of the issues; basically, they seem to be too case-specific. The Basel Committee has announced further regulations on synthetic securitizations.

We would like to recommend that synthetic and conventional securitizations be made subject to one uniform set of principles. Any other approach could be too restrictive for future transactions and solutions.

In our opinion, this will not have adverse implications for the banking supervisors' interests, since securitizations of bank assets have already been realized in accord with the respective supervisory authorities.

III. Implicit risks and residual risk

Para 544 and para 90 Annex:

As to action beyond contractual obligations banks may take to enhance the performance of a securitized asset pool or the transfer of assets (e.g. buying back or subsequent exchange of nonperforming with performing assets) to prevent reputational damage (i.e. implicit recourse to credit enhancement or "moral recourse"), the Basel Committee suggests the following: a first-time breach entails the loss of all advantages derived from securitization for the entire transaction.

On any further occasions of implicit recourse, preferential treatment is canceled for all present and future transactions (prevention from further securitizations for a limited period of time; public disclosure of the breach). The sanctions applying to repeated breaches are draconian. It would be sufficient to withdraw the advantages for the securitization in question.

Para 545 and para 91 Annex:

The Basel Committee regards the penalties cited in paragraph 90 of the Annex as the minimum requirements for containing the credit risk banks incur for securitization transactions. In future, the Committee plans to apply ex ante capital charges to securitization transactions to fully address implicit and residual risks. As in the case

of operational risk, we object to such capital charges.

IV. Disclosure requirements

Para 546 and para 93 Annex:

The disclosure requirements pertaining to originating banks, sponsoring banks and third parties (aggregates) are justified or in line with similar accounting requirements. These data may only be published in a consolidated form, since the dissemination of information on individual transactions would gravely violate the interests of third parties (deal-specific data are supplied only to rating agencies for multi-seller conduits).

V Operational risk

SUMMARY

- The Austria banking industry welcomes Basel’s view that more attention should be paid to operational risk. Past experience has shown that operational risk can cause high losses, albeit not very frequently.
- Given that little progress has as yet been made in the development of measurements for operational risk, the Austrian banks cannot currently imagine their inclusion in Pillar 1. Adequate industry standards do not yet exist anywhere in the world. Consequently, in the initial phase, operational risk should be moved to Pillar 2 and thus – in the absence of precise quantitative measures – be subject more to qualitative assessment by the competent national supervisors. In addition, national supervisors should be supplied with state-of-the-art information about operational risk. Furthermore, precise definitions and demarcations (e.g. from legal risks) are needed.
- Despite the comparative lack of experience to date, we can already say that a Loss Distribution Approach should be recognised as a fourth method for calculating operational risk capital charges.
- The acquisition of the necessary information could be based on the methods proposed, but a number of limitations exist, including the following:
- The proposed factors and indicators (alpha, beta und gamma) seem arbitrary and have nothing to do with existing operational risks. Apart from that, the suggested alpha of 30% seems disproportionately high. Further developments and investigation are needed on this point (see also our proposal of the issue’s relocation to Pillar 2).
- Bank’s should at least be able to <u>define</u> their own business <u>segments</u> within the scope of the Internal Measurement Approach, because otherwise *IASC*-based segmental reporting would prove impossible in that it would lead to double-counting. The same should also be possible under certain circumstances (mapping of beta factors) within the scope of the Standardised Approach (i.e. greater flexibility in the configuration of the Standardised Approach subject to certain preconditions).

- Two of the factors suggested as components of measurements within the scope of the Basic Indicator Approach – gross income and annual average assets – are not acceptable. The use of gross income would disadvantage profitable banks and favour unprofitable banks, and annual average assets are an equally inadequate basis for the measurement of operational risks. We therefore suggest waiting for the results of the proposed *Impact Study* before further factors are specified. That apart, the suggested factors would cause distortions in that investment bankers are primarily interested in gross income and retail bankers in assets.
- We are in principle in favour of encouraging the use of more complex approaches by offering lower capital charges in return (insofar as operational risks are captured). At the same time, though, one must ensure that smaller banks are also able to use the Internal Measurement Approach.
- None of the proposed measurement methods create sufficient incentive to mitigate risks. Both Basel's Consultative Document and the Supporting Document would limit the recognition of insurance as proposed within the scope of the Internal Measurement Approach to "mandatory traditional insurance products" and "professional liability insurance such as bankers' blankets and traditional insurance products", with the result that inadequate allowance would also be made for this form of risk mitigation (creating competitive disadvantages for Continental European banks).
- The criteria for recognising risk mitigation techniques should suit the approach being used. Complex assessments of risk mitigation techniques should not be required within the scope of the Basic Indicator or Standardised approaches, where simplified methodologies should be admitted.
- We are firmly opposed to setting a floor in the Internal Measurement Approach because that would thwart the use of the approach's much more precise (validated) measurement procedures.
- *De minimis* rules should be introduced with respect to the mandatory creation of separate management departments and/or it should be possible for management functions to be performed by internal audit groups. Basel should recommend but not require the creation of databases.
- The disclosure of operational losses is inconceivable (see below).
- All things considered, we feel the Basel Consultative Document's approach to be questionable in that it starts by setting the desired level of capital charges and then calibrates measurements to suit that figure. That is inconsistent with the goal stated by the *BIS* itself, which is to ensure that banks have adequate capital to support risks on the basis of precise measurement of those risks.

GENERAL REMARKS

We refer you to our “General position”.

- As developments stand at the moment, the measurement of operational risks has not yet reached the necessary level of sophistication. Consequently, actual operational risk is not yet measurable. That is particularly evident in the use of “gross income” as a factor in the proposed methodology. “Gross income” is risk insensitive and bears no relation to actual risks.
- Uncertainties regarding and differences between the approaches, the nature of the underlying risk and the processes for monitoring and managing such risk are much more marked in the case of operational risk than in the field of interest rate risk (treated under Pillar 2; see also Para. 630).
- In particular, the application of the proposed factors (alpha for the Basic Indicator Approach, beta for the Standardised Approach and gamma for the Internal Measurement Approach) seems arbitrary and fundamentally at odds with the whole concept of a Consultative Document that is designed to strengthen the relationship between capital requirements and the particular bank’s risk profile and economic capital needs.
- An industry standard has yet to prevail. The systems and loss databases that are currently on the market (e.g. *MORE* and *PWC*) are still at an early stage of their development.
- The more complex approaches proposed in the Consultative Document (the Internal Measurement and Loss Distribution approaches) have not been clearly defined and/or are not yet recognised. One should await further research regarding the nature of risks so that more precise criteria can be defined.
- As a result, the key factors underlying operational risk should be investigated before it is integrated into Pillar 1. Until that time, it should be left to the discretion of national supervisors whether to assess operational risk on the basis of concrete measurements and/or appropriate reports and to decide whether correspondingly higher capital charges can be set. However, it must in general be said in regard to Pillar 2 that in Austria (as elsewhere) the constitutional *Legalitätsprinzip* (which requires that executive action be based solely on legislation) must be taken into account.

- Inadequate allowance has been made for risk mitigation techniques (e.g. recognition of insurance or improved IT systems [such as straight through processing]). The result is an unsatisfactory situation in which measurement methodologies have been refined but concrete measures to mitigate risk are not recognised. A framework in which only “mandatory professional liability insurance” (EU) or “traditional insurance products such as bankers’ blankets and professional liability insurance” are recognised would primarily take the Anglo-American situation into account (above all bankers’ blankets), leading to competitive distortions.

C Other Aspects of the Supervisory Review Process:

Interest Rate Risk in the Banking Book

Summary

- Para. 630 of the draft of the New Basel Capital Accord allows supervisors to define additional minimum capital requirements to support interest rate risk in the banking book. Clear legal guidelines are required in this connection, laying down the extent to which national supervisors can fall back on that option and which conditions will apply. This proposal could lead to unequal treatment and thus to competitive distortions in competing markets (*G10* and/or EU). It would be wise to establish a uniform methodology within the European Union.

- We are firmly opposed to any automatic mechanism (of the kind proposed in Para. 632) that would create an obligation to hold additional regulatory capital as soon as an outlier threshold has been passed.
- The supporting document entitled *Principles for the Management and the Supervision of Interest Rate Risk* requires the application of all internal strategies for managing internal interest rate risk at consolidated level and at the level of individual affiliates. However, <u>in our view</u> that requirement should only apply to fully consolidated entities (or those that exert a controlling influence), since otherwise the means will not exist to ensure the implementation of such strategies. In addition, it must be understood that consolidation must take place at the level of individual entities' risk profiles rather than at the level of individual transactions because the process will otherwise prove impossible in the foreseeable future from the point of view both of data processing requirements (i.e. differing systems landscapes) and of costs. Furthermore, transitional arrangements of several years' duration should be permitted with regard to newly acquired investments to allow for the fact that the implementation of a functioning system to manage interest risk in the banking book is a very time-consuming and complex process.

- In this connection, we particularly welcome the proposal of a *de minimis* exemption in the EU Consultative Document:
  The new directive should not apply to banks whose proportion of gross interest income to total income does not exceed 25% or banks whose gross interest income does not exceed € 5 million. This arrangement should at all events also be incorporated into the New Basel Capital Accord.

- We concur with the proposal that separate analysis should only be required for currencies accounting for 5% or more of a bank's banking book assets. We believe that this would be a very sensible solution which would save banks unnecessary additional work.

- Para. 6 of the Summary of *Principles for the Management and Supervision of Interest Rate Risk* expressly endorses the principle that banks' internal measurement systems should, wherever possible, form the foundation of the supervisory authorities' measurement procedures. We reject the suggestion – made in various parts of the Supporting Document – that this freedom of choice in model usage should in certain points be limited by applying standardised assumptions (e.g. Annex 2.C.8. and Annex 4.A.2.(e)).

- We are of the general view that extremely broad disclosure requirements would impose heavy administrative burdens and additional expense on banks and, in the final analysis, release an overwhelming flood of data. A significant reduction of the disclosure requirements will be essential. In particular, we regard disclosure of the following as greatly overshooting the mark:

    - disclosure of the results of the standardised interest rate shock;

    - disclosure of internal caps;

    - the *de facto* disclosure of outliers

    - the publication of *ex post* performance analyses

- The documents to hand do not say anything about the treatment of non-interest-intensive positions. It would be desirable to include a general treatment of such positions in the *Principles for the Management and Supervision of Interest Rate Risk*, but thereby recognising the differing approaches used by internal models to measure interest rate risk in the banking book.

General remarks

We refer you to our *"General Position".*

The New Basel Capital Accord

Para. 630

Besides these general comments, we would like to record the following more specific responses to the Consultative Document.

Within the scope of the supervisory review process, it is proposed that “supervisors who consider that there is sufficient homogeneity within their banking populations regarding the nature and methods for monitoring and measuring this risk” should be able to impose a mandatory minimal capital requirement.

> **Clear legal guidelines are needed to define the extent to which national supervisors could resort to such means and which conditions would apply. This proposal could lead to unequal treatment and thus to competitive distortions in competing markets (G10 and/or EU). It would be wise to establish a uniform methodology within the European Union.**
> Furthermore, increasing capital charges is not the most effective means of persuading banks to change systems for measuring and controlling interest rate risk in the banking book (above all because of the differing time lags that exist before interest rate risk positions knock-on to income statements).

Para. 632

This paragraph states that supervisors must require action if they determine that a bank is not holding commensurate capital. Particular reference is made to so-called “outlier banks”. However, the vague term “commensurate” also gives supervisors scope to demand action (holding of additional capital, reduction of risk) from banks that are not really outliers. Here too, more precise wording will be needed to ensure that national supervisors cannot go it alone and thus create competitive distortions.
We are firmly opposed to any automatic mechanism that would create an obligation to hold additional regulatory capital as soon as an outlier threshold has been passed.

Principles for the Management and Supervision of Interest Rate Risk

Principle 3

When applying this principle, one must ensure that smaller banks are not compelled to set up additional organisational units to cope with the new regulations.

Principle 4

This Principle requires the application of all internal strategies for managing interest rate risk at consolidated basis and at the level of individual affiliates. In our view, that can only be expected of fully consolidated entities (or those that exert a controlling influence), since otherwise the means will not exist to ensure the implementation of such

strategies. In addition, it must be understood that consolidation must take place at the level of individual entities' risk profiles rather than at the level of individual transactions because the process will otherwise prove impossible in the foreseeable future from the point of view both of data processing requirement (i.e. differing systems landscapes) and of costs. Furthermore, transitional arrangements of several years' duration should be permitted with regard to newly acquired investments to allow for the fact that the implementation of a functioning system to manage interest risk in the banking book is a very time-consuming and complex process.

In this connection, we particularly welcome the proposal of a *de minimis* exemption in the EU Consultative Document:
The new directive should not apply to banks whose proportion of gross interest income to total income does not exceed 25% or banks whose gross interest income does not exceed € 5 million. This arrangement should at all events also be incorporated into the New Basel Capital Accord. It should also be explicitly stated that the *de minimis* exemption will likewise apply to subsidiaries within the scope of consolidation.

Para. I.B.19.

This paragraph also demands analysis of the interest rate sensitivity of non-interest income. We believe that such analyses are in principle useful, but fear that they would – if the disclosure requirements were strictly interpreted – have to be published. We cannot endorse such a disclosure requirement because income that is not directly interest income is very heterogeneous and therefore not easily open to comparisons.

Para. I.B.22.

This paragraph proposes that embedded gains and losses should also be incorporated into the risk measurement process. We must expressly point out that the publication of such figures would constitute a level of market-value accounting that goes beyond even the requirements laid down by the *IASC*.

Para. V.A.50.

This paragraph proposes that any manual adjustment to data should be documented. We believe that such a requirement, if over-stringently interpreted, would unleash a confusing flood of documentation, necessitating the introduction of a "materiality threshold" that would have to be defined by national supervisors.

Para. X.79.(c)

The precise demarcation of products with embedded options and the adequate capturing of the associated risks are repeatedly stated to be necessary. It will be important to define more precisely which kinds of embedded option are being referred to.

Para. X.81.

The proposed rate shock analyses (initially suggested here as an option) are to be based on historical data. We anticipate difficulties obtaining the requisite six years of historical data for many rate curves, above all when measuring exposures in non-G10 currencies (especially in Central and Eastern Europe).

A one-year holding period as proposed in Para. 3 is far too long and therefore unacceptable: Banks act far more quickly to control interest rate risk, including risk associated with positions in the banking book.

Para. X.82.

We would like to stress our support for the proposal that separate analysis should only be required in the case of currencies that account for 5% or more of banking book assets. We feel this to be a very sensible solution that would save banks unnecessary added work and expense.

Annex 2.C.8.

Para. 6 of the Summary of *Principles for the Management and Supervision of Interest Rate Risk* expressly endorses the principle that banks' internal measurement systems should, wherever possible, form the foundation of the supervisory authorities' measurement procedures. We therefore reject the suggestion – made in various parts of the Supporting Document – that the freedom of choice in model usage should in certain points be limited by applying standardised assumptions.

For instance, Annex 2.C.8. proposes that local supervisors be given the option of assessing alternative assumptions than those used by the institution. In addition, Annex 4.A.2.(e) proposes that core deposits be slotted assuming a maximum duration of 2.5 years, and Para. X.79.(d) gives such core deposits an expected maximum maturity or repricing frequency of three to five years. Besides encroaching upon the bank's own risk control mechanisms, those limitations could wrongly lead to the conclusion that a bank's interest risk allowance is too small.

The Third Pillar – Market Discipline

We are generally of the view that the <u>extensive</u> disclosure requirements proposed in the Consultative Document would increase banks' administrative burdens and costs and unleash a massive flood of data. The disclosure requirements must be significantly reduced. That applies above all to disclosures in the following areas:

It would be unwise to require the publication of internal limits because they could send the wrong signals and give the markets a life of their own. For instance, a bank that initially publishes a relatively high limit will probably never have problems with it, whereas a bank that states a realistic limit might possibly also reach it and then be penalised by the market. The incentives created could therefore be the wrong ones.

The Supporting Document on Market Discipline defines "core quantitative disclosure" as concerning the absolute change in earnings and economic value in response to standardised rate shocks and the magnitude of those changes relative to earnings and regulatory capital. We believe that the imposition on banks of this *de facto* obligation to disclose their own outliers would merely encourage them to take avoiding action. We therefore reject this proposal.
We cannot endorse the requirement to disclose the results of internal rate shocks (whether in absolute or percentage terms). The welcome recognition of banks' individual assumptions, for instance regarding customer behaviour, would mean that such results could not be compared and would mean little without the detailed disclosure of the underlying assumptions. In addition, this requirement could encourage banks to employ assumptions in their risk measurement systems that would be most advantageous to them from a disclosures point of view. The internal underestimation of interest rate risk could result.
As an alternative, we propose merely requiring annual reports to state whether and, if applicable, how often the threshold of 20% of regulatory capital has been exceeded within a given fiscal year.

As regards the disclosure of assumptions underlying *embedded options*, we refer your to our earlier insistence that the term needs to be defined more precisely.

The mandatory publication of *ex post* analyses has also been proposed. We believe that such publications would generate a flood of data because the reasons for any deviations could be multifarious and complex; understanding those reasons would presuppose a solid grasp of the associated risks and models. We believe that such analyses should be made available to national supervisors when needed rather than being published.

Concluding remarks

The documents say nothing about the treatment of interest-rate insensitive positions. We would welcome the inclusion of a clarification of the basic treatment of such positions in *Principles for the Management and Supervision of Interest Rate Risk*, whereby, however, the differing approaches employed by internal models for measuring interest rate risk in the banking book should be recognised.