Response to the Basel Committee's Second Consultation on a new Basel Accord

May 2001

Prepared jointly by the:

British Bankers' Association
London Investment Banking Association

Table of contents

1. General comments and Executive Summary

The British Bankers' Association (BBA) and London Investment Banking Association (LIBA), who together represent over 350 banks, investment banks and securities houses operating in the UK, welcome the opportunity to comment on the Basel Committee's (the Committee) second consultative paper for a new Capital Accord. We are pleased that the Committee has so obviously listened to the industry lobby and believe that the proposals, in sum, represent a substantial step toward a more risk based Accord. BBA/LIBA endorse the general conceptual structure. It has the potential to act as a positive catalyst for banks to develop and apply risk assessment systems and risk mitigation techniques.

1.1 General comments

Further consultation

Given the scale of the task, the scope and depth of the proposals are impressive. In a number of significant areas, however, the Committee was either publishing detailed proposals for the first time or indicated that proposals were not yet complete but will follow. In total, these greener areas will have a critical impact on the outcome of the proposals for individual firms and the industry as a whole. Therefore, whilst we appreciate the timing pressures that exist we believe that further consultation with the industry will be necessary over the course of this year on the following issues:

- Treatment of retail and SME exposures
- Treatment of project finance
- Treatment of equity exposures
- Off balance exposures and other counterparty risk
- Securitisation: IRB approach and synthetics
- Operational risk
- Pillar 3: Market Discipline

Unfortunately without such an initiative we do not believe that the consultation process could be considered complete.

Transparency

Before commenting on the substance of policy, BBA/LIBA feel obliged to comment on the presentation of the proposals. A general concern exists amongst members that the Committee could have been fuller in its documentation. In particular that input data as well as model structure are available for analysis and comment. Going forward BBA/LIBA very much hope for an early release of the data and analysis generated as a result of the second Quantitative Impact Study. BBA/LIBA strongly support this study in the expectation that it will result in a significant re-calibration of the existing proposals. BBA/LIBA would argue that full and early documentation of the basis of these calculations is an essential foundation to the credibility of the new Accord.

1.2 Executive summary

Standardised approach

BBA/LIBA support the continuance of a basic approach open to all banks. It must remain available to banks that are unable, or who do not choose, to adopt the internal ratings based approach. The

proposed approach is broadly an advance on the first round proposals. The primary exception would be the lowering of the benchmark maturity for inter bank claims to 3 months. This will have a detrimental effect on inter- bank funding markets and trade finance. BBA/LIBA would propose this be raised to twelve months.

Internal ratings based approach

BBA/LIBA welcome the fact that the internal ratings based approach is now the foundation of the new Accord. This single innovation encompasses a great deal of the value of the reform process. It has the potential to be the basis of a risk based regulatory capital regime that rewards good practice and is broadly aligned with economic reality.

Unfortunately that welcome is conditional as BBA/LIBA have serious concerns that the rules as currently drafted will not allow the realisation of the Committee's objectives. Issues of particular concern include the calibration of the IRB risk weighting function and the minimum operational requirements for entry to the IRB. In sum BBA/LIBA believe that these concerns threaten to undermine much of the value of the IRB approach.

In response BBA/LIBA would propose that, as a matter of urgency, the Committee reviews the proposed calibration of the IRB risk weighting function to bring it more in line with estimates of economic capital and to create an incentive path where none currently exists. In addition BBA/LIBA propose that the current balance of the minimum operational requirements, which govern entry into and within the IRB, are reviewed. Currently these are overly focused on process standards and in effect create a standard regulatory rating methodology. BBA/LIBA advocate a rebalancing of approach that relies in equal parts upon minimum standards, methodological principles and validation.

Retail exposures

BBA/LIBA welcome the new proposals on retail portfolio as a great advance on the June 1999 proposals. As argued in the BBA/EBF/ISDA Retail Portfolio Study (2000) - it is right to include retail portfolio within the internal ratings based approach but on a basis that recognises the difference in risk profile and risk practice. Broadly, we believe that the proposals are moving in the right direction and have the right objective but, in common with other areas, we have significant concerns about their practical realisation. BBA/LIBA would hope that these issues can be addressed as part of the continuing consultation on this area over the balance of 2001.

The current retail proposals are an adaptation of the approach to corporate exposures, this extending to the calibration and methodological standards. In parts this has been successful, elsewhere less so. For example:

- The calibration to expected and unexpected loss does not recognise the degree to which expected loss is priced into retail products
- The transfer of the corporate reference definition of default does not work well.
- An insistence upon historical data series contradicts industry practice based upon dynamic risk data and assessment.

Considerable further detailed work is required. BBA/LIBA is keen to support the work of the Committee.

Project and asset finance

BBA/LIBA welcome the fact that the Committee has recognised project finance as a distinct asset class and is developing a differentiated approach to the assessment of capital adequacy within the general IRB structure. It is hoped that any eventual solution will recognise the generally favourable loss record of lending in this asset class. We would also highlight types of asset finance which also merit a differentiated approach. BBA/LIBA are keen to work with the Committee to achieve an approach that is built upon industry practice in the assessment of project risk.

Asset securitisation

BBA/LIBA believe that securitisation is a valuable tool in the management of credit risk, capital and the creation of market liquidity. As currently structured, the proposals on securitisation express a contrary view centred on the potential for capital arbitrage. This will have the effect of constraining growth of a market that has the potential to contribute to systemic stability. BBA/LIBA urges the Committee to revise the current proposals to express a more neutral view. It therefore proposes an approach based fundamentally on consistency of treatment with the general approach taken to credit risk in the banking book.

We welcome the proposals that ratings be used and that firms should be able to look through to underlying assets when allocating capital. The differentiation between the capital allocated to risk positions dependent on whether they are held by sponsors, originators or investors, on the labelling of a particular tranche of a deal or whether the structure is a cash or synthetic is not appropriate.
We encourage regulators to apply capital charges that are consistent with claims on corporates and to remove incremental capital requirements which may restrict flexibility in asset securitisation deal structuring. An approach which does not parallel the helpful proposals for corporate risk capital will damage the systemically beneficial asset securitisation market.

Credit risk mitigation

BBA/LIBA are concerned that the proposals on the recognition of credit risk mitigation, whilst positive, do not go as far as the industry would hope. BBA/LIBA would restate the view that credit risk mitigation techniques offer a net systemic gain and should be supported by the structure of the new Accord. This is not always the case. BBA/LIBA would lay particular emphasis on the withdrawal of the “w” factor. This is an arbitrary floor on the recognition of the economic value of credit risk mitigation that may well distort market pricing and practice. BBA/LIBA urge the Committee to withdraw a proposal which it believes has no basis in fact. Additional major items include the lack of recognition of non-financial collateral and joint default effects.

Securities financing

The current proposals also suggest that the Committee envisages treating securities financing/ liquidity transactions[1] under the proposed collateral rules. It is recognised, by both participants and regulators, that such transactions are an important element in the infrastructure of the securities market and it would not serve the interests of any party to do damage to that market. Whilst BBA/LIBA recognise the Committee has a legitimate prudential interest, it is essential that this is balanced by potential market implications. In response BBA/LIBA would propose that such transactions form a distinct class of activity and an appropriate regulatory capital approach to them needs to be developed from first principles.

---

[1] By "securities financing/liquidity transactions", we mean those transactions which consist of financing of, or by, securities positions; this category would include stock lending/borrowing, repos and reverse repo and buy/sellbacks and sell/buybacks, prime brokerage and margin lending activities.

Operational risk

BBA/LIBA remain concerned that a poorly constructed and overweight charge will not contribute to the achievement of a risk based capital charge. The present proposals are over focused upon the achievement of a quantitative solution. In particular a calibration based upon an arbitrary and unrealistic 20% of total capital is unhelpful. At a minimum the industry would wish to see this calibration reviewed and the quantitative assessment methodologies balanced by the development of a qualitative scaling factor that is able to appreciate the value of institution specific risk mitigation and offer incentives for better operational risk management. The general development objective should be to capture the true drivers of operational risk within the structure of the regulatory capital process.

BBA/LIBA are also concerned that the process of policy development on operational risk is particularly pressured. This has two implications. First, the necessary level of debate, development and testing prior to the finalisation of the new Accord must be maintained, at least for the rest of this year. Testing itself is an absolute requirement prior to implementation. Second, the Committee must commit to an ongoing review of the impact and form of these proposals. Operational risk management is a new and rapidly developing field. Whilst the industry reluctantly accepts the necessity of a separate capital charge, this must not unduly define or constrain the future direction of industry risk management practice. BBA/LIBA would anticipate a near term need to revisit and revise the current proposals in the light of industry and regulatory experience in application.

Trading book

It is right that the current proposals for revising the Capital Accord have been developed in the context of the banking book in general and lending activities in particular. However, it cannot - and should not - be assumed that proposals developed in that context will necessarily be appropriate for trading activities. We do not think it can be assumed that the current proposals can simply be "carried across" without further thought and work. We recommend that the Committee give early consideration to the way in which the proposed changes to the rules with respect credit risk, operational risk and disclosure should be amended for the trading book.

Pillar 2: Supervisory review

BBA/LIBA support the concept of Supervisory Review and believe it to be an integral part of the new Accord that must be applied by all supervisors. It can accommodate the assessment of bank specific activity and circumstance. This is particularly important in the context of issues such as pro-cyclicality where mechanistic adjustments based upon universal assumptions would be unhelpful. BBA/LIBA would argue that the improved risk sensitivity of Pillar 1 makes any routine requirements for banks to hold capital in excess of the minimum unjustifiable. This capability should only be exercised as the exception when specific cause and need can be identified and demonstrated.

BBA/LIBA would also support the view that as the Accord shifts toward a greater reliance upon internal risk assessment, supervisory review creates a vital structure for the consistent assessment of risk management standards and, in turn, a platform for the equal implementation, and application, of the new Accord. To further strengthen this element BBA/LIBA would propose that Basel co-ordinate the publication of key statistics, by national regulators, on the application, and take up, of the various elements of the new Accord and establish a thorough and regular programme of peer review. The objective to create a continuing momentum behind the consistent application of the new Accord.

Pillar 3: Market discipline

BBA/LIBA do not, at the level of principle, disagree with the view that the new capital regime should be supported through enhanced disclosures on capital, risk, their management and the capital adequacy of an institution. However, we are concerned that the proposed disclosures are an excessive burden, potentially confusing and have little relevance to users of general purpose financial statement.

The audit implications of including this information within financial statements are a particular concern. Going forward the Committee should work with the banking industry, users of financial statements and accounting standards setters to ensure that disclosures are understandable, relevant, reliable and comparable.

2. Scope of application

2.1 Consistency of application

The Accord states that its requirements will apply at all levels of an internationally active banking group. To ensure a fair outcome of the Accord, it is important to ensure that this requirement does not lead to conflicting capital adequacy rules for a banking group. The Accord leaves a good degree of discretion to national supervisors. This introduces the possibility that capital adequacy measurements will be significantly different between jurisdictions, depending on the approaches that are approved by the different national supervisors.

Most internationally active banking groups operate through a combination of branches and subsidiaries in many different countries. Reporting on a consolidated and solo basis is already a requirement in the UK, and additionally most banks report to host country regulators under the local regime. The Accord's requirement to report individually at every level of a group is, therefore, not totally new. Under the New Accord, though, the varied approaches that can be adopted, together with Pillar 3 disclosure requirements and various technical aspects of the IRB approaches (such as the granularity adjustment) could result in an onerous compliance burden on groups operating through networks of subsidiaries. In addition, the need to meet the higher of home and host capital requirements throughout a group could lead to the aggregate capital charge being much higher than either set of regulators intended.

A useful precedent was set in this respect in the implementation of the market risk capital proposals in Europe, where capital determined under the local rules of a regulator operating a Capital Adequacy Directive equivalent regime can be incorporated into the group's capital requirements on an additive basis. This is instead of consolidating the exposures of all group companies and then using the rules of the regulator of the consolidated group to calculate the capital required for the consolidated exposure. Where a local regulator has adopted the new Basel capital framework, there should be the possibility that the capital requirement assessed by that regulator could be added to capital requirements of other parts of the group to give the consolidated total. This may be less onerous than combining the exposures in each local jurisdiction and applying the capital rules to the combined exposure, especially if the exposures are not managed on a combined basis. The method used should be agreed with the regulator individually, taking into account how the relevant exposures are managed.

In addition whilst BBA/LIBA agree that internal risk management processes and methodologies should be subjected to rigorous supervisory review, the requirements should be realistically achievable. We are particularly concerned about the suggestion in the consultative document that the same approach has to be applied to all products and businesses. The Accord recognises the difficulty of moving to the same approach completely simultaneously and proposes that there should be a plan to capture all activities in a short period of time. In our opinion this is too aggressive a requirement. It is potentially a threat to the implementation of the Accord. Our response on the internal ratings based approach further explores this point (see 4.6).

2.2 Deduction of investments in de-consolidated entities

The current proposals state that "Deduction of investments in de-consolidated entities will be 50% from tier 1 and 50% from tier 2." It is not clear whether this is intended to mean

1) 50% of investments will be deducted in arriving at tier 1 capital; or

2) 50% of investments will be deducted from tier 1 capital as currently calculated, for the purpose of calculating the tier 1 ratio.

The first interpretation would be a major change from the current position where investments in de-consolidated entities are deducted from the total of tier 1 and tier 2 capital. It is difficult to see the relevance of this change to the overall thrust of the proposals, in terms of improving the quality of banking supervision, and it could have a major impact on the capital structure of some institutions.

A hypothetical bank making full use of the current rules could have its capital substantially affected as follows:

	Current	Proposed
Core tier 1	170	170
Innovative tier 1 - restricted to 15% of total tier 1	30	12
Deductions from tier 1		(100)
Total tier 1	200	82
Upper tier 2	100	100
Lower tier 2 - restricted to 50% of tier 1	100	41
Deductions from tier 2		(100)
Total tier 2 - restricted to 100% of tier 1	200	41
Deductions	(200)	-
Net capital	200	123
Risk assets	2,000	2,000
Tier 1 ratio	10.0%	4.1%
Total ratio	10.0%	6.2%

The reduction of the total ratio from 10.0% to 6.2% arises because of (a) the restriction of innovative tier 1 to 15% of total tier 1; (b) the restriction of lower tier 2 to 50% of tier 1; and (c) potentially the restriction of total tier 2 to 100% of tier 1.

In contrast the second approach would resolve the lack of comparability of tier 1 capital ratios between pure banks and bancassurers. In the example above this would give a tier 1 ratio of (200-100)/2000 = 5.0%. On this basis BBA/LIBA would propose that the proposal in its current form should be clarified along the lines of the second approach or be withdrawn.

2.3 Insurance subsidiaries

Under current rules, an insurance group with a subsidiary bank is not required to deal with that bank by way of deduction - its assets and liabilities are consolidated into the overall solvency ratio calculation. This would appear to reflect the nature of risk in the subsidiary business, and the capital resources available, more accurately than the treatment that currently applies to a banking group with a subsidiary insurer, where a deduction must be taken from capital for the whole amount invested. The deduction approach effectively considerably overstates the capital requirement of the insurance business in the banking group.

BBA/LIBA believes that the fairest and most logical approach would be to permit banking groups to consolidate insurance subsidiaries, and suggests that this could be achieved using the "aggregation plus" technique. This approach ensures that capital resources are fully consolidated into Group Tier 1

and Tier 2 capital, and the capital requirement of the subsidiary regulator is reflected in the Group capital requirement. Should the Committee wish to retain the deduction approach, BBA/LIBA believes that this should be applied in a way that minimises the competitive disadvantage currently suffered by banking groups against competing insurance groups. This could be achieved by ensuring that the deduction would be equal to the risk-related requirement set for the subsidiaries by the relevant Insurance Regulator (as suggested in Part 1C, 12 of the Draft Accord).

Pillar 1 – Minimum Capital Requirements

3. Credit Risk: Standardised approach

Overview

BBA/LIBA support the continuance of a basic approach open to all banks. It must remain available to banks that are unable, or who do not choose, to adopt the internal ratings based approach. The proposed approach is broadly an advance on the first round proposals although we would still express concerns at the cliff effects still implicit in the broad risk weighting buckets. This is despite the welcome inclusion of a 50% bucket for corporate exposures. We believe that these effects will bear particularly upon smaller banks.

Option 1 and Option 2

The treatment of banks is of particular concern, although views amongst our own membership differ on the desirability of Option 1 and Option 2. Unfortunately we do not imagine that consensus on the core issue will be achievable. We do however believe that the decision on which Option should be adopted as standard should be taken at a Basel/EU level and not open to national discretion.

The preferential treatment of short term claims is appropriate for risk management purposes. BBA/LIBA would therefore propose that the preferential treatment of short term claims, currently available only under Option 2, should be extended to Option 1 if that is the preferred solution.

Short term claims

BBA/LIBA is concerned with the proposal to reduce the short term maturity cap to three months. The result would be to reduce liquidity and to distort the market, creating a perverse incentive for banks to fund themselves short. The proposal also raises considerable practical issues in terms of the constant necessity of demonstrating the absence of intent in rolling contracts. BBA/LIBA strongly prefers a twelve month cap based on the residual, rather than the original, maturity of the claim.

Trade finance

Documentary credit transactions supporting trade finance are a substantial market for banks in London (and for internationally active banks). It is a market which has shown very low losses. It receives no comment in the consultation paper.

There are two major issues. First, that confirmed documentary credits or similar represent claims on banks and will therefore be subject to the short-term claims regime outlined under paragraph 32 of the draft Accord. Given that trade related documentary credits are generally of 3 months tenor, and often 6 months or longer, and may frequently be extended, the proposed regime for short-term claims on banks represents a significant increase in capital requirements, which has little to do with the inherent risk of the transactions.

There are two aspects to this. The first is that claims which hitherto were weighted at 20% could in future be weighted at up to 150%. The second point is the simple one that the primary obligor, the bank issuing the documentary credits, will find that exposure weighted at 20%, whilst the confirming bank will find their secondary exposure weighted at anything up to 150%. This is an obviously unintended and perverse outcome of the proposals.

The second concerns the loss profile. Trade-related documentary credits (all of which operate under the international UCP convention) show an extremely low LGD. This is partly because of their contingent nature, which is reflected in the current 20% risk weighting which they enjoy. It must be assumed, in the absence of any other guidance, that issuance of documentary credits will be treated as

unsecured advances to corporates. In that case, the risk weighting would increase to 100% under the Standardised Approach and attract a 50% LGD under the Foundation Internal Ratings Based Approach. Both assessments fly in the face of current practice and historical experience and BBA/LIBA would recommend that appropriate recognition should be given for trade finance transactions.

Sovereign floor

The proposed sovereign floor on the risk weighting of corporates should not apply to exposures in, and funded in, the domestic currency of the corporate. The domestic rating should also apply.

Claims secured on commercial real estate

The Committee passes a rather damning indictment on historic commercial property lending. There are a number of contributory factors for this, ranging from bank lending practice and policy to valuation practice and standards. At this stage, we would only say that BBA/LIBA has been working with the Royal Institution of Chartered Surveyors in the UK to improve the quality of property valuations and of banks' understanding of them in the UK. We are also aware of the work of bodies such as The European Group of Valuers' Associations and International Valuation Standards Committee to raise valuation standards generally. We understand that the IVSC is writing to the Committee to explain this in more detail and we would hope that the Committee will work with these and other appropriate bodies to enable criteria to be established which will lead to a reduced LGD for commercial property lending. We comment on this in more detail in our response to the Foundation IRB.

Despite its indictment, the Committee nevertheless offers users of Mortgage Lending Value (MLV), subject to their being able to compare loss rates against both MV and MLV, an LGD of 50%. MLV is a methodology used only in Europe and, to the best of our knowledge, not at all in the UK. Availability of the exceptional treatment would therefore be available to a few states which have well established markets in commercial mortgages, which maintain detailed historical national data to support their lending experience using both MV and MLV, have enacted appropriate legislation, and have generally enjoyed stable markets over long periods. The narrowness of the treatment's availability makes it inappropriate as the basis of exceptional treatment under an international Accord.

Treatment of defaulted loans

The industry objects to the blunt imposition of 150% weighting for any asset 90 days past due net of specific provisions. This standard does not necessarily automatically imply that an economic loss has been or will be suffered by a bank. Rather it may simply be a timing issue, for example in retail portfolio or in lending to local government. It would also not seem sensible to impose a 150% weighting in the instance of loan which is 75% written down. This is an issue we will explore in more depth in our response to the internal ratings based approach.

100% risk weighting for all other assets

The industry accepts the continuation of a 100% risk weighting for all other assets.

External credit assessment institutions

We are concerned that the eligibility criteria outlined present a barrier to recognition which even the major credit rating agencies may fail. This cannot be the intention of the Committee. Particular concerns are the Disclosure and Resource criteria which we believe to be unrealistic as drafted. Provision should also be made for the recognition of specialised agencies that provide ratings for limited sectors of the economy.

For practical reasons the industry would prefer that the ECAI recognition process is a central activity perhaps carried out by the BIS. This should include central mapping of ECAI grades to a common default scale. We would otherwise be concerned at the creation of a confusing patchwork of recognition and non-recognition. The exception to this rule would be national supervisory recognition of domestic ECAIs, the proposed disclosure requirements applying as drafted. Within the standardised approach we believe that this proposal will resolve perhaps the single most significant issue of international comparability.

4. Credit Risk: Internal ratings based approach

Overview

BBA/LIBA welcome the fact that the internal ratings based approach is now the foundation of the reform process. We support the general structural and conceptual framework proposed. This includes the:

- basis of the approach in common risk components
- reliance upon internal risk assessment subject to minimum requirements
- a flexible evolutionary path and incentives to progress
- the intended level of access.

Taken together we believe the internal ratings based approach has the potential to create a risk based regulatory capital regime which rewards good practice and is broadly in line with economic reality.

Unfortunately, that welcome is conditional as BBA/LIBA have serious concerns that the rules as currently drafted will not allow the realisation of the Committee's objectives. Issues of particular concern include the calibration of the IRB risk weighting function, the minimum operational requirements for entry to the IRB and the provisional nature of the rules as they relate to various significant exposure class. In sum BBA/LIBA believe that these concerns threaten to undermine the value of the IRB approach and the new Accord.

4.1 Transparency

Prior to discussing the detail and impact of the proposals we would wish to make a general point on the presentation of the IRB approach and the supporting technical background. A general feeling exists amongst our membership that this has been lacking and as a result made a full analysis of the proposals difficult. Issues of concern include:

- in the documentation, the discussion states several times that the equations and coefficient values have an empirical basis (see for example art. 166 IRB-SD), yet there is no reference to available published empirical studies or evidence
- in the documentation, many coefficients and formulas are presented without any background discussion or references

We would request that going forward the Committee provides more depth in presentation. In particular input data - what data was used, how it was estimated - rather just the model structure. This would allow a full analysis and response from the industry.

As noted above BBA/LIBA would place particular emphasis on an early release on the data and analysis generated as a result of the second Quantitative Impact Study (QIS). BBA/LIBA strongly support this study in the expectation that it will result in a significant re-calibration of the existing proposals. BBA/LIBA would argue that full and early documentation of the basis of these calculations is an essential foundation to the credibility of the new Accord. At a level, of course, that cloaks the identity of either individual banks or national data sets.

4.2 IRB risk weighting function

Absolute calibration

BBA/LIBA are concerned that the current IRB risk weighting function results in a requirement to hold economic capital well in advance of economic necessity. Industry analysis suggests a range from 20% to 50%. BBA/LIBA with the European Banking Federation and International Swaps and Derivatives Associations are undertaking a separate impact analysis and will revert to the Committee with results in the June 2001. At this stage however we do not believe that this reflects the risk profile of the industry.

Given the lack of transparency the risk weighting function appears crude and conservative. BBA/LIBA are concerned that this is the result mainly of the inclusion of two crude uplift factors[2] within the risk weighting function intended to buffer against measurement error (+20%) and a lack of loss-absorbing capital (+30%). In sum this represents a 50% buffer universally applied to all banks. BBA/LIBA unequivocally oppose the introduction of these factors and would suggest they seriously undermine the risk sensitivity that is the purported objective of this reform process.

Each factor is idiosyncratic to a degree that makes universal assumptions and a universal charge untenable. Each factor would be better dealt with as an institution specific issue. Supervisors should, as proposed, review bank capital and risk assessment methodologies on an institution specific basis, ensuring that the minimum standards for risk assessment are met and that capital is held commensurate with those risks. As the Committee has noted on various occasions, banks regularly hold, at their own discretion, economic capital above the regulatory minimum. The value of this buffer, against error or over the cycle, is best assessed bank by bank.

The assessment of measurement error is also already intended to be a core process within the Pillar 2 assessment regime. We would expect that any bank systematically mis-estimating their risk by a margin of 50%, as assumed in the calibration of the 20% buffer, would cease to qualify for the IRB approach. To assume mis-estimation on this scale is certainly not the experience of BBA/LIBA members and should not be the basis of a standard charge. We do not believe that this is the right approach and will send a perverse message to banks. For example, what incentive will be retained to be conservative in the estimation of PD if an assumption of error, especially of this scale, has already been made.

BBA/LIBA are also concerned that the inclusion of a 1.5 multiplier will only serve to amplify artificially any negative cyclical effects already identified as a concern by the Committee. This would create an artificial break upon bank lending which is entirely without the influence of bank management. In addition it is unreasonable to assume, as has been argued by a number of regulators, that any increase in regulatory capital can be accommodated within current economic capital holdings. Rather banks will be expected, by the market, to maintain the current differential between actual and regulatory capital. This suggests that any over calibration of the regulatory minimum will be further exaggerated by market pressures.

Finally BBA/LIBA would question whether an overarching buffer is required given the number of buffers which have already been built into the calculation model. The IRB approach is based upon conservative assumptions and conservative operational standards. Already the sum of these conservative parts is equal to a very conservative whole. Elements identified included:

- calibration of various risk components (PD/LGD/EAD)
- calibration to EL & UL

[2] Basel Paper: Note on Issues Related to Overall Capital

- through the cycle definition of PD
- no recognition of risk diversification

This does not suggest, to the industry, that any need exists for any additional buffer to be built into the structure of the IRB approach.

Relative calibration

Perhaps the most serious by-product of the current calibration is the impact on the incentive offered to banks to advance from the standardised to the FIRBA. The industry strongly supports the introduction of an evolutionary path, in which banks are rewarded to advance to and within the IRB approach. This is part of the fundamental value of the new Accord. It is therefore unfortunate that the current calibration creates a counter prudential incentive to remain on the standardised approach. Initial surveys of the impact upon banks suggest that the best case is neutral whilst the majority of respondents report that the transition from standardised to FIRBA results in an increase in regulatory capital. Simulations on a representative portfolio confirm this is the case.

Currently the FIRBA is victim of a number of factors which put those using it at a relative disadvantage to banks operating both the standardised and the advanced internal ratings based approach.

- overweight risk weighting function with a cap of 625%.
- conservative calibration of risk factors.
- minimum operational requirements.

There are, however, no compensating gains, as per the AIRBA, in the form of internal estimations of LGD, EAD and CRM. BBA/LIBA would not support any adjustment to the standardised risk weighting matrices. Therefore this makes a re-calibration of the IRB risk weighting function an essential requirement. As above, the solution to this issue lies in the data and analysis that will be undertaken as part of the Quantitative Impact Study.

SME financing

It should also be noted that there are concerns, and evidence, that the FIRBA bears relatively harshly upon SME financing, in comparison to banks operating both the Standardised and AIRBA approaches. In particular, SME exposures which do not fall within the retail definition but which are of insufficient size, or length of track record, to attract a good internal rating could attract a very high PD translating into a very high risk weighting. BBA/LIBA would anticipate that this analysis will be confirmed by the QIS and again request that the output be released early for industry consideration.

In essence the single corporate approach under the FIRBA does not make sufficient allowance for the application of different risk management practices in different segments of the corporate market. BBA/LIBA suggest that this will result in an overstatement of required capital and that this is driven by four primary factors:

- 1.5 multiplier within the IRB risk weighting function
- property and physical collateral not well recognised
- no recognition of CRM value of <1year maturity
- IRB risk weighting function based on inappropriate correlation assumption for SME portfolio.

The first three factors are each dealt with separately within the BBA/LIBA response and would go some way to redressing the current imbalance.

BBA/LIBA is also investigating the merits of introducing an additional risk weighting function that better reflects the characteristics of SME portfolio and in particular is based upon a lower asset correlation assumption. A case can be made that SME portfolio demonstrate a lower asset correlation and that this has a significant impact on capital requirements within the current structure. An impact reflected in industry economic capital models. However generally BBA/LIBA are reluctant to introduce additional complexity into an already complex Accord. Therefore rather than making an unequivocal recommendation it is currently reviewing the issues raised. This review includes the definition of those exposures that will fall within the retail internal ratings based approach. BBA/LIBA would strongly support the articulation of a risk based definition for retail (see 5.0 Retail exposures) which could sensibly include SME portfolio that meet the general requirements.

Calibration to EL / UL

The current calibration of the IRB risk weighting function to the sum of expected and unexpected loss runs contrary to general industry practice. Economic capital more generally is allocated to unexpected loss only. Expected loss is covered by a combination of pricing and provisions. The calibration to EL and UL raises some fundamental issues as to the function of regulatory capital, which has to date been commonly held to cover UL.

The industry accepts that practice in this respect is not standardised and that further convergence is made more difficult by differing tax and accounting regimes. These factors, combined with the current definition of regulatory capital, suggest that a common regulatory solution based upon a calibration to unexpected loss would be problematic. Therefore, absent an amendment to the definition of capital, BBA/LIBA reluctantly accept the calibration to EL plus UL subject to a number of critical conditions. Most specifically the removal of the 1.25% cap on general provisions as Tier 2 capital and recognition of expected margin income against EL in the retail portfolio.

4.3 Foundation IRB risk components

Risk weighting function

BBA/LIBA reserve a particular welcome for the introduction of a continuous risk weighting function rather than a reliance upon mapping of internal ratings to a common scale. As per our submission of March 2000 we believe that this approach greatly enhances the risk sensitivity of the IRB approach.

Loss Given Default

BBA/LIBA is satisfied that whilst conservative the proposed standard LGD values are reasonable for the general corporate portfolio. It is an open issue whether the same assumptions hold across exposures to sovereigns and banks/investment firms.

The definition of loss used in estimating LGD should not be economic loss (paragraph 339). If discount effects, funding costs and indirect as well as direct costs associated with collecting on the instrument are included in the determination of the loss, the amount recorded will be extremely subjective and there will be no consistency between institutions, or even within the same institution. It is essential that the definition and quantification of loss used to determine regulatory capital is objective, clear and independently verifiable. The advantage of using losses recorded in the accounting records is that they already had to meet financial reporting criteria, in particular that they must be independently verifiable.

Methodology for Recognition of CRE and RRE Collateral

BBA/LIBA are concerned that the proposed recognition of the value of commercial and residential real estate as collateral is unduly conservative and that the impact is particularly felt in lending to SMEs. The LGD band of 40% is excessively conservative. It is really highly unlikely that where the

loan is only 70% of value, this has the effect of only reducing likely loss by 10%. Put another way it is highly unlikely, in the event of a default, that 70% LTV will see the property fall in value from 100 to 42 (to allow for a loss of 40% of 70%), even allowing for cost of recovery. Rather, initial industry data suggests recovery values closer to 80%. BBA/LIBA would suggest that in this circumstance an LGD closer to 20% is justifiable. BBA/LIBA recommends that the Committee collates more data, which we believe will show that a lower LGD is justified than the 40% proposed.

On a more practical note the paper (paragraph 319) states that valuations should be "monitored" on at least an annual basis and that a professional revaluation should take place at least every three years. Full professional property valuations are expensive, the costs being borne by the borrower. Bank practice is to review valuations at the time that the underlying loan is reviewed. Given that the property collateral is a secondary source of repayment, and absent any problems in the underlying loan, it would be extremely unlikely that banks would call for a fresh professional valuation. This is particularly true of residential property and would simply not be possible when applied to a large mortgage book.

Exposure at Default.

BBA/LIBA do not understand the difference in standard EAD values between the Standardised and Foundation approaches. Specifically the proposed 75% CCF in the FIRBA contrasts harshly both with industry experience and also the values presented in the standardised approach (20% CCF < 1year, 50% CCF > 1 year). BBA/LIBA would suggest that consistency and economic reality argue for the adoption of the standardised values across the piece.

4.4 Maturity Adjustment.

As a point of general principle BBA/LIBA would support the inclusion of a maturity adjustment within the internal ratings based approach. Industry practice would clearly suggest that maturity does impact credit risk both positively and negatively. The maturity of a loan is an important credit mitigation tool. Yet as the Committee also notes it is important to balance the trade off between risk sensitivity, cost and impact.

BBA/LIBA undertook an analysis of the relative merits of the two approaches presented, mark-to-market (MTM) or default mode (DM), on the basis of the information presented. Members expressed no strong preference for either option in theoretical terms, although concern does exists at the relatively harsh treatment of longer maturity exposures under the MTM/Table 4 approach and a general preference for the outcome of DM/Table 5. In both instances further analysis was restricted by the absence of an empirical basis to the calibration. The industry would therefore request that the Committee, prior to finalisation of the calibration, publish the background data on which the current adjustments are based.

Consideration was also given to the standard assumption of an average maturity of three years. It is clear that the relevance of this assumption varies by product and exposure class. Options for reflecting this variation, including self-determination, were considered but in conclusion rejected as over complex. Therefore, as a general rule, three years represents an acceptable, if conservative, benchmark for banking book exposures.

Industry concerns focus upon the factors that the Committee itself identifies as conservative. First the proposed definition of effective maturity. Second, the lack of any recognition of the role of maturity as a credit risk mitigant. BBA/LIBA would suggest that the result is an overly conservative maturity adjustment.

The proposed definition of effective maturity concentrates upon the full contractual maturity rather than "expected maturity". BBA/LIBA believe that this is an overly conservative assumption that has a real impact upon a number of product groups such as mortgage backed securities. In such instance the

contractual maturity is simply not relevant to the actual performance of the product. As an alternative we would propose that the maturity adjustment should reflect the behavioural characteristics of the product in question. Therefore where a bank can demonstrate a relationship we would recommend that Basel allow the recognition of behavioural maturity.

As the Committee notes, "a failure to recognise the role of maturity as a credit risk mitigant under the IRB approach could result in unduly high capital charges on loans to lower-quality customers by not accounting for a common technique to reduce the riskiness of such loans." BBA/LIBA share this view and would suggest that the impact will be particularly felt on short term facilities e.g. bridging loans, underwriting facilities, committed standby liquidity lines, drawn inter-bank lending, short term trade related facilities. The current proposals will penalise these facilities as they will attract a capital weighting equivalent to a facility with a one year maturity. We also believe that the impact will fall most heavily upon lending to the SME sector.

It should be noted that, contrary to the conclusions of the Committee, we believe that an amendment reflecting the credit mitigation value of maturities less than 1 year does reflect industry practice. First as reflected in the actual risk management policies of banks. Second, as recognised in the economic capital models of third party vendors (e.g. RiskMetrics, KMV, McKinsey's) all of which allow for facilities with maturities of less than one year to be modelled.

We accept that the Committee has concerns that banks may gain a concession on this issue by deliberately restructuring long-term exposures as a series of short-term contracts. Equally, the rollover of short-term money market loans, repos, etc. is common place and does not necessarily represent an attempt to change the economic maturity of long-term lending. What is crucial is whether there is an obligation to renew the contract. To counter this concern we would propose the articulation of a number of minimum operational standards that would need to be applied by banks recognising the mitigation value of exposures less than one year:

1) Creation of explicit short-term products. The capacity for banks to recognise short-term maturities could be explicitly recognised through the product type – probably defined in the institution's lending policy.

2) Documentation. A commitment to rollover lending is likely to be evidenced in the documentation relating to a facility. Where there is evidence of the continued renewal of existing contracts, a bank should be able to demonstrate, if so required, that there was no requirement so to do.

3) Supervisory oversight. In order to ensure that banks are complying with the spirit of the proposals, supervisors could check as part of the Pillar 2 process, that this is indeed the case. Given that short term lending would be separately trackable it should be relatively easy for supervisors/auditors to check that the rules are being complied with. This process should ensure that banks operate a credit review process that creates the opportunity to cancel a facility. Banks found to be violating the principles would be expected to use a minimum one year PD.

In order to gain the proposed benefits, banks should be able to reduce the PD to reflect the shorter maturity in an analogous manner to that for longer term maturities. So for instance in the standard risk weighting function:

$$RWC = \mathrm{Min}((LGD/50) \times BRWC (PD) \times [1 + b (PD) \times (M – 3)], 12.50 \times LGD)$$

Therefore M would be 0.5 for a 6 month exposure.

In conclusion, overall BBA/LIBA support the optional adoption of a maturity adjustment by banks operating the FIRBA and inclusion within the AIRBA but only on the basis of the conditions articulated above.

4.5 Granularity Adjustment

The industry understands the objective and the theoretical basis of the proposed granularity adjustment. An adjustment to account for the residual undiversified idiosyncratic risk makes theoretical sense in the context of the overall construction of the IRB approach. In essence the granularity factor is a second step adjustment that reflects the difference between a hypothetical infinitely fine grained portfolio, assumed in the calibration of the IRB risk weighting function, and an actual bank portfolio. This should result in an adjustment that better aligns regulatory and economic capital.

BBA/LIBA would in the first instance request publication of the documentation of the inputs that inform the calibration of the granularity adjustment. Without this background it is difficult to comment on the calibration of the adjustment except in general terms. This initial analysis does suggest that the output of the proposed procedure is vulnerable to relatively minor differences in portfolio structure. (See Annex X for a more detailed analysis.)

The granularity adjustment ignores diversification. Currently the adjustment is based solely upon single borrower exposures. No recognition is given to the value of portfolio diversification across border, sector or exposure class. In fact, contrary to the logic of the proposal, the inclusion of retail portfolio within the scope of the aggregate portfolio is explicitly excluded. Exposure concentration in sectors or regions occurs in corporate as well as in retail portfolios. For example two portfolios one international and sectoral diversified and the other concentrated on a national and sectoral level would have the same granularity adjustment, given all other parameters equal. This seems to make little intuitive sense.

BBA/LIBA are also concerned that the implementation of the adjustment factor will be a considerable burden to the industry. The data requirement are demanding:

- at a counterparty level, information about rating, loss given default and maturity is required. Additionally the exposure at default (EAD) for every single counterparty has to be available.

- in case of multiple exposures to a single borrower the determination of the counterparty data might not be straightforward. For example when facilities have different LGDs and ratings. Basel proposes the use of EAD-weighted averages (art. 437 IRB-SD). But there is no guidance for the determination of maturity at counterparty level.

- in cases where two obligors are related even though they have separate legal status they should also be treated as a single borrower (art. 437 IRB-SD).

As a result banks will have to gather and maintain all the necessary data to be able to aggregate facility information appropriately to counterparty data. Across a global banking group the MIS implications attached to this objective will be considerable and, BBA/LIBA would suggest, out of proportion to sophistication to the one factor granularity model. BBA/LIBA would strongly suggest that this mis-match is unreasonable and that the Committee should explore other alternatives.

The objective of this proposal is to capture significant single counter party concentrations. BBA/LIBA would not dispute that this objective is justifiable or that the proposed granularity adjustment is not essentially theoretically sound. In practice however the adjustment is untested, complex and costly. Whilst the impact of a one factor model is at least non-intuitive. The industry is supportive of a continuing dialogue to explore more practical alternatives to the current proposal. For example BBA/LIBA believe that the current EU Large Exposures Directive, and its various national equivalents operated through out the G10, offers a more practical alternative. An alternative that achieves much of the purpose of the current proposal at a fraction of the cost. BBA/LIBA would support further dialogue on this issue.

4.6 Adoption of the IRB approach

BBA/LIBA, as a matter of priority, would urge the Committee to review and revise the requirement that progression into, and within, the IRB approach is to be subject to an "all or nothing" requirement. The industry accepts that the Committee has a legitimate interest in policing progression between the standardised and IRB approach but would argue that the introduction of a simplistic rule is not the best way to proceed. Such a requirement does not mirror industry practice and may well lead to perverse risk management and investment decisions. For example banks may be:

- pressured not to undertake otherwise beneficial acquisitions
- reluctant to enter new markets
- reluctant to develop new products
- pressured to sell business segments or close business segments for which an IRB approach is not appropriate

To avoid these negatives the industry would argue for a twin track approach. Firstly the retention of a general presumption that all material portfolio should migrate to the same approach over time. Secondly the development of a regulatory procedure and principles which could be the basis of exceptions to this rule. In essence banks would have to demonstrate and disclose "good reason". For example:

- New market: a bank that enters a new market will not be able to implement an IRB approach for a significant number of years, especially if there is slow growth and the initial years do not provide enough robust data to reach the regulatory standard.

- Inappropriate: a significant number of BBA/LIBA member operate in markets, either sectoral or geographical, where an IRB approach, in the required regulatory form, might be considered inappropriate or undesirable. For example an emerging market where historical PD data is either unavailable or unreliable. Consequently it is not practical, nor would it make prudential sense, to apply an IRB approach.

- M&A: a bank may purchase a significant business entity and this may take some significant time to be brought into the rest of the bank's IRB risk management system. The "all or nothing requirement" should not act as an artificial barrier.

- Immaterial: a small book of business (irrespective of whether it is within a non-significant business unit) that has limited exposures and limited risk would not warrant a sophisticated and expensive IRB system

In these instances it should be noted that there should be no general presumption of a +100% risk weighting. Also, in the instance of good reason, the general prohibition on intra-group transactions should not be applied.

Finally BBA/LIBA would request more clarity around the phrases "a reasonably short period of time" and "aggressive, articulated plan". The tone suggests movement toward the IRB within the near term. This may not be practical. The development of an internal ratings approach of the required quality is a substantial project. In addition banks will have to clear a standing requirement for five years PD data. This suggests a 5-7 year roll out plan could be considered a minimum. BBA/LIBA would be interested in the Committee's views on this issue.

4.7 Dual operating requirements

The majority of BBA/LIBA members operate cross-border and have a shared concern at the uneven adoption of the new Accord across and outside the G10. As above we would expect in these circumstances that the general prohibition on intra-group transactions should also be dis-applied. Consideration needs to be given to a mechanism for the avoidance of dual operating requirements, or at the very least minimisation of the cost. BBA/LIBA would invite the Committee to comment on a mechanism or process for cross-border supervisory co-operation on this issue. Certainly there should be an appreciation that this may serve as the basis of a "good reason" exception and as above the general prohibition on intra-group transactions should not be applied.

We appreciate the supervisory concern that unless the New Accord is introduced on a consistent basis world-wide by an international banking group, there is the possibility of regulatory arbitrage through cherry picking between the different options. We note, however, that there are enormous practical problems in rolling out a new system internationally, and that a banking group is likely to be reluctant to commit itself to switching to a new risk management system internationally, but rather to adopt a staged implementation over time. We would therefore urge supervisors to adopt a practical approach to permit banks to migrate from one system to another in phases, rather than expect a single change-over date to be implemented world-wide.

Furthermore, the situation is complicated by the possibility, or even the probability, that some jurisdictions will not necessarily be able to offer all the various options. Either initially in 2004 or possibly at any stage in the future. Whilst we hope that there will be close co-operation between supervisors in different jurisdictions regarding the supervision of complex banking groups, there remains the prospect that some local subsidiaries may be forced to adopt different supervisory reporting and capital measurement systems from the parent bank or the rest of the group in general. This would mean that the subsidiary had to measure its capital adequacy according to two systems – one to meet local supervisory requirements and one to meet consolidated supervisory requirements.

In order to avoid this unnecessary cost, we would urge supervisory authorities to take a practical approach, and permit local rules to be applied at the consolidated supervision level where the local supervisor is unable or unwilling to offer all the options proposed under the Revised Accord.

4.8 Minimum requirement for IRB approach

General orientation of requirements

BBA/LIBA welcome the fact that a central theme of this reform process has been a shift towards a reliance on internal risk management practice and internal risk assessment. The industry understands that this shift will require regulators to articulate minimum standards that enable them to have confidence in the output of internal risk management systems. Whilst BBA/LIBA support this in principle, in practice we believe that the current proposals go beyond the requirements of sound risk management practice. The result is a set of minimum requirements that are over-specific, over-prescriptive or just unnecessary. The impact upon industry practice and the operation of the capital regime are a serious concern.

Taking the impact upon industry practice first, the result of this over specification is not just an increase in cost to banks seeking to achieve entry into the IRB approach. The industry accepts that there may be a need to upgrade or adapt systems to meet regulatory standards, but rejects the articulation of a standard process. This would be acceptable if bank internal rating systems were consistent but this is rarely the case within a single institution let alone across a global industry. This diversity in approach is a positive signal that banks have adapted their approach to the relevant product set, environment and experience rather than operated blindly irrespective of circumstance.

The industry is concerned that the proposals as drafted will divert resources from the development of internal risk management practice. Creating a process focused upon compliance rather than risk management. This presents a real risk that banks will have to create either dual systems, the first to comply with the given standard, a second to manage risk. Or even worse that a single risk management system will be created within the confines of the standard rules rather than first and foremost for the purposes of that bank. On both counts banks would fail the proposed use test.

The implications for the rational application of the new Accord are as serious. The introduction of standard rules at the level of detail also creates a network of boundaries which mark significant breaks in the regulatory capital regime. It is of particular concern where these boundaries exist in the rules but do not match a constant economic reality. For example some of the issues raised by the reference definition of default (see below).

Minimum standards are necessary but should be focused upon the delivery of enough consistency to allow comparable performance analysis and to provide standard inputs into the regulatory model. A regulatory reference definition of default, for example, is an absolute requirement. Overall a better balance should be struck between minimum operational standards and minimum output standards. The bulk of the BBA/LIBA response in this area is a list of minimum requirements that have the potential to distort or divert internal risk management practice or the functioning of the new Accord. The volume of issues has driven BBA/LIBA to conclude that a re-orientation or re-balancing of approach is required in this area. BBA/LIBA advocate an approach that relies in equal parts upon core minimum standards, methodological guidance and validation.

Transitional data requirements

BBA/LIBA support the transitional data requirements as a reasonable standard except in the instance of the 7 year requirement for LGD and EAD. The requirement will act as an unreasonable restraint upon the ability of banks to enter the AIRBA. On this point BBA/LIBA would propose a 5 year standard, consistent with the standard for PD data, and no transitional concessions. As a general point BBA/LIBA would suggest that supervisors give equal weight to the quality, as well as the length, of the data series. Certainly BBA/LIBA would object to the requirement that if a longer observation period exists then this should be used (para. 283). The period varies by portfolio but there exists a point beyond which data ceases to be relevant to current conditions and produces only a meaningless, or misleading, average.

Categorisation of exposures

BBA/LIBA accept the proposed exposure definitions except in the instance of retail (see below) and project finance. On project finance property investment companies should generally be included in the corporate approach, or at least there should be no standard presumption, but a categorisation based upon the substance of the facility and relationship.

30% per grade rule

The Committee currently require that "no more than 30% of the gross exposures should fall in any one borrower grade". BBA/LIBA believe that such an arbitrary standard is unhelpful and, in view of the ease with which it could be gamed, meaningless. There are various good reasons why one might see such concentration in niche markets, for example the inter-bank markets. BBA/LIBA would propose that if the requirement persists, then regulators should instead use 30% as a guide (or trigger for supervisory review) and have confidence in the application of all the other minimum requirements.

Rating per legal entity

The current proposals require that "each separate legal entity to which the bank is exposed should be separately rated." BBA/LIBA believe that this requirement is unnecessary and unhelpful. Various

examples can be advanced where this rule should not apply, for example group overdrafts. Unless addressed the industry believes that this requirement could substantially add to the costs of implementation with no corresponding prudential gain. The present presumption that you can take no comfort from ownership simply does not reflect commercial reality.

BBA/LIBA would propose that the request for a separate rating should be based on a 'per Credit Agreement' basis. The key is the scope of risk that has been taken by a bank. The scope is normally defined in the agreement with the borrower (regardless whether multiple separate legal entities are allowed to draw under one and the same agreement). Therefore, the proposal could be re-worded as follows: 'Each borrower within a given portfolio must be assigned a rating before any loan is originated. In respect of connected borrowers, each separate credit agreement under which the bank is exposed should be separately rated.'

Independent review and internal audit

BBA/LIBA understands and is supportive of the review of ratings carried out by an independent unit or individual. Again we are concerned that in the creation of a rule the Committee must be aware of those circumstance that do not, for good reason, fit the model approach. This model works well in an environment or in an organisation, that has a centralised mechanistic rating process functionally separate from the business. This is the norm in a number of markets, notably in lending to large, listed and externally rated counterparties. The ratings process in organisations which operate cross border or which have substantial middle market exposures is often more diffuse. For accurate rating of middle market clients it is necessary to have people who understand the local market, the quality of financial information available, and have a good knowledge of the customer. In this environment, delegation of authority below agreed materiality limits is an absolute operational requirement.

All of this has implications for an independent review model based upon a central process and unit. BBA/LIBA propose this requirement needs to be made sympathetic to risk rating processes that deviates from the model. This would include an appreciation of delegated authority, the necessity of sample testing, materiality limits and market efficiency. BBA/LIBA believe that this could best be effected by the re-characterisation of what is now a rule as guidance.

Annual review or re-rating.

Related to the above the current proposals suggest that borrowers should be reviewed by an independent unit on an annual basis, or sooner if new information comes to light. In addition, a process should exist to update risk ratings within 90 days of the receipt of new information, or within 30 days if that information suggests deterioration. This requirement should be redrawn as guidance. Bank management should have the discretion to re-rate. In the instance of low risk exposures, in particular, this requirement is inappropriate.

Senior management oversight.

The current proposal requires that the Board should demonstrate an understanding, and approve all material aspects of the internal rating system. This requirement is to be supported by detailed reporting. BBA/LIBA would suggest that this represents a mis-understanding of the role of the Board and the number and complexity of rating systems that a bank may operate. Management discretion should be the basis of all Board/senior management reporting in terms of scope, frequency and presentation.

Internal and external audit

The requirement for internal audit to review the full scope and detail of the internal ratings based approach goes beyond what is reasonable. Internal audit practice in many institutions demonstrates an effective concentration upon risk process and sample validation. Allowing internal audit to

concentrate resources upon issues of consequence rather than attempting to duplicate the consideration of every item. If a literal application of the proposed rule stands BBA/LIBA would be concerned that it would be a retrograde step for risk based internal audit. The proposal may also place too burdensome requirements on firms which do not currently have the necessary expertise in house to independently review all aspects of a model. The Accord should therefore clearly allow for the use of independent external parties to conduct certain reviews.

Borrower risk assessment

The proposed minimum criteria for borrower risk assessment were considered appropriate only as a guide rather than a rule and in some instances irrelevant. The factors that are relevant to the assessment of borrower risk are widely varied and prescription of standard analytical inputs is unhelpful. Again we suspect that these requirement have been drafted in the context of lending to large, publicly listed corporates. It is difficult, for example, to understand the relevance of these factors in middle market lending. This requirement should be redrawn as guidance.

Minimum requirements for the estimation of PD

BBA/LIBA are concerned that there is currently no clear articulation of the conceptual basis of a PD based rating system. The current requirement for a forward looking, conservative, one year long run average based upon historical experience PD is confusing and in places contradictory. It is also unclear whether PD is borrower or transaction specific (paragraphs 238-239). Clarity is required. We would wish to confirm that the objective of the Committee is to obtain a clean estimate of the probability of borrower default over a one year horizon based upon the consideration of both historical experience and borrower condition.

Reference definition of default

As noted earlier BBA/LIBA believe that consistency in the measurement, and therefore the definition, of the probability of default is an absolute requirement of the new Accord. In broad terms BBA/LIBA would support the intent and the formulation of the current reference definition of default. It is right to attempt to strike the difficult balance between consistency and flexibility. Within this general welcome BBA/LIBA would note a number of significant concerns.

In the first instance BBA/LIBA would note that the proposed reference definition of default is in fact a mixture of impairment and default. Furthermore, by insisting on a rigid "90 days past due" rule banks will have to record a regulatory default in instances where no economic loss is envisaged and no provision allocated - for example the current definition will capture local authorities which are habitually slow to pay. The cumulative effect of such exceptions will have a distorting effect upon certain credit markets or internal risk management. For example it may lead banks to encourage customers to keep loan indebtedness current (or rather within 90 days) at the expense of overdrafts. Or, depending upon how banks decide to collect data to calculate PDs, it may force banks to transfer assets to realisations/recoveries' functions, which would not add value and would not be an economically sensible use of resource.

The preferred BBA/LIBA solution is to enable banks to apply broader judgement as to when default is called, the objective being to ensure the regulatory breakpoint matches an economic reality. The process will, after all, be subject to far greater internal and external scrutiny in categorising defaults as such and calculating PDs robustly. BBA/LIBA is particularly concerned that there is no automatic linkage between the reference definition and the regulatory capital treatment of non-performing loans. BBA/LIBA would like to see a link to international accounting standards which define when an impairment has occurred and provisions made, rather than an arbitrary cut off date for overdue payments.

BBA/LIBA would propose that the current reference could usefully be amended to overcome this and associated issues. The amendments as follows:

1. limit 'defaults' emanating from restructured credits to those that carry terms which are more onerous or more heavily priced than open market credit terms

2. limit defaults called where the borrower is 90+ days past due to those situations where the debt is to be crystallised and the customer relationship is terminated.

The definition in all instances should explicitly exclude those cases where a bank has good reason to believe it will receive good value and where the customers ability to repay all sums due is not in question. The current reference definition also contains an implicit assumption of cross default. BBA/LIBA would note that there are, and should be, practical limits to this assumption. Clarity would be useful on this point.

BBA/LIBA have also given consideration to the relevance of the given reference definition of default across exposure class. The current definition is acceptable as the basis for corporate exposures but works less well for bank, sovereign and retail. For banks and financials institutions an alternative might be that a default is considered to have occurred when one or more of the following events have taken place:

1. entered administration

2. entered liquidation

3. had its authorisation revoked, or

4. voluntarily surrendered its authorisation, except when motivated by corporate restructuring (e.g. following take-over) or by a strategic review of the benefits of the licence

The issues connected with the read across to the retail book are dealt with specifically elsewhere. BBA/LIBA are exploring the basis of an alternative reference definition for sovereigns.

Even in the event of these amendments it is clear that the implications of monitoring all four elements of the reference definition, across a global banking book segmented by business unit, will be considerable. To an extent this burden is an inevitable consequence of the reform process and an acceptable price relative to the cost of imposing a standard definition. To a degree banks will be able to build this requirement into their forward systems planning.

The treatment of historical data sets is of more concern. BBA/LIBA would argue strongly that the Committee give consideration to grandfathering data series developed prior to the finalisation of the reference definition of default. It is clear that these data sets were not developed to game an unknown future regulatory standard and it would therefore be unreasonable to penalise institutions which have invested in internal data collection. This concession would be rescinded upon finalisation of the new Accord.

Minimum requirements for PD estimation

BBA/LIBA welcome the Committee's acceptance that PD estimation can be based upon internal default experience, mapping to external data or statistical default models. In an environment in which data is limited it makes sense to allow banks the flexibility to use what is currently available, within sensible guidelines, and also to provide incentives to develop more. In particular we expect that the support for pooled data series will bear fruit in the near term.

BBA/LIBA understand that the mapping process should be undertaken on a conservative basis but would be concerned if the interpretation of that requirement resulted in undue restrictions. For example it is not clear whether US corporate default data would be considered relevant to the assessment of European corporate risk under the terms outlined (paragraphs 274-282). It can be anticipated that the impact of a narrow interpretation would be particularly felt in sovereign and bank debt markets where default data is scarce. This low incidence of default makes it unlikely that an institution will be able to meet the current IRB requirements on the basis of internal data. A pragmatic approach will be required if low risk asset classes are not to be excluded from the scope of the IRB. BBA/LIBA would wish to emphasise that in such instance no alternative exists other than to map across external data sets. BBA/LIBA would be keen to pursue further dialogue with the Committee on this issue.

The above comments relate to the Foundation approach but BBA/LIBA believes that this is an issue that potentially impact the utilisation of the Advanced approach. It is likely that global organisations will have portfolios in certain countries for which only part of the information to support the advanced approach (most likely an estimate of PD) will be available. Industry practice would suggest that it should be possible to use suitably prudent estimates of other measures (EAD and LGD) from similar portfolios that fully meet the requirements of the advanced approach. Again BBA/LIBA would urge the Committee to take a pragmatic approach to this issue.

BBA/LIBA supports the requirement that banks should store the data to support their internal credit risk measurement and management process (paragraphs 284 - 288). The storage of key data on clients and the maintenance of robust MIS is good practice. However, if taken literally, the data collection and IT systems requirements will mark a step change in the volume of risk data for little added risk management value. For example the requirement to hold data to enable the retrospective rating of obligors is unreasonable and unnecessary. BBA/LIBA propose that there needs to be either flexibility in application and a more focused articulation of regulatory objectives and requirements.

Usage test

As noted in the introduction to this section, BBA/LIBA are convinced that the use test should be the foundation and objective of the IRB minimum operational requirements. As currently constructed the minimum operational requirements make this an unachievable objective for the majority of banks. Unless modified we believe that the result will either be the maintenance of dual systems or the constraint of industry practice. Neither outcome is desirable and both would negatively impact the achievement of industry and regulatory objectives.

Internal validation

BBA/LIBA support the introduction of internal validation standards. Indeed, as noted above, we would recommend that the Committee should place more reliance on validation and, in compensation, revise the current reliance upon process standards. The industry argues for a balanced approach recognising the limitations of credit risk validation relative to standards articulated for market risk models. Rather validation should concentrate upon a practical demonstration that the internal rating system is delivering a robust and continuing assessment of credit risk rather than percentage point accuracy. For example, this would be demonstrated through a demonstration that the risk assessment system is capable of differentiating risk, that ratings are stable and through mapping to external benchmark.

5. Retail exposures

Overview

BBA/LIBA would wish to emphasise how welcome the new proposals on retail portfolio are and what a substantial advance on the June 1999 proposals they represent. As argued in the BBA/EBF/ISDA Retail Portfolio Study it is right to include retail portfolio within the internal ratings based approach but on a basis that recognises the difference in risk profile and risk practice.

Broadly we believe that those proposals are moving in the right direction and have the right objective but, in common with other areas, have significant concerns at the realisation. To a large degree the current retail proposals are an adaptation of the already developed approach to corporate exposures, this extending to the calibration and methodological standards. This works in general terms but in some instances adaptation is unsustainable and new approach is required. BBA/LIBA would hope that these issues are addressed as part of the continuing consultation on this area over the balance of 2001.

5.1 Retail risk weighting function

BBA/LIBA **s**upport the proposed 50% adjustment to the corporate risk weighting function when applied to retail exposures as proposed by Basel. It is in line with the previous position of BBA/LIBA as expressed in their March 2000 response and in the BBA/EBF/ISDA Retail Portfolio Study of September 2000. In recommending the current calibration, BBA/LIBA did not anticipate a calibration to the sum of both expected and unexpected loss.

BBA/LIBA believe that the impact of the current calibration of the corporate risk weighting function to the sum of expected and unexpected credit losses bears relatively harshly on retail portfolios characterised by a stability of both expected loss and core margin income. If the current relative calibration persists un-amended then BBA/LIBA would be concerned that this will have an unreasonable impact. The cost to be borne within product portfolios, such as credit cards and mortgages, is critical to the interests of the majority of banks and consumers.

To address this potential imbalance BBA/LIBA would argue for recognition of expected margin income or provisions against expected loss in the retail book. Specifically BBA/LIBA would propose that banks, subject to a Pillar 2 review process, apply a risk weighting function which excludes expected loss. That Pillar 2 assessment process should satisfy regulators that either core margin income or provisions are available to cover expected loss. It is right that this process should focus upon the stability of both margin income and expected loss over a reasonable period.

Risk components

BBA/LIBA support the exclusion of maturity from the retail approach. It is however concerned that the retail risk weighting function implicitly contains a 4% uplift factor for granularity. Retail portfolios by their nature do not contain large concentrations and this uplift factor should be removed.

5.2 Minimum requirements for retail IRB approach

Definition

A clear consensus exists that the definition of retail should be risk based and not focused on either absolute values or an absolute definition. Rather the definition should be based on portfolio characteristics and methodological approach. BBA/LIBA would propose the following primary portfolio characteristics:

- Homogenous product group
- Granularity

The methodological approach reflects these factors and suggests loss forecasting methodologies which have a tendency toward objective statistical analysis based upon loss data. In addition BBA/LIBA believe that a defining feature of retail portfolio is a concentration upon customer behaviour and the use of behavioural models.

There is no appetite for further differentiation of the retail portfolio in general and no need for the disaggregation of the mortgage portfolio in particular. Any difference in risk profile will be driven and evidenced by differing LGD values.

SME exposures

BBA/LIBA support the inclusion of SME exposures within the retail portfolio where the SME portfolio meets the general risk based definition. The term retail banking is generally taken to refer to lending to individual clients. However, for many banks, lending to very small companies (including the self employed) is closer in nature to lending to individuals than it is to corporate lending, which generally implies a long-term continuous relationship and multiple loans to each counterparty. Thus it is often the case that statistical decision support tools used in loan issuance (scoring, expert systems, etc.) and recovery, are similar to those methods commonly applied in the individual lending market. It is therefore very important that the differentiated treatment of retail exposures is applied to all lending portfolios where the methods applied to risk control follow the same 'industrial' approach to loans, both at issue and in recovery.

Definition of default

BBA/LIBA support the adoption of a reference definition of default in the retail portfolio, but only as a reference definition for the determination of regulatory capital. The reference definition as proposed, is broadly relevant to corporate portfolios but not to retail exposures, due to the following reasons

- The concept of default in the retail portfolio more often marks an analytical break point than an economic event.

- The concept of cross default does not apply well in the retail book as an individual borrower may default on a credit card facility while continuing to repay a mortgage loan.

- The definition of default may differ by product category, usually later for secured products and earlier for unsecured loans.

Probability of Default (PD) in retail portfolios (at least for newer portfolios) will typically be determined using application, behavioural or performance scorecards. Scorecards are built to predict the probability of a certain event occurring. This event, often called the ‘bad’ event, is defined prior to building the score card and is based on the various management purposes the score card will serve. Conditions bounding scorecard development can include availability of certain data, a trade off between an optimum ‘bad’ definition and one where sufficient data is available to build a statistically robust scorecard. It may also be that one factor has been clearly identified as being the most statistically satisfactory predictor of ultimate loss. Either way there is almost certainly a clear correlation between default (as defined by the ‘bad’ definition) and ultimate loss.

Reported default rates will therefore usually be related to the probability of reaching XX days overdue within YY months of the decision being made. The magnitude of XX and YY will reflect the nature of the portfolio and the dynamics of the default building over time. For example, a credit card portfolio may be 60 days overdue within 9 months and a mortgage portfolio may be 90 days overdue within 30 months.

To monitor the performance of the credit decision system (scorecard) will require tracking against the 'bad' definition selected. A time series of data will be held to both monitor the scorecard and have data on which to rebuild or realign the scorecard when required in the future. Even if there was a correlation with the Basel reference default definition it would not be a definition which was used for day to day credit management purpose other than capital adequacy. This would therefore fail the use test. Score cards are often amended to enhance performance and the historical reference definition may be amended. In addition lenders may not have any performance history based on Basel reference definition.

Despite the various issues highlighted above there is a need to have a common reference definition of default for application of the Basel retail risk weight formula; otherwise it leaves scope for abuse in its individual interpretation while applying the formula. An earlier definition of default with higher PD but lower LGD gives rise to a more favourable risk weighted exposure for capital purposes.

Example: If a portfolio (definition of default = 90 dpd) has a PD of 0.88% and LGD of 20.53%, the RW of the portfolio is 24%

As the LGD lowers with the definition of default being brought forward to 60 dpd (new PD of 1.7% and LGD of 10.61%) the RW of the portfolio lowers to a more favourable 20%.

BBA/LIBA have considered various alternatives to the current proposed definition, including a "no reference definition solution" applied within a retail approach based solely upon EL. These have been disregarded in favour of a simple standard definition and a flexible mapping process. For example if the current internal mapping of a bank is based on 60 days past due (dpd) and we have to move the reference definition of default across to 90 days. One can determine the PD based on flow rates to 60 dpd, define LGD based on recovery on any account ever 60 days past due and derive an EL using the formula in option 1.

Using the same portfolio recalculate the flow rate to 90 dpd to get a new PD and amend the LGD to retain the portfolio EL same as above. The EL for this analysis remains the same as the actual historical loss (to which the EL averages to) of the portfolio does not change. The customer accounts are already on the lenders books based on an earlier definition of default and a particular score cut off.

An example from a sample portfolio to illustrate:

PD derived on flow rates to 60 dpd = 1.7%, LGD = 10.61 and EL = 0.18%
PD derived from flow rates to 90 dpd = 0.88%, we can derive the new LGD base EL/PD 0.18/0.88 or 20.53% to keep the EL same at 0.18%. Alternatively derive the new LGD by looking at the flow rates from 60 to 90 dpd which averaged 51.8 %.

This option needs to be developed further and BBA/LIBA would welcome further dialogue with the Committee.

It should be noted that any proposed reference definition is explicitly referenced to a particular facility rather than obligor. This is because the concept of cross default does not hold in the retail environment. For example passing 90 days past due on a credit card does not automatically imply that the same individual will default on their mortgage. Additionally we would suggest that the 90 day rule is applied sympathetically and that banks who have, for example, constructed a system based upon 3 calendar months should not be required to make major systems changes.

Segmentation

BBA/LIBA believe that any rules on the basis on which segmentation should be undertaken would be counter productive. Rather, beyond a minimum number of buckets, BBA/LIBA is strongly in favour of complete flexibility of approach. An open approach would resolve a number of difficult issues:

inclusion of behavioural scores, customer orientated risk management, the absence of application scores on old accounts. It would also allow banks to pursue a purely risk based approach and future proof the new Accord.

The division of exposures into homogeneous segments is an important part of the risk management of retail assets. Each segment should be as homogenous as possible with respect to the credit characteristics of the assets within it. However, each segment must also contain a sufficient number of assets to allow statistical estimation of default probability, severity, and exposure at default. There is therefore a tension between achieving homogeneity, which would naturally tend to increase the number of segments, and having statistical significance, which would tend to restrict the number of segments. Getting the right balance between these two is extremely important.

The suggested segmentation in the draft proposal may not be appropriate for all portfolios. The most ideal segmentation is likely to differ between products, jurisdictions, and even between banks within the same jurisdiction. The key test is that the characteristics chosen by the bank should be those used internally to manage the business. Each institution should be free to choose the segmentation it deems most appropriate, and specific segments should not be made compulsory. The institution should justify its chosen scheme (on the basis of performance) to the regulators in the supervisory review process.

Not allowing an institution to choose its own segmentation will lead to a number of problems:

- The most appropriate variable to distinguish borrower quality may well change over time. For example, an application score may be appropriate for the initial few months, after which a behavioural score may be a better estimate of default probability.

- New techniques for assessing the risk of a portfolio are being continually developed. The proposals are not sufficiently flexible to allow for this.

- New products are also being continually developed. It is important that the proposals are able to accommodate such market developments.

- The “tension” described above implies that a bank should optimise its choice of segments by using those which are most discriminating. However, if compulsory segments are set which are less discriminating, then banks will either have to use a sub-optimal segmentation, or have unduly small populations in some parts of the overall segmentation.

- The current proposal uses “product” as one of the segmentation factors. This does not fit with a single/whole customer orientated risk management view.

- Assets which do not have the requisite attributes may lead to these assets being unfairly penalised. For example, assets originated prior to the introduction of scorecards may be unscored. However, because they are “old” assets they are likely to have performed for an extended period, and therefore be of very high quality. A more flexible segmentation scheme would allow for these assets, where it can be established (e.g. from delinquency rates) that they are of higher quality, to be treated favourably.

The key point is that, whilst a bank should be free to choose its own segmentation, it must be capable of mapping each of these segments to a probability of default, LGD, and an EAD. This mapping will ensure that capital levels are consistent over time, across products, across jurisdictions, and across individual banks.

Data mapping and collection

In common with the general corporate approach BBA/LIBA have concerns at the proposed requirements for data mapping and collection. For retail portfolio any systems or data issues are amplified by the sheer volume of exposures involved, millions rather than thousands. As noted in comments in the corporate IRB approach the data storage requirements are very substantial and will require an industry level step change. Again the requirements to retain a capability to re-grade entire portfolio is excessive and, as detailed below, inappropriate. Further dialogue on this issue will be required, as will discussion of the general carry across of minimum standards from the corporate to the retail approach.

Risk assessment and validation

Regulators will face something of a conundrum when setting validation standards for retail models and scorecards. The Basel papers frequently refer to, or call for, long run data series to validate models and assumptions. On the other hand, they also want models to pass the "use test". In practice, retail scorecard builders make regular adjustments to their models, believing this to be necessary in order to keep up with rapidly changing customer behaviour in the retail marketplace. In other words, it is widely believed that scorecards need frequent modification in order to remain predictive and useful. This would, for example, contradict the requirement to use the longest run data series available (paragraph 272). Additionally it does not make sense that risk assessment techniques built for their predictive value should be tested on the basis of their performance when applied to historical situation. It is simply not legitimate, except within a very limited retrospective period, to test current models by reference to how they would have performed in the past.

Validation needs to be suitably defined in order to accommodate this practice. For example practice within banks might typically include the following elements:

Segmentation

- The chosen level of segmentation should utilise key variables which are likely to have a significant impact on the accuracy of the loss forecast.

- Banks should continue to review the appropriateness of the segmentation approach adopted to ensure that it continues to remain valid and look to identify any potential improvements that improve accuracy.

Historic Data Sets

- Ensure the availability of historic data sets at the appropriate level of segmentation that will provide robust results.

- Pay attention to differences in trends over the short, medium and longer term to identify:-

    - recent trends which may need to be given more emphasis
    - one-off exceptions which may need to be ignored or adjusted for
    - seasonality

Model Development

- Models should be developed using a standard statistically valid approach

- Alternative methodologies should be used where appropriate and also considered as a secondary means of validation to confirm the forecast provided by the primary model

Results

- Loss forecasts should be reviewed regularly with actual results compared to the original forecasts to identify variances

- Variances should be analysed to confirm that the original models remain valid and/or to identify ways in which the models could be improved.

BBA/LIBA anticipate pursuing further work on retail validation standards in the near term and would welcome a dialogue on this and all the other issues raised relating to retail exposures.

6. Project finance and asset finance

Overview

We welcome the fact that the Committee has recognised the fundamental difference between project finance and other types of finance and that they should, and perhaps have to be subject to a different treatment.

Definition

BBA/LIBA broadly accept the definition of project finance provided by the Committee. BBA/LIBA have three minor comments on it, which are detailed below. Consideration should be given to incorporating the specific characteristics of project finance. In general, project finance represents lending in partnership with sponsors to a unique, usually immobile, asset where the primary risk drivers are completion and performance of the asset being built. These factors are reflected in the Committee's proposed definition. Size is also generally a characteristic. Importantly, in addition, recognition should be given to the nature of the covenants which are imposed by lenders. In the main, these are written to trigger opportunities for refinance or restructuring, rather than as protection against credit risk. BBA/LIBA make this point below in considering default, under regulatory challenges, but feel it should be recognised in devising an appropriate definition, or at least guidance towards a definition.

Apart from this, the three detailed points are:

- "loans" is a rather narrow term for the range of financing instruments used; a better word might be "financing transactions";

- a further characteristic of the market, and one which speaks to the quality of risk management which is one of its characteristics, could be reflected in the addition of the words, "The performance of the project is, typically, monitored against projections on a regular basis."

- the term "warrant" could be interpreted as meaning "guarantee", which we assume was not the Committee's intention. If it was so intended, we believe that this is misguided and unacceptable.

Whilst it may not necessarily form part of a definition, it is generally true that the risks of the financing will be mitigated not only by charges over the relevant assets and/or cashflows but by the robustness and commerciality of the contracts which detail the project.

As regards the categories of transaction, which might fall within the definition, these are offered as guidance. BBA/LIBA suspect that lending for "raw land" or lending for construction will rarely meet the criteria. However, where it does, it should receive the appropriate regulatory treatment. In addition, and related to this, lending on investment property should be considered separately.

Regulatory challenges

BBA/LIBA believe the Committee has identified the principal challenges in arriving at an appropriate capital regime. In particular the unique nature of each project precludes validation of gradings through historic data. Before considering the types of rating or grading systems currently used by banks, there are two important points to make.

The nature of project financing is that projects are structured against cash-flow and are generally subject to frequent review of progress against projections and forecasts, via coverage ratios, performance targets and other covenants. From these, the probability of a problem is identified and

an assessment made of the likely loss. This may, and often will, result in a restructuring of the project or of its financing, rather than be reflected in crystallisation of the position and lead to a work-out.

In addition, default may, and frequently is, called as a result of a covenant breach, which may reflect the failure to provide information on the due date. Usually, this does not reflect an increased probability of loss. The concept of default is therefore very different from that used in the corporate lending field.

Rating and grading criteria

In general, project financing are graded on a basis which, in its attempt to reflect the probability of project default, is necessarily different from that used for the corporate book.

It will be derived from an assessment of a number of elements. These range from objective, quantitative elements such as cashflow and debt service coverage, including assessments of the robustness of those projections, to assessment of such risk factors as: technology supply contract demand (off-take) contract completion risk operating risk country risk environmental risk. Most of these are subjective and reflect the various parties to the contract as well as the legislative framework and jurisdiction in which disputes will be resolved. In sum, the grading ascribed will largely reflect experienced judgement. The important factor to bear in mind is that, as a result of the regular reviews to which projects are subject, all of these factors are probably being reviewed on a rolling basis, the trigger for action being a material change to the EL which has been assessed. Given the unique nature of projects, however, this EL cannot be validated with any accuracy.

To answer the Committee's specific questions, therefore: rating grades are assessed from a basis of objective and subjective elements to reflect the bank's existing loan grade structure; the assessments are primarily aimed at assessing cash-flows and their vulnerability; the orientation of the system is to a 2-dimensional (EL and EAD) approach; the nature of projects means that they are subject to more frequent review than the generality of corporate lending.

Project finance and the IRB approach

BBA/LIBA welcome the fact that the Committee has recognised project finance as a distinct asset class and is developing a differentiated approach to the assessment of capital adequacy within the general IRB structure. It is hoped that any eventual solution will recognise the generally favourable loss record of lending in this asset class. BBA/LIBA believe that experience shows, certainly in certain markets, that projects have an extremely good loss record. BBA/LIBA are keen to work with the Committee to achieve an approach that is built upon industry practice in the assessment of project risk.

Asset finance

BBA/LIBA believe that there are forms of asset finance that should also be included within the scope of the IRB approach on a basis which recognises a difference in risk assessment methodology and risk profile. In particular application of the standard corporate 50% LGD assumption is harsh for assets secured by receivables, trains, planes, ships and cars. These assets should be recognised as eligible collateral.

Asset finance could itself usefully be divided into two categories, which are recognised throughout the industry – big ticket finance of assets such as aircraft, ships and trains, and small ticket asset finance, such as for motor vehicles or office equipment. Asset finance has similar characteristics to project finance, but with the difference that repayment, as well as coming primarily from the cash flow of the asset can, in extremis, come from sale of the asset itself.

With regard to big ticket asset finance, BBA/LIBA are aware of work which has been, and is being, undertaken by Aviation Working Group and International Air Transport Association, as reflected in their letter to the Committee. The letter highlights the very low loss experience of this particular sector. BBA/LIBA believe similar claims can be made for ship finance, therefore urge the Committee to work with appropriate industry groups to collect data and assess criteria under which recognition could be given in a reduced LGD for these types of finance.

With regard to small ticket finance, BBA/LIBA are similarly aware of the work which the Finance and Leasing Association (FLA) is undertaking to ascertain loss levels for other forms of asset finance. The statistics provided to the Committee by the FLA demonstrate the very low loss experience in leasing. Again, would urge the Committee to explore with the FLA and other specialists the data which is available to support a reduced LGD for this form of finance.

Members of the FLA are also, largely, members of the BBA through their parent banks. who would therefore welcome working with the FLA and the Committee on developing a risk-sensitive approach for asset finance.

7. Asset securitisation

Overview

This section of the response has been developed jointly between BBA/LIBA and ISDA (the International Swaps and Derivatives Association). The associations welcome the Basel Committee's focus on asset securitisation and its objective of introducing consistency between different national supervisors in their treatment of such techniques. In particular we believe the Committee's proposal that the ratings of Eligible External Credit Assessment Institutions (ECAIs) be used in setting capital requirements is helpful. The ability to set lower levels of capital against highly rated asset-backed securities (ABS) is a recognition of the lower risk of such instruments. It should result in more appropriate portfolio management decisions by both originators and investors in ABS.

7.1 The rationale for securitisation

The Committee's proposals appear to reflect its belief that the primary motivation for securitisation is capital arbitrage. However the associations believe that the benefits of asset securitisation are that it promotes better capital management by:

- creating the freedom to exchange financial assets amongst market participants, thus enhancing liquidity, both within a bank's balance sheet and externally;
- transferring credit and operational risk to those institutions best able to understand and manage it;
- facilitating portfolio management so that issuers can match liabilities to the tenor of assets;
- enabling banks to optimise the risk-return profile of a portfolio and to manage concentration and diversification accordingly;
- diversifying issuers' sources of capital, allowing an issuer to minimise funding costs, even in a deteriorating environment, reducing its dependency on traditional financing routes;
- creating new structures, the benefits of which can be passed on to end-users as lower borrowing costs in their financing of the underlying assets;
- focussing an institution's attention on the quality of its loan origination and administration process, so that it has appropriate systems, documentation and organisational structure to manage its asset portfolio;
- stimulating functional specialisation by separating origination, administration and funding which maximises the efficiency, flexibility and responsiveness of the financial system.

As currently structured the Committee's proposals on securitisation will provide a disincentive for financial institutions to manage their risk via asset backed or synthetic structures. Our interpretation of the proposals is that substantially more capital will be allocated to ABS transactions as the table below shows:

Securitised Assets	Nominal	Basel 1988 100% RWA	Basel 1988 50% RWA	Standardised	FIRB1	FIRB2	FIRB3	AIRB
AAA	1,000,000,000	80,000,000	40,000,000	23,750,000	33,425,832	16,712,916	8,356,458	18,803,703
AA	1,000,000,000	80,000,000	40,000,000	23,750,000	39,735,110	19,867,555	9,933,778	21,754,485
A	1,000,000,000	80,000,000	40,000,000	59,375,000	65,095,738	32,547,889	16,237,935	32,769,692
BBB	1,000,000,000	80,000,000	40,000,000	118,750,000	149,820,474	74,910,237	37,455,119	129,374,929
BB	1,000,000,000	80,000,000	40,000,000	178,125,000	334,638,364	250,975,773	187,319,182	373,780,156

Assumptions

Standardised Risk Weights	IRB PD	FIRB 1 LGD	FIRB 2 LGD (ABS)	FIRB 3 LGD (MBS)	AIRB LGD	AIRB Maturity
20%	.03 %	100%	50%	25%	25%	7 yrs
20%	.04 %	100%	50%	25%	25%	7 yrs
50%	.09 %	100%	50%	25%	25%	7 yrs
100%	.34 %	100%	50%	25%	50%	7 yrs
150%	1.20 %	100%	75%	50%	75%	7 yrs

Notes:

A trigger ratio of 9.5% is assumed - 8% plus 1.5% pillar 2 increment
A 20% Operational Risk charge is included
IRB PDs are indicative only and would be different for each institution
FIRB1 has LGDs set to 100% as per current proposals
FIRB2 has LGDs set at more realistic levels as per this response
FIRB3 has LGDs set at more realistic levels for MBS
AIRB LGD and PDs set to indicative levels (i.e. not substantiated by any industry wide data)
AIRB Maturity assumed at maximum of 7 years, given that the average legal duration would be expected to be around this level

Securitisation potentially transfers some types of risk out of the banking system whilst allowing those risks which banks manage best to be retained in it, bringing a net increase in systemic stability. The imposition of further capital on the ABS process as suggested by the above table would act as a brake on this beneficial risk transfer process.

A general comment

Where risk is transferred out of the banking system there should be an overall reduction in the capital required. If extra capital is required in one area, perhaps because of the nature of a particular role played by a bank, then the amount of capital required in other areas should be correspondingly reduced, so that no extra capital is added to the banking system.

BBA/LIBA are uncomfortable with a differential approach being applied dependent on whether the bank is an originator or investor. They believe the Committee should focus on the nature of the risk retained or transferred and the concomitant amount of capital that is required or released, rather than the status of the owner of the ABS.

Transition

The Committee’s proposals could have a significant impact on the economics of pre-existing ABS. Significant unwind costs could be incurred by banks were they required by the new capital adequacy framework to replace/amend hedges supporting existing structures which did not benefit from early call options.

BBA/LIBA suggest that only new cash or synthetic ABS deals launched after the announcement of the Committee's final proposals should be subject to the provisions of the new Capital Accord.

7.2 Securitisation under the Standard approach

Treatment for Originating Banks

Minimum capital requirements for liquidity facilities

A 20% credit conversion factor for liquidity facilities has been proposed. BBA/LIBA believe this is too high, given that these facilities are extremely rarely drawn. If a facility is a real liquidity facility, with reimbursement of the cash advance ranking ahead of payments to investors, there should be no need for any incremental capital to be allocated. We suggest that facilities should be regarded as purely for liquidity purposes if they have the following characteristics:

- drawings
  - can only be made to cover cash flow timing differences, not to support a structure's financial condition
  - benefit from the ABS security package

- reimbursement of liquidity advances
  - is made from portfolio cash flow received immediately after the relevant advance
  - is not subordinated to investors' cash flow

The identification of the nature of the liquidity facility would be made by the liquidity provider but subject to supervisory review.

Liquidity facilities are structured to prevent the funding of non-performing assets through the inclusion of asset quality tests. No incremental capital is needed. However if the Committee does decide to impose a credit conversion factor 10% would be more appropriate.

Furthermore BBA/LIBA seek clarification of whether the capital allocated to liquidity facilities will be a function of both the credit conversion factor *and* the rating-dependent weighting. This currently is unclear but we believe that this would be consistent with the Committee's general approach.

BBA/LIBA recognise that a credit conversion factor should be allocated to liquidity facilities with maturities in excess of one year but believe that 20% is a more appropriate level. This factor should not be applied however when liquidity facilities are subject to a genuine annual review at which non-extension of the facility is a possible outcome.

Where it is deemed appropriate to allocate capital against these facilities the credit risk weighting used should correspond to the *average* quality of the underlying assets, based on the originator's knowledge of the assets that it is removing from its balance sheet.

Minimum Operational Requirements for revolving securitisations with early amortisation features

The Committee plans to apply a minimum 10% credit conversion factor to the underlying risk weighting of the off-balance sheet asset pool in revolving credit facilities with early amortisation features.

The Consultative Document seems to indicate that non-economic triggers, such as the breach of a performance covenant, perhaps in relation to the originator failing to provide support services, do not

give rise to risks with which it is concerned. We concur with this, as the credit quality of the underlying assets is only compromised when an economic covenant is breached. However we seek confirmation from the Committee that this is its view.

We consider that a capital charge (of 10%) might only be appropriate where economic triggers within the structure allow investors' interests to be amortised at a greater rate than the amortisation of the underlying asset pool.

In fact, depending on asset type (e.g. term and mortgage loans), revolving transactions already impose an implicit additional capital charge as credit enhancement levels (as a proxy for capital) are generally greater for revolving transactions than for amortising transactions based on the same initial pool. For synthetic transactions that do not use excess spread for credit enhancement, the additional capital effect can be more extreme.

However if the Committee does not agree with this suggestion we propose that different approaches should be developed, depending on the underlying asset class. For instance there is less risk in a mortgage or term-loan backed structure that incorporates a replenishing feature and this should be reflected in the Committee's approach.

Finally BBA/LIBA seek clarification from the Committee as to whether its concerns relate solely to revolving credits (i.e. assets where there is an ongoing obligation to fund) or revolving structures (i.e. where sales of assets by the originator to the issuer take place more than once, typically monthly or quarterly). Revolving structures may of course be comprised of either revolving credits or term credits.

Treatment for investing banks

BBA/LIBA welcome the Committee's helpful suggestion that external ratings be used by investing banks to assess capital requirements. However present proposals for ABS are not consistent with the weightings used for corporates carrying the same credit rating, with the result that a small difference in external rating could have a significant effect on the amount of capital required, creating arbitrage opportunities.

A parallel approach to corporates should be applied which would have the added benefit of consistency. This approach is sustainable as ECAIs view the same rating category as being interchangeable, regardless of whether the security is an ABS or corporate bond. (An ancillary point, which supports this approach, is that it is difficult in some circumstances to distinguish between a 'true' corporate and an SPV.) Even so this parallel approach will be more conservative than necessary, as data from the ECAIs suggests that ABS demonstrate a lower default rate and less rating migration.

We also welcome the opportunity to use the 'look-through' approach for unrated securities but see no reason why this approach should not also be applied to mezzanine or subordinated tranches. In the case of junior tranches we recommend that a risk weighting according to the highest rating in the pool be used, whereas in the case of senior tranches the average risk weighting of the assets in the underlying pool be used. The weighting should also discriminate between retail and corporate assets, with a 50% discount being applied to retail assets.

Treatment for sponsoring banks in conduit programmes

The risk weighting treatment for sponsoring banks should be no different than for originating or investing banks – based on the internal or external ratings of the underlying assets. As noted above a 20% credit conversion factor for liquidity facilities is too high. If the liquidity facility meets the tests listed above no further capital need be added.

7.3 Securitisation under IRB

There should be a real incentive to move from the standardised approach to an IRB approach. This should be provided by a tangible reduction in the amount of capital allocated to ABS structures. As demonstrated earlier our current view is that this will not be the case and that consequently these proposals will not promote better risk management.

Foundation Approach

Treatment for issuing banks

BBA/LIBA note that the Committee is seeking to follow the same economic logic in the IRB approach as used in the Standard approach. Our fundamental premise is that capital set against an ABS should be no higher than that which would be allocated against the underlying assets were they held on balance sheet.

The foundation IRB approach requires a 75% risk weighting for undrawn facilities, compared with a 20% credit conversion factor in the standard approach.

Assuming a AAA SPV (with the liquidity lender in a senior position such that it can benefit from this weighting) the effective risk weighting for undrawn commitments will be as follows:

	Effective risk weighting	
standard	CCF * risk weighting	20% * 20% = 4%
foundation IRB	CCF * benchmark risk weight	75% * 14%[a]= 10.5%

[a] *the lowest risk weight for a drawn corporate exposure given a 50% LGD*

It therefore appears that the foundation approach under IRB leads, counter-intuitively, to a higher capital charge than under the standard approach.

BBA/LIBA think that the deduction of retained first loss from capital, regardless of the IRB capital requirement that would otherwise be assessed against the underlying portfolio, is risk insensitive.

The definition of retained first loss as the aggregate of all originator-retained tranches up to the first tranche transferred to a 3rd party could be a grossly exaggerated measure of risk. The decision about retention or transfer of a tranche is often determined by funding cost rather than credit concerns. This inconsistency is even more marked for externally rated tranches retained by the originator and deducted one-for-one from capital as part of the retained first loss treatment. Consistent capital treatment for risk, regardless of where it is held is one of the development aims of the New Accord.

Furthermore, the Foundation Approach, which requires the IRB capital charge for a pool to be securitised to be used as a floor for the calculation of the capital attaching to the related securitisation tranches, incorrectly assumes a one-for-one relationship between: (i) the IRB capital requirement for the pool held on the originator's balance sheet, taking into account the granularity of the originator's total portfolio; and (ii) the IRB capital requirement for the pool to be securitised, viewed in isolation.

In this way, the Foundation Approach is triply punitive:

- it requires greater capital to be held against the aggregate of all securitised tranches than would be required if the pool were to be held on balance sheet;

- the floor IRB capital requirement is over cautious, as the granularity of the originator's book is not taken into account; and

- as is true across all IRB approaches, for transactions with replenishing features, the effect of the above is compounded by the implicit imposition of an additional capital charge. This arises through the higher credit enhancement levels (as a proxy for capital) required for the longer transaction average life in replenishing transactions compared to amortising transactions, even though the initial pool is the same.

In addition, the application of a one-for-one deduction from capital for the retained first loss position is inappropriate as it contains elements of both expected and unexpected loss (EL and UL). In accordance with standard credit risk management principles, we agree with a one-for-one deduction from capital for EL. However, that proportion of first loss relating to UL (as determined in extreme stress scenario credit risk modelling using Chebychev or Monte-Carlo-type simulations) should be risk weighted in accordance with the applicable PD and LGD assumptions as per any other credit facility.

Furthermore, current thinking suggests that a 1:1 deduction from capital for the retained first loss position is not appropriate. For the net present value (NPV) of the calculated Expected Loss (to be discounted with an equity discount factor), a 1:1 deduction is correct since this is the expected Mark-to Market (MTM) -amount of the losses deriving from credit risk, if expectation comes true. The limited amount of the remaining first loss position (first loss minus NPV of EL) means, that catastrophic scenarios responsible for the fat tail of loss distribution curves for credit risk do not apply. This can be demonstrated with Chebychev or Monte-Carlo simulations, used by credit risk models. As a consequence, the remaining first loss position has to be assessed like any other credit facility and a PD/LGD assigned accordingly.

We therefore recommend that individual securitisation tranches be weighted according to each tranche's PD and LGD profile and that this approach should be applied to all tranches, regardless of whether they are externally rated or subordinated or not. To not adopt this approach would require different amounts of capital to be allocated to a particular risk dependent on whether it remained in the hands of the issuer or not. This would be inconsistent.

Treatment for investing banks

The 100% LGD assumption is far too cautious. It contrasts with the Foundation approach for corporate loans under which LGDs of 50% or 75% are proposed for investment and non-investment grade exposures. Banks should be able to internally rate tranches, either using their own models (which would be subject to supervisory review) or by using ECAI models and adopting their correlation assumptions.

We recommend that in cases where the originator of the ABS is using the IRB approach and chooses to disclose to investors (perhaps by using a calculation agent – maybe a qualified ECAI) there is merit in allowing the investor to use the originator's IRB weighting. We believe that those tranches kept on the banking book should be weighted using internal weightings (or external ones if these are not available) with the 50%/75% approach being used.

Advanced approach

Under the advanced approach an investing bank should be able to use its own LGD data or, (if the universe of a bank's own LGD data is not sufficient to be statistically valid), pooled data from an ECAI. Banks using this approach would have to make sure that the pooled data is representative of the underlying pool and that applied calibrations, definitions and models fit into the internal methodology.

7.4 Synthetic Securitisation

BBA/LIBA look forward to reviewing the Committee's further paper on synthetic securitisations and are supportive of its proposal that there be a standardised approach for synthetics, subject to appropriate operational requirements.

There should not be a material regulatory distinction between the amount of capital provided for a typical synthetic securitisation transaction and that provided for a cash securitisation. The distinction only relates to the transfer of title on the underlying assets and the immaterial credit risk associated with the most senior tranche (third loss) that is hedged with a credit default swap.

The Committee discusses the possibility of restricting the size of any retained first loss position to the amount of the expected loss, an approach that is not proposed for conventional securitisations (nor should it be). The first loss portion can not be limited in this way, as the rating agencies typically require a higher multiple in line with their requirements in cash transactions. Furthermore the capital charge associated with the retention of a first loss position already makes this requirement redundant.

In general we believe that the framework should concentrate purely on the amount of risk transferred and allocate appropriate capital charges against retained positions, rather than trying to regulate the degree of risk that may be retained and under what circumstances.

Synthetic securitisation – standardised approach

In November 1999 the US Office of the Comptroller of the Currency and the Federal Reserve issued guidelines dealing specifically with Synthetic Securitisation. With some modifications this publication could form the basis for the regulatory capital treatment of Synthetic Securitisation transactions within the Standardised Approach. The proposal addresses two important themes that are also discussed in the Basel Consultative Document.

1) *Capital relief on the most senior (third loss) tranche <u>without</u> hedging*

The OCC/Fed proposal provides for the possibility for a sponsoring bank obtaining regulatory capital relief on the most senior tranche (senior AAA or third loss tranche) of a Synthetic Securitisation transaction without entering into a credit default swap with an OECD bank. If the bank meets three stringent minimum requirements, it may assign the unhedged senior position to the 20 per cent risk-weighted category. These conditions are:

- transfer of virtually all of the risk to third parties
- ability to evaluate remaining banking book risk exposures and provide adequate capital support
- adequate public disclosures of the risk profile and capital adequacy of such transactions

We believe that these requirements are very strict. In particular, Condition 1 - the requirement that virtually all of the credit risk needs to be transferred to third parties - needs to be relaxed as first loss positions are to be deducted from capital anyway. The requirement that any retained first loss position must be no greater than the estimated expected losses needs to be dropped, as the originators' motivation and the ECAI methodology with regards to first loss are no different from conventional securitisation transactions.

After relaxing the requirements as described above, the OCC/Fed approach should form the basis for the capital treatment of Synthetic Securitisation transactions in which the most senior position is not hedged.

2) *Capital treatment of a Synthetic Securitisation transaction <u>after</u> hedging the most senior tranche*

Equally important is the capital requirement for the overall Synthetic Securitisation transaction that is proposed in the OCC/Fed paper. The regulators assume a typical structure, in which a first loss is retained, a second loss position is collateralised with Treasuries (or other 0% risk-weighted assets) and the most senior third loss position is hedged using a credit default swap with an OECD bank.

The regulators propose the holding of capital equal to the higher capital charge resulting from the application of two methods:

Method 1:
- retained first loss: dollar-for-dollar capital charge
- second loss: no capital charge
- third loss: no capital charge

or

Method 2:
- retained first loss: 100% risk-weighting, i.e. 8% capital charge
- second loss: no capital charge
- third loss: 20% risk-weighting, i.e. 1.6% capital charge

Example

For a transaction with a sample capital structure of 1% first loss, 7% second loss and 92% third loss, the capital charge would be the higher of

- Method 1: 1% *100% + 7% * 0% + 92 % * 0% = 1.0%
  or
- Method 2: 1% * 8% + 7% * 0% + 92% * 1.6% = 1.55%

resulting in a capital charge of 1.55%

This calculation assumes an underlying loan portfolio that is fully drawn. In the case of undrawn facilities, the relevant credit conversion factor (e.g. of 50%) is to be applied. In the capital structure described above, the capital charge for a fully undrawn portfolio would be the higher of 1.0% (method 1) and 0.78% (method 2).

This methodology results in a capital charge based on the worst of a substance over form or form over substance approach for the whole transaction. As a result the OCC/Fed approach is fully compliant with the current Basel Capital Accord, conservative, but also risk sensitive.

While the OCC/Federal Reserve approach has very desirable features, it is possible, in the context of the current Basel review, to amend it in order to even better align capital charges with underlying economic risk by deducting the first loss from capital and applying a counterparty risk charge (based on interest rate add-ons) on the third loss.

This approach is in line with our recommendation regarding the treatment of joint default risk for single name exposure.

The range of eligible collateral should be broadened in line with the recommendations for collateral in the Credit Risk Mitigation section of the Committee's proposals.

Synthetic Securitisation - IRB :

Treatment of originating banks

We do not believe that originators should be allowed to retain risk only in the form of first loss and/or super senior tranches. More flexibility should be permitted, enabling originating institutions to retain any level of risk on the underlying portfolio, provided that the amount of capital held in relation to this risk is adequate. This would notably mean that if an institution transferred no risk at all, then its capital requirement should in principle equal that applying to the unhedged portfolio.

Where transactions are tranched using ECAI models, we believe that, regardless of whether or not the tranches are effectively rated, the implied capital requirement on the liabilities side of the structure should be at least equal to that on the unhedged portfolio. This is because the approach taken to tranching by the agencies is more conservative than that implied in the IRB function, notably as far as correlation is concerned. We would therefore suggest that capital be held by originating banks as a function of the IRB charge on the tranches retained and capped at the capital charge on the unhedged portfolio. As per our comments above, first loss should not systematically be deducted.

Treatment of investing banks:

The treatment of investing banks should be the same in synthetic securitisation as that applied to investors in cash securitisation tranches. Bilateral portfolio swaps between banks are easy and simple to arrange and result in beneficial risk sharing in the financial system. The Committee's assumption that all unrated tranches (as such bilateral portfolio risk swaps generally are) are necessarily of low credit quality is incorrect. The requirement that unrated tranches should be deducted from capital is therefore risk insensitive. The Committee should focus on the amount of risk transferred rather than on the nature of the transfer process and allow banks to risk weight according to the retained risk.

7.5 Implicit and residual risks

BBA/LIBA do not share the Committee's concern about implicit and residual risks associated with asset securitisation.

Where a bank repurchases or substitutes assets in an ABS issue, it takes a commercially justifiable decision, weighing up the potential losses on the repurchased assets against the benefits of enabling the issuing vehicle to continue in business. It should be permitted to buy back assets as long as it:

- does so at the market price;
- does not destroy the clean break.

We are not completely comfortable with the re-characterisation of all an institution's securitised assets as being on balance sheet following a regulator's determination that implicit support has been provided. The 'two strikes and you are out' approach is too draconian. It should be modified to:

- prevent a miscreant bank removing further assets from the balance sheet until the expiration of a fixed cure period (say one year), but
- allowing banks to retain off balance sheet status for those ABS structures for which it has not provided support.

Furthermore the proposed approach may prove unworkable were the offending bank to come close to failure because of capital inadequacy, posing significant moral hazard for regulators.

We may be able to concur with this modified approach were the Basel Committee to reconsider the possibility of the imposition of an ex-ante minimum capital charge. Such a charge would have a

significant impact on the very vibrant and systemically beneficial ABS market and should not be contemplated.

The Committee should address issues of implicit recourse through Pillars II and III of the Accord:

Pillar II – supervisory review

Banks must be allowed to evaluate the risks of individual transactions using their own risk management techniques, which would be subject to appraisal by a firm's local regulator

Pillar III (Market Disclosure)

Through the disclosure of appropriate information about ABSs to market participants, investors will be able to scrutinise a firm's behaviour, ensuring that it continues to act prudently.

7.6 Disclosure

BBA/LIBA are generally supportive of the need for adequate disclosure of information relating to ABSs but believe that the Committee's proposals are excessive, may lead to information overload, and will be unduly onerous for our members to provide.

The buying and selling of assets is part of a bank's normal trading activity. To require information about asset disposals into SPVs, when other types of asset disposal – quite properly – do not require additional information to be disclosed, places a heavy burden on those banks that employ this technique and is inconsistent.

We would wish that disclosure standards should be no more onerous than those required for the underlying asset portfolio and respect any applicable banking secrecy laws. Furthermore there should be no requirement for disclosure that may lead to the loss of proprietary advantage.

The proposed level of information disclosure far exceeds anything required to assess the quality of an SPV's underlying assets. By requiring such full details of a bank's involvement in ABS transactions in its annual report, there is a risk that unsophisticated investors may be led to believe, erroneously, that an SPV is actually part of a bank group and that some form of residual recourse to the bank exists in times of stress.

Where possible, BBA/LIBA suggest that the Committee should defer to the locally applicable accounting standards and not insist on additional ABS disclosure requirements by the reporting bank.

8. Credit risk mitigation

BBA/LIBA welcome the extension in the recognition of credit risk mitigation from the 1988 Accord. This is a major contribution towards a new Accord that is more sensitive to actual levels of risk. There are, however, aspects of the proposals that run counter to that objective and thus provide perverse incentives. Some major items are:

- the proposed charges for "residual risks" – the so-called "w" factor
- the lack of recognition of joint default effects, particularly in combination with the various eligibility restrictions
- the lack of recognition of non-financial collateral (physical/commodities) in the standardised and foundation IRB approaches

It is also disappointing that, despite the broad objective of adopting a "top down" approach to ensure consistency of outcome where there is consistency of risk, various elements of the proposed treatment of credit risk mitigation techniques have been applied in certain areas so that inequalities do arise which can only produce inappropriate incentives.

In addition BBA/LIBA do not believe that it is appropriate to treat securities financing transactions (securities lending/repo) as a sub-category of collateral arrangements: these form a separate class of transactions in their own right for which a capital treatment needs to be developed from first principles – see Annex 2.

w factor

It is not clear what the exact purpose of the proposed charge for residual risks is. It is variously described in the draft Accord and supporting documents as being intended to provide: an incentive for banks to continue to monitor the credit quality of the underlying obligor; against legal/documentation risks; and against mark to market disputes and realisation problems as a result of general market illiquidity. Each of these is considered in turn below.

Incentives for banks to continue to monitor the underlying obligor: the type and amount of credit risk mitigation taken is a function of a bank's assessment of the credit quality of the underlying obligor. As such, banks will regularly review credit quality and adjust the mitigation required as necessary. The idea that banks need a regulatory incentive to do so is extraordinary. In any case, given that the residual risk charge is the same whether or not such reviews are undertaken (except to the extent that a downward internal rating might result), it is difficult to see how this provides any "incentive" at all.

Legal/documentation risks: virtually every transaction which a bank enters into is underpinned by a contract of some sort and therefore carries a certain level of legal/documentation risk. This, amongst other things, is the supposed purpose of the operational risk charge. We do not understand why the Basel Committee believes that there are particular risks associated with credit risk mitigation documentation such that an additional capital charge is needed. The evidence suggests that such techniques are legally robust. Indeed, if they were not, they would fail the "minimum standards" for capital recognition!

Mark to market disputes: given the relatively limited range of eligible collateral in the standardised/foundation IRB approaches, it is difficult to see how there could be serious valuation disputes. Where a bank has approval to calculate its own haircuts, it goes without saying that it must be capable of calculating a reliable mark to market value. As for the underlying, the valuation is irrelevant in an historic cost/accruals accounting environment and most OTC derivatives can be marked to market using well-established models even if no market price as such is available.

Realisation/liquidity problems: this is an issue of relevance only to collateral. We do not think that this is a serious issue in relation to the instruments for which standardised haircuts are available. For those modelling haircuts, suitably conservative assumptions should deal with this issue.

As a general observation, even if one were to accept the reasonableness of such a charge, it would not provide structured incentives towards good risk management practices unless banks were able to see what they had to do in order to reduce the "w" factor. As it stands, not only is a coherent explanation of its purpose lacking, but the charge continues - at the same level - no matter how rigorous a particular bank's management of "residual risks" might be. In conclusion BBA/LIBA would request that the Committee withdraw the proposal for a w factor.

Joint default

It is very disappointing that, although the Basel Committee recognises the joint default effect (i.e. that the joint probability of both the obligor and the provider of credit protection etc defaulting simultaneously is less than the probability of either party alone defaulting), it has not found a way to give recognition to this for regulatory capital purposes, except by disallowing recognition where default correlation is not low!

Eligibility issues: range of eligible collateral/acceptable protection providers

On financial collateral, we recognise that it is difficult for the regulators to determine standard haircuts for instruments beyond those specified in the Basel Committee's proposals. Where a bank has approval to calculate its own haircuts, however, we cannot see any logical reason to restrict the range except on a case by case basis by reference to the scope of each bank's approval.

In addition, we think that it should be possible to determine standard haircuts for many commodities and for certain physical collateral (see 6.0 Asset finance). We believe that metals and commodities, which have international terminal markets, where there are good, consistent and long-term data on valuations available (and appropriate loss data) would support a different treatment. We therefore recommend that the Committee works with the industry and the relevant markets to establish appropriate criteria and LGDs.

We would also like to see a clarification that cash held by a third party custodian is eligible for recognition - the current definition "Cash on deposit with the lending bank" does not imply this.

On guarantees and credit derivatives, we can see no reason to restrict the range of eligible providers; provided that the risk weighting is lower (standardised) or internal rating is better (foundation IRB), substitution should be allowed.

On-balance sheet netting

Whilst the recognition of on-balance sheet netting of loans and deposits to a single counterparty is welcomed, its benefit is significantly curtailed by the dis-application of maturity mismatched hedges of less than one year residual maturity. This is particularly pertinent to banks but also applies to corporate customers.

We do not believe that it is appropriate or necessary to restrict on-balance sheet netting to just loans and deposits. Netting should not be restricted to specific products, but should be allowed for any product, provided that the minimum legal and operational standards (e.g. as regards documentation) are met. To restrict netting to certain products does not operate as a positive incentive for firms to put netting agreements in place.

Bucketing sub-one year maturities

Internationally active banks manage short-term (up to one year) liquidity very closely. For risk management purposes they routinely allocate inter-bank loans and deposits to maturity buckets. This recognises the depth of the short-term money market, the ability to liquidate investments in instruments such as CDs at very short notice and that balance sheet liquidity is managed on a portfolio basis rather than instrument –by instrument.

We therefore recommend that the one-year cut-off be removed and replaced with three buckets:

- up to three months;
- three months to six months; and
- six months up to one year.

Whilst many of our member banks have highly sophisticated treasury management systems the provision of a regulatory capital incentive in respect of a bank's money market asset/liability portfolio may encourage smaller banks to develop better liquidity management techniques, thus enhancing systemic stability.

Definition of to 'a single counterparty'

We are further concerned that the definition 'to a single counterparty' could be interpreted too literally, such that netting is restricted to a single legal entity rather than a single group. We believe on-balance sheet netting should be permitted to enable the netting of customer accounts where those customers are in the same group e.g. a parent company and its subsidiaries, rather than being restricted solely to a single subsidiary.

Not to do so would create problems including:

- inefficiencies for corporates who would pay interest on net rather than gross amounts
- higher costs for corporates as banks allocate more capital against group positions
- creation of extra settlement risk as payments systems potentially became stressed at the end of day, when surplus funds are swept into a single head office treasury account

We recommend that the Committee acknowledge that group wide netting brings benefits for banks and customers alike by permitting netting of sub one-year on-balance sheet exposures, on a maturity bucketed basis amongst a group and its subsidiaries.

We also believe that the Accord should keep open the possibility to give recognition for cross-product netting and netting between on and off balancesheet. These risk mitigation techniques are becoming increasingly important, and Regulators should be able to give due recognition in order to give proper incentives. We hope to continue a dialogue to examine the issues related to netting.

Other issues

Collateral haircuts

It is difficult to understand why haircuts should be applied in relation to the volatility of both the underlying and the collateral. In an accruals accounting environment (ie the banking book in general terms), variations in the mark to market value of the underlying exposure are not relevant to the

determination of recognised (accounting/regulatory) gains and losses. The proposed FX haircut of 8 % is too high, at least for major currencies. Major currencies are highly liquid and any FX exposure can be closed out almost immediately.

Initial margin

The current proposals (paragraph 64) of the Accord appear to imply that initial margin (collateral) placed with a Clearing House or Exchange will be subject to a capital charge even when only a security interest is created. Under the current rules, capital is only required for cash or where a full transfer of title is made. We understand the legal basis of initial margins to be clear and do not believe that a capital charge would be justified. We would therefore appreciate a clear statement that such a change is not envisaged. If it is, in fact, the intention, then further discussion with the industry is needed since it could have significant impact on the economics of these markets.

Maturity mismatches

Maturity mismatch should be based on behavioural maturity (for both sides) rather than latest scheduled (exposure) and earlier effective (hedge).

Minimum standards

We do not believe that it is practicable to require banks to have legal opinions in all relevant jurisdictions updated at "appropriate intervals (eg annually)".

Operational requirements for guarantees

The conditions stated in paragraph 125 should be clarified to ensure that clauses in a guarantee preventing the guarantor from competing with the lender in the obligor's insolvency does not prevent the guarantee from being recognised, as such clauses in effect strengthen the rights of the lender.

9. Operational Risk

9.1 Overview

Banks have incurred and managed operational risks from the moment they have opened their doors and before they have made their first loan. The results of surveys the BBA undertook, with Coopers & Lybrand in 1997, and with ISDA and RMA in 1999, resulting in the report, *Operational Risk: the next frontier*, demonstrated the fact that centralised management of operational risk is, however, at an early stage in the banking industry, with operational risk managers having a variety of responsibilities and reporting lines, and using a variety of techniques to fulfil those responsibilities. Partly reflecting this, but partly reflecting the nature of the risk itself, quantification measurement of operational risk is still in its infancy, in comparison with credit and market risks.

Arriving at a regulatory capital framework for both credit and operational risks therefore creates significant challenges for both banks and their regulators. The scale of these challenges, which we believe are understood by regulators, highlights the very tight timescale in which regulators and regulated are trying to arrive at a solution which is accepted as reasonable and appropriately risk-sensitive. The present paper is the first opportunity the industry has had to respond to firm proposals from regulators. We trust that we shall have the opportunity to comment on a further paper before the Accord is finalised.

We welcome the evolutionary approach proposed, but are concerned at the apparent aim of the paper to work towards a wholly quantitative solution as the means of calibrating the operational risk capital charge. BBA/LIBA are firmly of the view that, whilst quantification will form the basis of calibration of the charge, there must be a strong and explicit qualitative adjustment within Pillar 1 which will incentivise good risk management. We would appreciate understanding how the Committee believes the proposed approach will incentivise changes in management action.

As regards those elements which will be quantified, we are particularly concerned at: establishing the scope of the charge; avoiding double-counting of capital as between credit risk (and credit risk) and operational risk; obtaining complete, consistent data; and the absence of a conceptual standard of soundness. BBA/LIBA are also concerned at the suggestion that the charge will represent approximately 20% of regulatory capital. This is too high, but whatever the outcome, it is important, as stated by the Committee, that there is no overall increase in capital across the industry from the new Accord.

There is a clear need for testing to avoid unintended consequences and to establish the potential impact on specialist firms as opposed to the average universal bank. This is particularly relevant in the context of consolidation of the banking sector. Testing will help to confirm that the output corresponds to intuition and will enable acceptance.

Given the present state and variety of industry practice, it is also important that the final Accord is not over-prescriptive at this early stage, and is flexible enough to allow for developments in methodologies. As things stand, the Internal Measurement Approach is viewed as a stepping stone to other techniques, which have yet to be fully explored, such as the Loss Distribution Approach. There needs to be the opportunity, over the coming years, for the industry and regulators to explore methodologies and their development. We are concerned at the possibility of an unacceptable degree of supervisory intrusion into the management of a bank as a result of the operational risk framework proposed and the excessive regulatory burden which it could imply.

BBA/LIBA are keen to work with the Committee to refine the paper and achieve an acceptable and risk-sensitive process. We therefore hope that there will be continuing close dialogue with the regulators to achieve this, and to address such important issues as outsourcing and risk mitigation.

An important part of that dialogue will be to ensure that there is consistency of application of the rules, i.e. level playing fields between banks, internationally and domestically, and as between regulated and non-regulated institutions. The operational risk charge has the potential to distort competition in particular between regulated institutions and those which are either unregulated or regulated with no capital charge for operational risk.

The application of the Accord in non-EU countries to internationally active banks only will lead to a situation where EU banks with subsidiaries operating outside the EU may well be in competition with domestically active banks which are not subject to an operational risk charge. BBA/LIBA strongly support the suggestion that regulators should be required to disclose on a differential basis their national policies, and the implementation of those policies, in areas where they use their discretion. This would assist in ensuring harmonisation of treatment for banks in different countries and thereby reduce the incentives for regulatory arbitrage.

9.2 Calibration

The Committee's stated intention is that the overall level of capital in the system should not increase. BBA/LIBA naturally endorse this approach and wish to emphasise its importance in calibrating the operational risk charge.

The paper suggests that there is a "capital buffer related to credit risk". There are two points to make. First, it is true that banks have held capital in excess of the regulatory minimum. There are many reasons for this, of which the most powerful drivers are that banks have considered it economically and reputationally prudent to hold sufficient capital, so that their capital ratios will not be unduly threatened at particular points in the economic cycle. The "additional" capital is not held purely to reflect their perception of the risks inherent in their business, which may not be caught by the regulatory capital charge. Further, banks may hold capital in excess of their current requirements in order to be able to take business opportunities in the future, for example increasing their level of risk or through acquisition.

Second, whilst the capital allocated for credit may historically have contained an element related to what is now being disaggregated as operational risk, an element will also have been included within the market risk charge. This is implicitly accepted by the Committee in its arguments relating to the "w" factor and the basis for the market risk multiplier in excess of 3. There is therefore a strong argument to suggest that the introduction of an operational risk charge should reflect not just a reduction in the charge for credit, but also a reduction in the charge for market risk. This is particularly appropriate for those firms whose business is primarily focussed on that area of risk and it would to some extent mitigate the current proposals for calibrating the operational risk charge which bear excessively on such firms.

Overall, it is important that there is no "double-counting" of capital as between credit or market risk and operational risk.

Quantitative Impact Survey

Individual banks will be commenting on their own responses to the Survey. BBA/LIBA would, however, like to take this opportunity to pass on the general concern which has been expressed by members of the danger of relying too heavily on the QIS for calibrating the operational risk charge. There are enormous difficulties within firms in collecting data down to the granularity required, disaggregating operational from credit losses where possible and appropriate, and undertaking the exercise consistently, especially within the timescale of the QIS. In many cases, the exercise will be a manual one, which underlines both the difficulties and the costs involved. In addition, the exercise will inevitably exclude those many banks which are not at the cutting edge of operational risk management and so are unable to provide data. The exercise is therefore unlikely to be representative of the general banking population.

Calibration to 20%

The Committee suggests that operational risk should represent 20% of overall risk capital for the average bank. We understand that this was based in part on findings contained in the BBA/ISDA/RMA survey, *Operational Risk: the next frontier (1999)* and from information provided by a small number of banks. These findings related to allocations of economic capital, which included, inter alia, recognition of business, strategic and reputational risk. Indeed, the survey explicitly stated that, because of the wide dispersion of results and practice in allocating capital, the results were unsuitable to be used for comparative or benchmarking purposes.

The 20% figure also appears to have been based on a number of assumptions, in particular that banks are of an average size, that there is a linear relationship between operational risk and size and that banks are averagely distributed across the seven business lines relative to the calibration pool. We believe that these assumptions undermine the objective of a risk-based, or even just equitable distribution, of the operational risk charge. For some specialist institutions an appropriate charge will be very different from that suggested. In any case, the further a bank is from the mean, the more unrealistic the calibration is likely to be.

The principal issue, however, is that the initial 20% calibration is clearly too high for the average universal bank. The calibration must match the definition of operational risk which is to be used for regulatory capital purposes and not the wider definition of operational risk quoted in the paper.

Expected vs. unexpected losses

The capital charge should relate to unexpected losses. We do not agree with the Committee's suggestion that the capital charge should be based on expected and unexpected losses. It is the nature of the great majority of operational losses that they are taken into the profit and loss account when they are incurred and form part of the underlying costs of the bank from which pricing decisions are made.

There is also an extent to which bank management is willing to accept levels of operational risk for good policy reasons. The Committee cites credit card fraud as an area where provision for loss is effectively made through pricing. The level of such loss is partly determined by management action and controls. It is strange that the Committee is prepared to accept that this loss - possibly one of the largest incurred by major retail and commercial banks - should not form part of the capital charge - whilst penalising other forms of loss, which are equally amenable to such analysis.

9.3 Definition and scope

BBA/LIBA generally support the definition in the paper of operational risk, which is identical to that recommended in the BBA/ISDA/RMA survey report, *Operational Risk: The next frontier (1999).* We agree with the exclusion of "strategic and reputational" risk. For the avoidance of doubt, we recommend that "business risk" should also be specifically excluded.

Scope of the regulatory capital charge

It should be recognised that the regulatory definition of operational risk is not identical with the scope of losses which we consider should be assessed to form a view of the appropriate operational risk capital charge.

The inclusion of legal risk is correct in a definition of operational risk. The problem with this lies in the danger of 'double-counting', with credit risk, if this aspect is carried forward to the scope of the regulatory charge and also with respect to the *w* factor.

Again, whilst it is correct to include direct or indirect losses in the overall definition of operational risk, it would not be helpful to include indirect losses within the scope of the regulatory capital charge for reasons given below.

Without clear and consistently applied boundaries between the risk types it becomes difficult to arrive at a robust calibration of the operational risk capital charge. A lack of clarity concerning these boundaries will also probably lead to inconsistency in the categorisation of losses across the industry, which, in turn, will have major implications for the further work to be undertaken in establishing a truly risk-sensitive regulatory capital charge. This includes internal allocation of loss data, industry sharing of loss data and ensuring consistent disclosure across firms.

BBA/LIBA believe that the Committee’s intention is to identify quantifiable costs and losses, which in general may be termed incremental debits to the Profit and Loss account. We agree with this approach as these will be easily identifiable, transparent and auditable, thus ensuring consistency across firms and jurisdictions. It will also help to create a level playing field. We therefore recommend that a list of loss-types should be agreed which would enable the industry and regulators to define the types of losses which should be reflected in a capital charge.

The following “indirect” costs and losses should be excluded: opportunity costs, near misses, latent losses and contingent losses. These may, in fact, be indicative of the quality of a bank’s approach to the management of operational risk (as may its investment in new management systems or its investment in controls and preventative action), but it is unrealistic to expect any consistency in their identification, capture and auditability, so that they should not therefore form part of a quantified calibration of the charge.

This highlights the need for the Committee to include in the calibration one of the most significant components of operational risk, namely the quality of management and controls, which should form a significant part of any assessment of a bank’s exposure to operational risk. This is consistent with the Committee’s September 1998 paper, *Framework for internal control systems in banking organisations*, which concluded that many, if not all, of the high profile operational risk losses it analysed could have been avoided if effective internal controls had been in operation.

“Double-counting”

BBA/LIBA have stated above that there should be no double-counting of the charge. It is important to ensure that assessments of overall operational risk do not result in that part of the credit loss which may be ascribed to operational risk (such as through documentary failure or fraud) being counted as part of the operational charge calibration as well as being recognised as part of the credit loss.

We are particularly concerned at the substantial infrastructure implications of paragraph 19 of the Committee’s Annex on operational risk which points to the need for disaggregation of operational loss from credit loss data and the benefits of data pooling. We deal with data pooling below.

As regards disaggregation of operational risk losses from credit losses, this has a number of quite serious implications, which require careful consideration:

- LGD data in particular is fundamental to the management of credit portfolios. Disaggregation would render existing LGD credit data unusable and change the basis on which credit portfolios have historically been managed.

- It would require a completely fresh calibration of the LGD element of the standardised and IRB approach.

- Given the need for banks to hold 7 years' clean credit loss data to enter the AIRB Approach, this could effectively prevent banks moving to AIRB for at least 7 years after definitional problems had been resolved.

- Even assuming resolution of these problems, there are significant systems implications which could further delay implementation.

Such a change should follow further extensive consultation and uniform implementation timetable, which would probably be many years after the implementation of the new Accord. In the meantime there is a need for clarity, as it will affect not only double counting but also data collection and the resultant calibration of the credit and operational risk charges.

9.4 Qualitative adjustment

BBA/LIBA's overriding concern and aim, which we assume is shared by the regulators, is to incentivise better quality risk management. This view formed an important part of our response to the June 1999 consultation.

Operational risk can be managed in a particularly risk-sensitive way, on many occasions more so than credit risk management in that, following a loss, remedial action can be taken immediately to prevent a recurrence. These possibilities and the importance of management quality should be reflected in a bank's capital charge.

There will also be circumstances when historical losses observed by an institution materially misrepresent the future risk of loss and there should therefore be a mechanism to adjust the measure of capital derived. Examples might include major business changes, such as mergers or divestments, major control changes or major corrective actions taken to prevent recurrence of losses.

BBA/LIBA therefore fully support and endorse the Committee's proposal that supervisors should apply qualitative judgement on the adequacy of a bank's control environment. This is a, if not the, critical element of judging capital adequacy for operational risk. However, in the paper, this statement is made in the context of a Pillar 2 adjustment which, by definition, can only be additive. Such a judgement should form an integral part of the calibration of the operational risk minimum regulatory capital charge and should be capable of adjustment down, as well as up, and available across all possible Approaches. We therefore believe that the adjustment must be found in Pillar 1.

To do otherwise could allow a situation where a poorly managed bank with good data could have a lower charge than a well managed bank with limited data. This provides little incentive to improve risk management and/or controls, especially if the Pillar 1 assessment may be as large an element as 20% of the overall capital charge.

The Committee will be aware of ISDA's September 2000 discussion paper on this subject, *Operational Risk Regulatory Approach*. BBA/LIBA believe that the criteria identified there provide a helpful and evolutionary approach to assessing the quality of operational risk management and control in an institution. This approach can be developed to provide strict assessment criteria through dialogue with regulators in which we are more than willing to participate. We would expect that the proposed creation of a College of Supervisors will help to establish international standards of supervision, and go a long way to support consistent regulatory implementation. The home supervisor's qualitative adjustment could be set as a percentage of the capital charge otherwise derived from the Pillar 1 initial calibration and formally reviewed at least annually. Such an approach would obviate the need for a Risk Profile Index.

To be accepted, the adjustment should:

- be capable of independent validation
- be clear and transparent
- be applicable to all sizes of institution
- be related to sound operational risk practices (we await the Committee's paper on this subject but would be happy to assist in its production)
- recognise internal risk management practices

and, as we have said above, should be consistently applied. We also need to agree at what stage an adjustment would be applied i.e. before or after other mitigants.

Importantly, the adjustment should be substantial enough to provide sufficient timely incentive to improve the quality of risk management.

Without such an adjustment, it would be helpful to understand the regulators' view of how the present proposals, combined with bank management action, will influence the capital charge and reinforce desired actions.

9.5 Databases and data pooling

The debates about many aspects of operational risk are be-devilled by a lack of data. Data is essential to clarify the potential extent of losses, as well as their relative importance by category. It could also clarify the extent of "double-counting". BBA/LIBA therefore fully support moves which promote the collection of data.

We counsel caution, however, in the use of external databases, or data pools, either for determining regulatory capital, for example in arriving at the Beta and/or Gamma factors, or for internal modelling purposes. Our reasons include:

- Loss events, certainly their causes, are not all objectively auditable.

- Different banks have very different levels of control, some for very good business policy reasons. This distorts the ability of banks to import data into their own models.

- The threshold level of reporting can have a material impact on the modelling of results. On occasions there are very good legal or insurance reasons which preclude the reporting of some losses.

- Some banks may decide that problems of disclosure in the event of litigation limit the data which they are prepared to pool (examples include repelling plaintiff's interrogatories and providing regulatory protection from civil litigation).

- Finally, and importantly, is the question of consistency of applying losses to particular categories. Our database contains a free form field to record the details of events. This has proved invaluable since the categories themselves do not provide the level of detail which banks require to enable them to use the data meaningfully. Short of expanding the categories appreciably, which we believe would be impracticable and unwieldy, we have found that the free-form field has enabled banks to use the database effectively and, importantly, has provided us with the information we need to achieve a greater level of consistency. Our experience is that this is a major issue, whose difficulties should not be underestimated.

Data pools undoubtedly help banks (and regulators) understand better the scope and extent of operational risk, but the limitations stated above indicate that they must be used with caution when contributing to the determination of the minimum regulatory capital requirement.

The Committee will be aware that the BBA started the first international industry-specific database of operational loss events on 1 July 2000. Its primary purpose was to enable banks to benchmark their performance, although obviously the data provided could assist them in any modelling or other quantitative analysis which they wished to undertake. There were 22 original participants which, through mergers, became 20. Participants are headquartered in 9 different countries. Schedules of the database data fields and loss categories are attached as Annex 3. Of direct relevance to the Consultation Paper, participants decided on some 112 loss event categories and 12 business lines, which they believed would give them the quality of data they were seeking. It was also agreed to include impacts (loss-types), although participants primarily saw the database as being "causal", since this more closely reflected the way they manage operational risk in their businesses. Each sub-set of loss categories includes "other". This was because we recognised that we were at an early stage of evolution in the process and that it might be that new categories would be required, either to achieve an appropriate degree of granularity, or because new risks had emerged.

The reporting threshold was another important issue. In the case of the BBA database participants agreed on thresholds of $50,000 retail, $100,000 non-retail. This level was chosen because it represented the level of "less-expected" losses from the point of view of our participants and so was more closely allied with those risks against which it might be appropriate to hold capital. There was also the issue of the cost/benefit of providing smaller, or even the smallest, event losses. Participants are not precluded from gathering and collating smaller losses internally, but our participants are satisfied that the level agreed provides them with the information they require.

Our experience in running the database is that all participants have contributed, although many have not reported fully from all their business units or countries of operation. This reflects the stage at which operational risk management has reached in banks, as well as the perceived cost benefits of trying to impose blanket reporting across the whole of a Group. Some summary analyses of the first three quarters' reports are attached for the Committee's information.

At this stage it is fair to say that the project has proved extremely useful for benchmarking and for providing information to banks to enable them to improve their operational risk management. We should be pleased to explain to the Committee in more detail the issues surrounding databases and our experience to date. We continue to promote the database, particularly in Europe through our contacts with other Banking Associations and believe and hope that this activity will expand. Most banks, however, are at an early stage in systematised operational risk management and there are inevitable national as well as institutional considerations, which preclude their rapid acceptance.

9.6 The measurement methodologies

Basic indicator approach

Using proxies for the size of operational risk is, of course, an admission that measurement of operational risk does not lend itself to the approaches which have been developed for market and credit risk. Indeed, the proxy proposed for this approach is simpler than the use of risk weighted assets in the current credit regime or the use of the market value of positions in the standard market risk calculations.

BBA/LIBA accept, though, the need to provide a methodology for calibrating a regulatory capital charge. As a basic indicator, we accept that gross income is probably a reasonable choice, given the compromise required of balancing the cost of generation with risk sensitivity. The Commitee needs to recognise, though, that gross income is not a risk-sensitive indicator. We therefore believe that the Committee and industry should continue to explore the identification of indicators which provide greater correlation with risk, and should recognise the need to incorporate such indicators into the Accord quickly, once identified.

Assuming its use, however, we would recommend that this should reflect a rolling 3 year average of gross income. It would be acceptable, and practical, to accept national GAAP definitions for this indicator. We are concerned, though, at a possible implication of the footnote to page 6 of the Operational Risk Annex, that such a measure will reflect income before deduction of operational losses. It should be noted that many operational losses are reflected in adjustments to reported revenue. We seriously challenge the need to disaggregate these frequent and small losses to arrive at another definition of 'gross income' which would be of limited value and only serve to confuse and over-complicate what is intended as a Basic Approach.

For calibration, the regulators are recommended to review the treatment of "Other Risks" in the Capital Adequacy Directive in respect of securities firms. This treatment has been implemented for a number of years and is set at 25% of one year's fixed overhead. This is considerably less than 30% of Gross Income, especially as this later amount is for a sub-set of "Other Risks".

Standardised approach

BBA/LIBA understand and support the aim to provide greater granularity and to focus on activities via business lines, which bear a more sensible relationship to both the types and scale of operational risks, than an approach which is uniform across the whole bank. Nevertheless, it is notable that few universal banks are structured along the lines of the proposed business lines and that the costs of mapping an organisation's activities to these business lines is unlikely to be trivial. Beneficiaries (in the sense of their being able to align their activities to the business lines) are likely to be specialist firms (large or small).

We believe that the number of business lines should be expanded. One answer might be to move to Level 2 of Annex 2 of the Operational Risk Annex. The risk sensitivity of this approach, in comparison with the Basic Indicator, is via the business lines each with their own Beta. You will see from our attachment that participants in our database favoured a list which mirrors this in part, but is not so detailed in the field of insurance, which should in any case be excluded as it is separately regulated and is outside the scope for regulatory capital assessment.

However, they felt that Mortgage Lending and Trade Finance deserved separate categories as having particular operational characteristics which distinguished them from others. They also wish to introduce an additional business line, representing central support functions, since many major losses can only be ascribed at this level. Similarly, there are certain losses, such as damage to physical assets or losses caused by certain employee actions, which are managed centrally and which do not suit the business-line approach. These might also fall within some form of central "business line". Whatever decision on these losses is taken, though, we would undoubtedly welcome greater granularity of business lines.

Given the approach, it is probably necessary to obtain proxies for the size or volume of a bank's activity. As for the indicators themselves, these are rough proxies of size. As with the Basic Approach, they are not proxies of risk. Again, it might be preferable for there to be a common indicator initially, such as gross income, but we should prefer to reserve judgement on this until we have had the opportunity to review the outcome of the QIS and to test any calibration proposed. It will also be of benefit, as our experience develops, to maintain a programme of testing to arrive at the best solution we can.

There are, however, three major issues. The first, which we referred to under the section on Calibration to 20% above, relates to calibration to the mean of universal banks. This will inevitably distort the charge for institutions, which are far from the mean, especially if they are large. The second issue is the determination of the Beta Factor. The third issue is that of linearity which is discussed in more detail below.

With regard to the Beta Factor, it is assumed to be structured around an allocation process involving the Exposure Indicator for the firm and also the sum of the exposure indicators from a sample of banks. The implication is that if the exposure indicator for a firm is 10% of the sample of banks then it will get 10% of the operational risk capital allocated by the regulators for that business line. We are concerned at the use of a (probably small) sample of banks, implying that it will not be representative of the range of banks to which the Basel requirements currently apply. This in turn implies that one consequence could be an increase in capital in the system. This situation is, of course, amplified when including the range of firms that will be subject to these charges in an EU context.

Finally, we assume that the capital charge under the Standardised Approach will be capped at the level of that calibrated under the Basic Indicator approach.

Linearity

We have highlighted above the issue of the charge being linear. Intuitively, this would seem to penalise larger firms unduly. BBA and LIBA have worked with ISDA on this matter. Our joint paper is attached as Annex 1.

Internal Measurement Approach

The Internal Measurement Approach (IMA) is significantly more risk-sensitive than the Standardised Approach, the differentiating factor being that the quantum of risk is determined by each bank using the average level of loss suffered. By reducing the occurrence or frequency, or severity of loss, an institution is therefore able to reduce its capital charge.

The IMA represents an evolutionary step from the Basic Indicator and Standardised Approaches to the Loss Distribution Approach or other more advanced techniques. It therefore represents an important step towards a quantified, risk-sensitive approach to the calibration of the operational risk charge. Whether this is the right direction to travel, it is important that the Approach is fully tested before it is implemented. This is not only to ensure that it delivers the desired result, but to assess the costs of data collection which are being proposed and their effectiveness in aiding calibration and to provide the opportunity to amend in the case of unintended consequences.

Quantification techniques, and the use of historic data, undoubtedly have their part to play in operational risk management but, as we have pointed out elsewhere, they have serious limitations as the sole basis for assessing exposure to operational risk, even assuming that regulators and industry agree an appropriate confidence interval and time horizon. In order to promote a forward looking approach, there must be a qualitative adjustment (up or down) in arriving at the net capital requirement for operational risk.

As written, the Internal Management Approach depends on the allocation of effect loss-types, as being the measure of operational loss. For the calibration of regulatory capital, we accept that incremental debits to the Profit and Loss account represent an acceptable basis (see Scope of the Regulatory Capital Charge above). However, we must make one important point. In paragraph 30 of the Operational Risk Annex, the statement is made that "the industry has not yet been able to show a causal relationship between risk indicators and loss experience". No definition of risk indicators is given. The evidence from our database is that there is not necessarily a direct relationship between a particular cause or event and a particular loss outcome or effect loss-type. The industry can hardly be criticised for not being able to show a link where there often is none.

An alternative perspective is that the Exposure Indicator acts as a normalisation benchmark. The normalisation process could be applied by the firm in an effort to make incidents that were experienced some time ago comparable to today. The second use of the Exposure Indicator is to normalise data that is acquired from external sources in an effort to make it comparable to the situation of an individual firm today. Linearity is an issue in both of these normalisation processes.

Subject to acceptance of the Exposure Indicator and recognition of the linearity argument above, we do not believe that effect loss-types, in themselves, are an appropriate way to measure exposure to operational risk and would strongly recommend an approach based on loss events or causes. This is the basis of the industry databases and bears a close relationship to the way in which banks manage and mitigate their operational risks.

The paper also seeks to identify a PE and LGE for different loss events. As we demonstrated above, this is flawed because the denominator for the PE calculation assumes that a loss event is directly related to a transaction. Fundamental breakdowns in control, however, which is where some of the serious loss events have occurred, are difficult to align to particular transactions or types of transaction. As for LGE, this is materially affected by matters which are within bank's management to influence i.e. decisions to pursue or not to pursue compensation, decisions about whether to insure or self-insure and so on. As a result of these decisions the response of firms to hazards and exposures is likely to differ and influence the net loss that serves as the basis for the calculation.

Turning to determining an appropriate time horizon, experience varies depending on the nature of the loss suffered and management policy. As indicated earlier, some losses trigger immediate changes in controls which effectively prevent their happening again. In other cases, it should be recognised that it can take years before a loss materialises or is recovered. We accept that the issue is difficult, and we should be pleased to discuss it further with regulators, but we are concerned at the absence of any reference to an appropriate time horizon or a clear statement of a regulatory objective or soundness standards. Related to this is the issue of the confidence interval. The time horizon and confidence interval come together in determining the Gamma. However, the paper is silent on these aspects, both of which are crucial to the issue of calibration. Again, this points to the need for ongoing dialogue and testing, and for the new Accord to be capable of amendment as a result.

One conclusion from the paper is that the Committee is encouraging capture of all operational loss events, however small or immaterial to an organisation (subject to the exclusions commented on under Scope above). If the capital charge is to reflect unexpected losses, as we believe it should, it is difficult to understand why banks should be exposed to the substantial costs of identifying all losses. There is the potential for the costs to be excessive compared with their probable contribution to improving the accuracy of the calibration of the charge. The cost is not only related to collection, but also to the data quality standards that surround data either in the Qualifying Criteria and/or Pillar 2.

Implicit in the simple summation of operational risk charges across event-types is an assumption that all unexpected losses could occur at the same time. We believe this is unrealistic and unnecessarily conservative. If the risks were perfectly uncorrelated, a "root sum of the squares" aggregation would be appropriate. Either an alternative aggregation method should be developed or the resultant overestimate of the risks involved should be factored into the calibration of the IMA.

Loss Distribution Approach

A number of banks are pursuing routes which are similar to that outlined in the Loss Distribution Approach (LDA). However, others are not, or are developing approaches which combine some elements of the LDA with other measures. It is important that future development of appropriate methodologies, whether within or without an LDA framework is not stifled by the Accord in the sense that any different approach will require a further Accord – and resulting EU Directive. Whilst there is little unanimity that the Loss Distribution Approach should be the industry's ultimate target, there is agreement, within the advanced approaches, for the need for a qualitative adjustment.

The LDA, as we understand it, applies techniques similar to those which have been applied in the management of market and credit risk, to operational risk. There are, however, important differences between these markets. With market risk, banks have access to very large volumes of data relating to a relatively small range of products, each data point being the price (externally determined by the

market) at which a particular transaction is undertaken. With credit risk, the foundation of reporting again relates to a specific transaction, the making of a loan or other form of credit, the extent of loss almost always being limited to the amount of the commitment. From that transaction, a variety of data can hang, which, for example, enable quantification of the volume of transactions and various characteristics of those transactions, such as the number which default at any one time. In addition, the credit loss which can be sustained on any particular transaction is finite – generally limited to the size of the transaction or commitment.

By contrast, the activities which may lead to an operational risk or loss consist of everything which goes on in a bank, whether or not it relates to a specific transaction – and even outside events such as fire, earthquake or terrorist activity. There is thus no simple approach to capturing comparative data. The result of this is that whilst there may be information available for the numerator of the appropriate calculation (although not complete and subject to the possibility that a loss can be very large and not related a specific control decision), the use of a transaction oriented denominator does not provide a complete reflection of the potential scale of operational risk.

Having said this, it is quite possible that fundamental issues of data collection will be overcome to provide the basis for a more risk-sensitive, quantified element of an advanced approach. It is important that these developments, which may or may not reflect the basic elements of the LDA, as described, are not precluded by the final Accord.

Risk Profile Index

BBA/LIBA recognise that the Risk Profile Index is an attempt by supervisors to reflect the quality of a bank's operational risk management. We welcome this intention. Our concerns lie with the acceptability of using historic data as a proxy for predicting future vulnerability to loss. Operational risk has emerged as an issue because of a number of high profile events. It is also conceivable that the distribution curve for operational losses probably has a longer and fatter tail than for market and credit losses, but this will not be known until sufficient data has been collected. The practical effect of this is that a bank may suffer one, or even a small number, of large losses which do not threaten its existence but probably reflect some gap in its control processes. Because the incidence of operational risk losses is directly related to decisions made by bank management about the level of controls they wish to apply and the external environment, the practical effect of a material loss or series of losses is for banks to tighten controls so that future performance will be an improvement on that previously enjoyed.

To avoid what could be significant distortion, it is important, therefore, that recognition is given to changes to management controls to prevent serious future operational risk losses. This is another pointer to the fact that a measure of whether a bank has better or worse exposure to operational loss should be that of the supervisors' opinion, given their experience and knowledge of all the banks under their responsibility and their knowledge of local factors which may affect exposure to operational risks both from the point of view of an individual bank and of the local industry. However, we recognise that relying solely upon this measure could result in the regulators becoming "shadow" controllers of banks and other firms. In addition to aspects of moral hazard and excessive regulatory burden there is also the issue of regulatory resources that are implied in such a detailed degree of scrutiny.

The "Floor"

It is difficult to comment on the concept of a floor without greater clarity regarding the calibration of the charge. In principle we do not support the imposition of an arbitrary floor, given the intention to incentivise management practice and make the Accord more risk-sensitive. As a practical point, it would seem that banks would have to run both the Standardised and Internal Measurement Approach in parallel in order to calculate the floor. This is something which, at the present time, does not seem reasonable to us.

We would also suggest, as a corollary, that there should be some form of cap, at least until the calibration methodology is proven.

9.8 Qualifying criteria

We accept the principles behind the concept of qualifying criteria to enable progress to the various Approaches.

As regards the present proposals, we have a number of points to make. The first is to question in the proposals for the Standardised Approach, whether it is necessary to attempt to gather loss data from all business units. The operational requirements of doing so could well be extremely onerous, the costs of which would far outweigh the benefits. Fundamentally, operational risk will continue to be managed, as it always has been, by sound and tested systems of control. Undoubtedly, assessments are made to identify particularly risky areas where intensified controls and/or audit may be required, but for the most part these decisions are based on subjective judgements based on local knowledge and observations.

The attempt by regulators to drive the industry towards a formulaic, quantitative approach, which would be based on criteria which are simply not consistent or complete enough to sustain such analysis is wrong in principle. The methodology for calibrating regulatory capital should relate to the way in which banks manage their operational risk.

As for the Internal Measurement Approach, where these considerations have more weight, our comments on the BBA database in particular and databases in general are particularly pertinent. Banks do not have extensive data at this time. They will undoubtedly develop more comprehensive databases internally, but we doubt whether these will become the main drivers of operational risk management or of their assessment of potential risk exposures across the industry. Of all risks, operational risk is the one least amenable to stress-testing or similar because it is the risk which is most exposed to both human and external factors.

9.9 Mitigation and risk transfer

Insurance

The BBA was a member of the EBF delegation which presented on this topic to the Risk Management group in the Summer of 2000.

Our principal thesis was that, as with credit and market risk, there should be scope for mitigating the charge through the use of appropriate instruments. We made the point that insurance was a valid and widely used technique for transferring a number of standard risks, such as fire and theft, as well as liabilities incurred through the Bankers' Blanket Bond and similar policies. Insurance was not something which solely concerned catastrophic losses – the high profile losses which have brought institutions down and which have led to raising the profile of operational risk both within the industry and the regulatory community. We argued, therefore, that the most active market for operational risk insurance in the future was likely to be risks of low to medium frequency and medium to high severity, probably those for which a capital charge should be designed to cover and therefore those for which mitigation of the charge should be allowed.

We acknowledged the problems which have to be overcome, for the insurance industry to be able to produce acceptable products for these purposes. These include:

- speed of payment (since the object of the exercise would be to replace capital)
- certainty of payment (which may restrict the pool of providers able to compete in this market)

- limiting conditions and exclusions.

The insurance industry is itself highly regulated and so is not in a position to take on risk which would be outside regulatory boundaries. Its use to effect appropriate risk transfer should be accepted.

The important thing is for regulators to articulate their concerns and requirements. BBA/LIBA believe that if this can happen, the industry and the capital markets can work to develop products which meet those concerns.

Outsourcing

There is a clear danger that if the regulatory charge for operational risk is considered to be too high, banks may choose to outsource a greater degree of their activities, possibly to unregulated entities. This could have a material effect on a bank's charge – provided it met the appropriate regulatory criteria for considering a risk to be outsourced – and create an unacceptably unlevel playing field.

The Committee suggests that the topic of outsourcing should be the subject of further dialogue. We agree with this and believe that this should happen as a matter of urgency. We need to have clarity and transparency over the definition of outsourcing (and insourcing), including what would qualify as a "clean break" and of how to assess the operational risks being transferred. Not to have this at the outset could seriously threaten the aims and objectives of the Committee.

It is important that in this regard, as in so many others, the Committee's proposals do not encourage banks to manage the capital charge, rather than managing the risks.

10. Trading Book

General

It is right that the current proposals for revising the Capital Accord have been developed in the context of the banking book in general and lending activities in particular. However, it cannot - and should not - be assumed that proposals developed in that context will necessarily be appropriate for trading activities. The Basel paper states that the framework addresses ‘credit risk in the banking book’. It has not been possible during the consultation period to clearly establish whether the rules are also intended to apply to counterparty risk in the trading book. This is important for all institutions that undertake trading book activities but is of particular significance in the EU context, where the rules will apply to investment firms whose activities tend to fall predominantly into the trading book.

We do not think it can be assumed that the current proposals can simply be "carried across" without further thought and work. The nature of counterparty risk in the trading book and the way in which it is managed differ significantly from the nature of credit risk in the banking book. In the trading book positions are marked-to-market daily and tend to be more liquid and shorter-term in nature. Application of banking book rules would result in a significant increase in capital charges for trading book exposures, and we are not aware of any evidence that suggests that this is the appropriate outcome. Further consideration of the capital regime for the trading book is needed to ensure that the correct levels of capital are held overall.

We recommend that the Basel Committee give early consideration to the way in which the proposed changes to the rules with respect to credit risk, operational risk and disclosure should be amended for the trading book, although it may well be necessary to defer work on this aspect for a short period until regulators and the industry are able to give it their full attention.

Definition of the Trading Book

We welcome the amendment to the definition set out in paragraph 567 of the Consultation Paper. In particular we welcome the emphasis on trading intent, and note that in principle this definition will now include loans, subject to the proviso that they can be fully hedged and are free of any restrictive covenants.

Operational risk

The proposed standardised approach to operational risk includes among its business line categories trading and sales activities. Furthermore, the basic indicator approach includes income from trading activities within the base figure of gross income to which the alpha factor is applied. Thus it is clear that the operational risk charge will include explicitly an element of operational risk in the trading book.

It is unclear whether the market risk charges introduced in the 1996 Amendment to the Accord cover operational risks or not. They are however considerably in excess of the equivalent typical VAR capital requirements that already incorporate a scaling factor for errors and operational risk, and therefore implicitly incorporate an element of operational risk already.

Any additional charge for trading activities will add significantly to the costs of trading, and represent a particularly heavy burden to those investment banks whose main activity is trading. We would emphasise that they are operating in a highly competitive global market, and that whilst the market risk capital charges are broadly comparable internationally, the addition of an operational risk capital charge will mean that a level playing field will no longer exist between European and North American institutions.

We do not believe there will be sufficient time before finalising the New Accord to investigate this and recalibrate the market risk charges accordingly. This combination of circumstances, we believe, argues for deferring the introduction of an explicit operational risk charge on trading activities at this stage.

Specific risk

We agree that there should be a link between specific risk charges and the new standardised risk weights. However, the proposals for limiting the use of credit derivatives in offsetting specific risk, do not go far enough. We therefore propose that the treatment of credit derivatives are subject to a fundamental review in the light of the structures currently being developed by the market for trading and risk hedging in this area.

Counterparty risk

The risk weights and factors developed for the standardised and foundation IRB approach were based on average banking book maturities. Counterparty risk in the trading book is for many transactions substantially shorter. For example a very significant proportion of repo business is overnight, and there are very few transactions beyond 6 months. Accordingly, the standardised risk weights over estimate the risk of loss. Annex 2 deals specifically with the capital charges for stock lending and repo business.

11. Pillar 2 - Supervisory Review Process

Supervisory review

BBA/LIBA support the concept of Supervisory Review and believe it to be an integral part of the new Accord that must be applied by all supervisors. If it is not, then the Accord will fail to achieve its objectives. Rightly Pillar 2 is intended to focus upon two main areas. Firstly the Committee's stated goal of ensuring "that banks have adequate capital to support the risks in their business". Secondly to ensure compliance with the various minimum standards required in the operation of Pillar 1. BBA/LIBA will comment on both elements in turn.

Adequate capital

Firstly BBA/LIBA would place particular emphasis on the Committee's own statement that bank management continue to have responsibility for the assessment of required capital beyond the core minimum requirements. Bank management is best positioned, and has the mandate, to make this assessment. It is also senior management that rightly defines a bank’s risk appetite.

Related to this, whilst we understand that supervisors will want to review banks' economic capital models as part of the Pillar 2 process, this is a means to an end rather than an objective in itself. Economic capital models will help supervisors understand the risks undertaken and the institution's own view of them, as well as casting light on the culture of the firm, and can therefore inform overall supervisory judgement. Ultimately, however, supervisors will need to make their determination on the basis of supervisory objectives and should not assume that there will automatically be a close relationship between their view of the total amount of capital needed and the institution's assessment.

Finally the capability of supervisors to require banks to hold capital in excess is clearly of critical interest to our members. BBA/LIBA would argue that the improved risk sensitivity of Pillar 1 makes any routine requirements for banks to hold capital in excess of the minimum unjustifiable. Considerable progress has been made on in terms of the effectiveness of the Pillar 1 assessment of risks and in the scope of risks considered. This suggests strongly that, the capability to require banks to hold capital in excess of the minimum requirement, should only be exercised as the exception when specific cause and need can be identified. In the event those specific circumstance should be articulated to senior management within banks and the requirement in excess of the minimum removed if appropriate action follows.

Consistency

BBA/LIBA believe that the scope for national differentiation in the application of these standards is the single most significant issue in the consistent application of the new Accord. As the Accord shifts toward a greater reliance upon internal risk assessment, supervisory review creates a vital structure for the consistent assessment of risk management standards and, in turn, a platform for the equal implementation, and application. To this end we welcome the requirement for supervisors to be "highly transparent" in the criteria on which they base their application of Pillar 2. For example, in the context of credit risk, this might include the minimum requirements in terms of data quality, data history and, most importantly, validation across countries.

To further strengthen this element BBA/LIBA would propose that Basel co-ordinate the publication of key statistics, by national regulators, on the application, and take up, of the various elements of the new Accord. The objective to create a continuing momentum behind consistent application. BBA/LIBA would suggest the following examples might serve as a basis for further debate:

- Credit risk: distribution of approach (Standardised, FIRBA, AIRBA)
  - Nos. of banks

  - Percentage of assets

- Credit risk : distribution across exposure class
  - Percentage of assets

- Operational risk: distribution of approach (Basic Indicator, Standardised, Internal Measurement)
  - Nos. of banks
  - Percentage of assets

- Operational risk: distribution across business line
  - Percentage of assets

- Exceptions record: record of issues where national supervisors have applied discretion as allowed under the new Accord.

BBA/LIBA strongly believe that the publication of key output statistics, such as those outlined above, would greatly assist in generating confidence in the equivalent application of the new regime.

BBA/LIBA would also urge the Committee to further strengthen the momentum behind common implementation through the establishment of a thorough and regular programme of peer review. To this end we welcome, and would encourage, the recently announced establishment of the College of Supervisors.

Supervisory resource

Finally, the supervisory review element of the proposals have clear implications for those supervisors who do not already undertake this sort of assessment, and also those that do. We would be concerned if the Committee underestimated the resource and skill sets this will demand. Some elements can of course be delegated - to external auditors for example - but BBA/LIBA would also stress that the burden could perhaps be eased by further enhancements in co-operation, co-ordination and information sharing between regulators. Again BBA/LIBA would hope that the College of Supervisors would develop a role in this process.

Interest Rate Risk in the Banking Book

We believe that the Committee is correct in placing "interest rate risk in the banking book" in Pillar 2 of the framework. BBA/LIBA would agree the difficulty of applying a specific Pillar 1 charge in the treatment of interest rate in the banking book. There is such a diversity of situations to encompass that it is appropriate to treat this under Pillar 2. That being so, we find the inclusion of a standardised interest rate shock (as detailed in the Annex of the Supporting Document on Interest Rate in the Banking Book) in the regulations unnecessary and contrary to the rationale for including it in Pillar 2.

This is especially the case when the standard is based on an apparently arbitrary value of 20% decline in the value of Tier 1 and Tier 2 capital. It would not add any value to the interest rate risk management of an internationally active bank, particularly as the scenarios are broad-brush and do not necessarily reflect the circumstances in different operating environments. We would also suggest that the current proposal also ignores the practical difficulties associated with determining what the economic value of the bank is for a complex banking group. Finally a holding period of one year is unrealistic in developed markets. In these markets there is deep liquidity and access to a variety of hedging instruments so that positions can be neutralised quickly. In less developed markets, the majority of banking book interest rate exposures will be kept to a short tenor to reflect the limited hedging opportunities. In both cases, a holding period of 1 month would be more appropriate.

As a general concluding comment we would have expected the relationship, under Pillar 2, to be more one in which banks were expected to justify to their regulator their existing methodologies and assumptions rather than apply, and pass, a standardised test.

12. Pillar 3 - Market Discipline

12.1 General considerations

In considering the Pillar 3 consultative document BBA/LIBA/ISDA brought together a group representative of credit risk management, credit risk analysts, investment relations and financial control and reporting. We support the concept of lower capital ratios and a lighter regulatory touch for those banks that operate in open and transparent markets. We are content – at the level of principle – with the view that the new capital regime should be supported through enhanced disclosures on capital, risk, their management and the capital adequacy of an institution. But we are concerned that the proposed disclosures will place excessive burdens on both preparers and users and consider the volume and detail of the disclosures and their focus on regulatory capital requirements to have little relevance to users of general purpose financial statements.

We are concerned in particular about –

- The nature of some of the disclosures envisaged in the Appendices to the Pillar 3 consultative document. In general, we do not believe that the broad range of market participants would benefit from the publication of data prepared for regulatory purposes and are concerned that the disclosures could potentially obscure the financial standing of a bank for most readers. Much of the information sought is unsuited to the financial statements and such is the nature and volume of the proposed disclosures that the overall effect may be to reduce - rather than enhance – accessibility and transparency.

- The disclosures being consistent with the frameworks for financial reporting and being developed in conjunction with accounting standard setters. As mentioned in paragraph 13, we urge Basel to work with the International Accounting Standards Board – if appropriate through the Steering Group reviewing IAS 30 *Disclosures in the Financial Statements of Banks and Similar Financial Institutions.* The objective should be for the proposed revision to IAS 30 to deliver Pillar 3 to the extent that the information sought is relevant to the users of financial statements. We believe that such co-operation would serve to ensure that the disclosures are understandable, relevant, reliable and comparable, which will best serve the purposes of Pillar 3. It will also ensure that proper account is taken of existing disclosure that is identical or similar. Embedding market discipline into IAS will help ensure enforcement as well as helping to keep the disclosures up to date in line with market developments.

- The recommendation, in paragraph 22, that banks make certain disclosures on a quarterly basis and the encouragement, in paragraph 23, for them to use electronic media to make available additional information. Further consideration should be given to the practicalities of these proposals and how they fit in the existing financial reporting frameworks of different jurisdictions. We firmly believe that there are benefits to providing information to the marketplace via the financial statements on a six- monthly basis and that more frequent reporting should not be contemplated without considering the broader implications. We would also question the desirability of publicly disclosing regulatory data in isolation as the regulatory disclosures need to be understood in the context of the corresponding financial reporting information.

- The audit implications of including this information in the financial statements, pointing to a need to consider whether the information is capable of audit verification and whether any of it would be better placed in the Operating and Financial Review or equivalent directors' statement. If the conclusion drawn is that information is not capable of being verified, the corollary may be that it is unreasonable for directors to be expected to provide it. There is then an issue about the frequency of the assurance work and the type of assurance. Some qualitative information may not

be capable of being audited but could be subject to some other form of assurance such as a review of the processes used by management.

- Published information should reflect information used for internal management purposes. We should therefore ensure that disclosure requirements do not drive additional data collection, but are drawn from data that is already collected, either in the calculation of capital or the management of risk.

- We therefore believe that the only practical way for Basel to meet its objectives is to work with the IASB. We consider that Basel will need to consult with representatives of the accounting profession, such as IFAC, to determine the types of assurance that is appropriate for the different types of information expected to be included in the annual report. It is not self-evident that there is a case for additional information to be made publicly available by individual institutions outside the financial statements. Indeed disclosure outside the context of the financial statements could be misleading. Since the provision of this information would still need to be within recognised financial reporting structures, consultation with listing authorities, preparers, auditors and users would be necessary before this could be enacted. Practical difficulties should not be under estimated, including cost benefit concerns and the risk of increasing investors' predisposition to take short-term views. There may also be a need to educate the readers of accounts on the meaning of the information disclosed to ensure that erroneous conclusions are not drawn. The effect, otherwise, would be the opposite of enhancing transparency.

12.2 Disclosure recommendations

In reviewing the disclosure proposals, the following considerations have been borne in mind:

- Whether or not the information is understandable for the broad range of informed and diligent market participants.

- Whether or not the information is useful and compatible with the type of other information provided in the financial statements.

- Whether there are concerns of a proprietary nature.

- Whether the disclosures are reasonable in terms of volume and materiality.

Many of the proposed disclosures are supported with templates. As paragraph 214 of the overview observes, it may be preferable for institutions to provide some of the information in textual form where this is deemed more appropriate. This would help give focus to key information that would remain in tabular form. The intention seems to be that the templates are intended to be indicative and not prescriptive – a point that perhaps should be underlined.

Scope of application (including appendix 1)

As paragraph 27 explains, it will be important for the group disclosure to explain how the basis of consolidation for prudential supervision differs from the basis of consolidation applied under the financial reporting rules – the obvious departures being insurance and associates. However, the disclosure of principal subsidiaries, associates, joint ventures and significant investments is already required by accounting practice. The existing disclosures should be given priority and then consideration should be given to what additional material may be necessary for the purpose of Pillar 3.

Capital (including appendix 2)

Banks already disclose information about the components and structure of their capital base and we have little difficulty with the core disclosures proposed. Disclosures about accounting policies and changes in accounting policy are already required under existing accounting standards and these requirements need not be duplicated with respect to regulatory capital. However, it should be recognised that financial accounting requirements and regulatory requirements may not be identical.

The disclosures, therefore, should include provision for the statutory reserves to be reconciled to the regulatory capital. On the other hand, the proposal that disclosure be made of the extent to which unrealised gains and losses are included in tier 1 capital and the influence of deferred taxes would seem selective.

Within the supplementary disclosures it is proposed that the fair value and terms of derivatives embedded in hybrid capital instruments be given. This is an issue that should be discussed with the IASB in the context of IAS 39 'Financial Instruments: Recognition and Measurement'.

On template 2.2 on innovative tier 1 capital, the residual maturity information could be stripped out and given in textual form. It would seem odd to stipulate the disclosure of an item identified as "undisclosed reserves". A more appropriate heading and an explanatory footnote would be better. Template 2.4 on hybrid and subordinated capital elements takes us to an unjustifiable level of detail.

Credit risk (including appendix 3)

Section I: Disclosures applicable to all institutions

We would readily agree with the view that banks should be expected to disclose information on the size of their total risk exposures and the approach or combination of approaches used to measure and control these risks. But we do not believe that it is necessary to dissect credit risk in the various ways set out in appendix 3. For example, it is difficult to understand why average exposure should be disclosed. There is a need for blind spots in the current disclosure regime to be identified and dealt with appropriately, but this needs to take place with an awareness of the need to avoid duplication and excess.

Under the caption 'geographic breakdown' on page 26, the reference should not be to cross-border exposure, but to country exposure. It is the exposure both within, and cross-border into, the country that is relevant. This is particularly important where there are significant operations within the country – which will usually be the case for multinational banking groups.

On page 27, the term 'lumpiness of the portfolio' should be defined, or restricted to the term 'concentrations', which is already used and is well-understood in financial reporting.

Some measure of the volume of business in each segment needs to be given, possibly on the basis of a segmental breakdown of economic capital.

Section II: Credit risk disclosures under the standardised approach

We consider much of the information sought by table 3.2 to be unnecessary. For example, why should each agency be named if a bank uses only highly reputable institutions? Is it really necessary for a bank's policy for translating public ratings on particular bond issues into borrowing ratings on its loans to be given? What is the merit of knowing the percentage of a bank's outstandings in each risk bucket covered by each agency's ratings? Would the value obtained justify the systems development costs that would be incurred in order to capture this data? In addition, the information shown in template 3.II.2 would presumably be the same for every bank and must therefore be of dubious need.

A more straightforward approach would be to require a statement to be provided on the use of agencies and any significant change during the year. Information should also be provided setting out the basis on which credit decisions are made. This should include a quantitative analysis supported by qualitative information explaining the underlying process. For example, while it would be valid to require a bank to disclose the basis on which it adopted individual ratings – whether it be the highest, lowest or mid-point, it would not be appropriate to mandate which they should use.

Section III: Credit risk disclosures for the IRB approach

While we do not disagree in principle with the concept that information should be publicly disclosed as a pre-requisite for the IRB approach, we do not believe that the interests of market participants are best served by the simple repetition of data prepared for regulatory purposes. The proposed disclosures, including the templates, are unacceptable primarily because of doubts about whether the information would be readily understandable, but also by virtue of their volume. This section therefore would benefit from a thorough review aimed at devising disclosures that would provide more accessible information on the IRB approach. For example, information about exposure to PD grades is insufficient to provide an insight into the losses that are likely to be incurred and raises the difficulty of how to explain the default correlation or the impact resulting from default.

As matters stand, we believe that the financial statements of banks could be debased as a result of the inclusion of the information proposed as we believe that it would open up a key element of the regulatory regime in a way that few would comprehend. The level of detail sought is also questionable. Why for example should it be necessary to provide information across fifteen rating categories?

It is also unclear from the paper how the requirement to disclose cumulative default rates by internal credit grade category will work. Should these default rates be based on the current grading at the point of default, which might not be meaningful given that issues in default would always have a low grade, or on an historic grading, and if so, over what time period? There is therefore a need for further thought on the basic ground rules that ought to apply.

In any event, we believe that it would be a mistake to adopt an unduly prescriptive set of disclosures at this stage given the differences in the institutions to be covered and the need to allow disclosures to evolve under the new capital regime. We therefore consider that the IAS 30 Steering Committee should be mandated to develop a framework for qualitative and quantitative disclosures in support of Pillar 1. Information provided should provide users with an insight into the way in which the business is managed, the institution's risk appetite, the quality of the book, management performance and bad debt provisioning. Quantitative information provided should be compatible with information used in the management of the business on a daily basis, though there will necessarily be limitations on the figures provided if the disclosures are to stop short of being proprietary in nature.

This type of approach would be compatible with the approach advocated by the Basel Euro-Standing Committee for the first stage of opening up market risk disclosures. In its discussion paper on 'The public disclosure of market and credit risks by financial intermediaries', September 1994, it proposed that the following factors be borne in mind when assessing the relative merits of the various bases for disclosure:

- Any disclosures should be meaningful in their own right;
- The information and its relative importance should be capable of being understood by informed readers;
- The amount of information provided should be proportionate [to the information provided on a bank's on-balance sheet business] and the scale of its [derivatives] activity;

- The information should be provided as far as possible within a standardised framework so that comparisons can be made between banks, though care needs to be taken to avoid the further development of risk management techniques and disclosure practices being stifled;
- The disclosure requirements should not result in commercially sensitive information being disclosed; and
- The information should be practicable and cost-effective to gather.

We believe that these factors should be broadly adopted as guiding principles for the development of credit risk disclosures for the IRB approach.

Section IV: Credit risk mitigation

The proposed disclosure set out in this section fails the reasonableness test by virtue of its excessive detail and volume. Moreover, requiring the disclosure of unweighted credit risk exposures before and after mitigation would seem meaningless given that they will be the same. It is further the case that the recommendation that banks disclose their main guarantors/protection providers would seem to stray into the field of proprietary information and may even raise systemic concerns.

Market risk (including appendix 4)

While we accept that there may be grounds for elaborating market risk disclosures made, and for best practice to be extended to less developed jurisdictions, we do not consider the radical overhaul implied by these proposed disclosures to be necessary. In each instance the disclosure sought is excessively detailed and the interests of market participants would be better served by the type of summary information currently given in the financial statements of many leading institutions. For example, we are not convinced of the usefulness of back-testing results in respect of market risk in the trading book and are unsure of how the market would interpret this information.

The appendix and the paper itself make frequent references to a portfolio approach. The level at which ‘portfolios’ are defined is not specified. It should be clarified exactly what a portfolio is and who defines the reporting level. If reporting portfolios are standardised across institutions, they may not be consistent with internal reporting and therefore require further work. If individual banks are permitted to define their own portfolios, then comparability will be an issue. If the definition is at a very low level there could be concerns about proprietary data. This comment also applies to Quantitative disclosures part (1): information for risk assessment.

On template 4.1, level and variability of market risk in terms of value at risk, we do not consider that the proposed value at risk disclosures can sensibly be totalled and regard the proposed provision of the variability data sought for each portfolio by period to be excessive.

On template 4.3, back test results, the proposed inclusion of results for each portfolio on an individual daily basis for 250 days would seem disproportionate and impractical.

Operational risk (including appendix 5)

We do not believe that many institutions will be in a position to quantify their exposure to operational risk and have serious concerns about the disclosure of the amount and circumstances of operational losses incurred. In any case, while there is still debate about the definition of operational risk and its boundaries with credit and market risk, it is difficult to see how actual loss data could be consistent between institutions. A more appropriate base for disclosure, therefore, would be to require banks to explain their operational risk management processes.

Interest rate risk in the banking book (including appendix 6)

We support the concept of disclosing interest rate risk in the banking book - subject to the usual materiality considerations - and agree that this is an area that merits attention. However, we consider the proposed disclosures to be excessive. We have particular difficulty with:

- The proposed disclosure of standardised interest rate shock by currency, which would be extremely onerous for an internationally active bank.
- The proposed disclosure of the potential impact of interest rate shocks on economic value and earnings. What, for example, is 'economic value' and which macroeconomic impacts should one take into account? The proposed disclosures look unworkable to us.

The concept of using parallel movements in interest rate shocks is largely invalid. Such parallel shifts are rare in practice and the reality is that market movements are more complex than this. Reference is made to alternatives to the parallel shift, however unless defined alternatives are specified, there will be no comparability between institutions. We should be cautious about specifying such alternatives as one size may not fit all.

In the summary on page 54, point 2(vii) asks for the notional value of derivatives used for hedging banking book assets or liabilities. Although easy to provide, this is not meaningful as notional values are a measure of the volume of hedging activity and not its effectiveness, which is addressed through financial reporting disclosures. The notional value of derivatives can be inflated by offsetting deals made as positions increase or decrease.

Requirement 3(i) of the summary table implies that goodness of fit of the models and/or validation of the assumptions used is required. This implies some kind of back-testing, but no parallel shift model for earnings is likely to be validated through back-testing. The effect of the interest rate shock is a stress test rather than a model and the effect of the shift is calculated assuming no management action in response to the rate shift, whereas in practice, of course management action would be taken. If the Basel Committee are proposing a model here, they should provide an indication of the parameters.

We support the intention that interest rate disclosures in the banking book should reflect behavioural assumptions made in the management of the exposures. We again believe that this is an area in which the IAS 30 Steering Committee should be mandated to devise suitable disclosures within International Accounting Standards.

Capital adequacy (appendix 7)

While we would not disagree with the proposed summary comparison of internal estimates of economic capital and regulatory capital, we do not see the need for capital adequacy ratios to be disclosed at the level of detail proposed. In particular, we cannot see a case for breaking down the credit risk capital requirements between on balance-sheet and off-balance sheet.

Annex 1: Linearity in the Operational Risk Charge

1. Introduction

The BBA , LIBA and ISDA ('the Associations') have prepared this joint paper to focus on one specific and, in their opinion, problematic element of the Basel Committee and EU authorities' proposals for a capital charge for operational risk – namely the 1:1 linear scaling of the charge[3]. This paper is submitted in an attempt to advance debate on this specific issue, which the Associations consider to be in need of prompt and careful analysis.

If necessary, the issues outlined in this paper could form the subject of a more detailed and thorough study pursued on a collaborative basis by industry and regulators and targeting data-rich areas. The Associations believe that non-linear scaling should be introduced from day one and that this issue merits analysis as a key factor, in the first instance ahead of finalising capital proposals but also subsequently as part of a formal, scheduled review of the impact of the rules on operational risk that they believe should be conducted within a limited time after implementation. The Associations further believe that regulatory support of any such study will be a critical factor in its effectiveness.

As currently proposed, a firm's capital charge will increase as an undifferentiated function of its size, as measured by a certain indicator or set of indicators. This is true of all three stages of the 'evolution' proposed in CP2. The Associations consider that this creates a disproportionate burden on larger firms, when both conceptual and empirical study suggests that, for individual firms, size is *very weakly correlated* to operational loss *and in diminishing proportion*. In other words:

1) the size of a firm (by whatever indicator one chooses to measure that size) fails to explain the majority of the variability of operational loss; and
2) such relationship as there is between size and loss is one of diminishing effect – for every unit increase in size, the increase in operational loss becomes smaller.

In particular, there is evidence to suggest that *both* the severity *and* the frequency of loss should *not* be thought of as the linear function currently proposed. This evidence is consistent with good theoretical reasons why this should be the case.

2. Conceptual issues

The main conceptual reasons for considering that operational loss does not increase as a simple 1:1 linear function of the size of a firm are as follows. Fundamentally, a firm's exposure to operational risk is a function of how it is managed and this key variable dominates remaining variables. A larger firm has the opportunity and incentive to invest in effective management, both in terms of governance and day-to-day risk control. Arguably, in fact, it cannot *become* big in the first place without investing in effective management, and this investment will to some extent be reflected in its loss experience.

The intuition behind linear scaling is that a firm will incur more errors, the more business it does. Yet even a modest increase in business will necessitate the introduction of efficiencies, in order to be sustainable; at the same time, a failure to introduce these efficiencies would be quite apparent to any objective observer.

Other things being equal, a larger firm will have stronger earnings (reinforced by economies of scale), and so more to spend on improvements in controls and control structures, including quality of staff, external support and systems. Many such improvements will be permanent in nature. Others will be readily renewed.

---

[3] Henceforth in this paper the term 'linear function' or 'linear scaling' will be shorthand for the 1:1 linear function, unless otherwise specified.

Larger firms will also have more opportunity to diversify earnings sources and run risks that are independent of each other, both within the category of operational risk and across risk categories. In practice, even without diversification (which may be limited for some large specialist firms), it is the core areas of a firm's business that are likely to be the largest, entailing:

i) the greatest experience and related governance and risk management skills; and
ii) the greatest incentive to invest in controls.

Moreover, strength of earnings gives a greater loss-absorption capacity.

In areas such as transaction processing, firms have found that higher volumes of activity are strongly associated with higher levels of automation, with reduced potential for manual error. Increased automation in turn means more emphasis on tested business continuity plans. (Typically, higher volumes are also associated with higher levels of market liquidity; combined with controls and automation, greater market liquidity reduces the potential for loss from trading errors.)

Research by one member firm suggests that risk in some circumstances will be exactly the same, regardless of size of indicators such as gross income. The capacity and standard deal size of some traded markets would mean that anyone with a transaction processing error could be hit in equal measure by an eventuality such as a sudden and large rise in interest rates. In other words, the inherent riskiness of certain situations outweighs the size effect.

It may be true that, across the industry *in aggregate* there is some higher degree of correlation between loss levels and gross income. (For instance, analysis of US financial-institution losses in excess of $50 million suggests this, though only when looking across *all* risk types.) However, this is not the same as saying that the relationship holds true for individual institutions, where the firm-specific factors discussed above will come into play. Expert opinion is that there may be a stronger statistical relationship between size and operational risk in individual business lines, but that the same underlying factors will dictate that a diminishing relationship applies here too.

Looking at other industries, for instance pharmaceuticals, it is apparent that the starting point in analysing risk and size is different: it is quality control. In a competitive environment, a larger firm simply cannot afford to lag behind a smaller one in this respect, and will use its size to achieve economies of scale that allow it to ensure this. It seems highly likely that there will be parallels for this phenomenon in the operational aspects of financial services.

It is important to note that a non-linear relationship does not necessarily discriminate against smaller firms or business lines – it assumes a standard level of risk (defined by the calibration of the charge) and then lower levels based on the real economic effects of running a larger business. Under current proposals, however, a larger firm, which is likely to be generating more revenue per unit of capital, will be penalised by a higher capital charge.

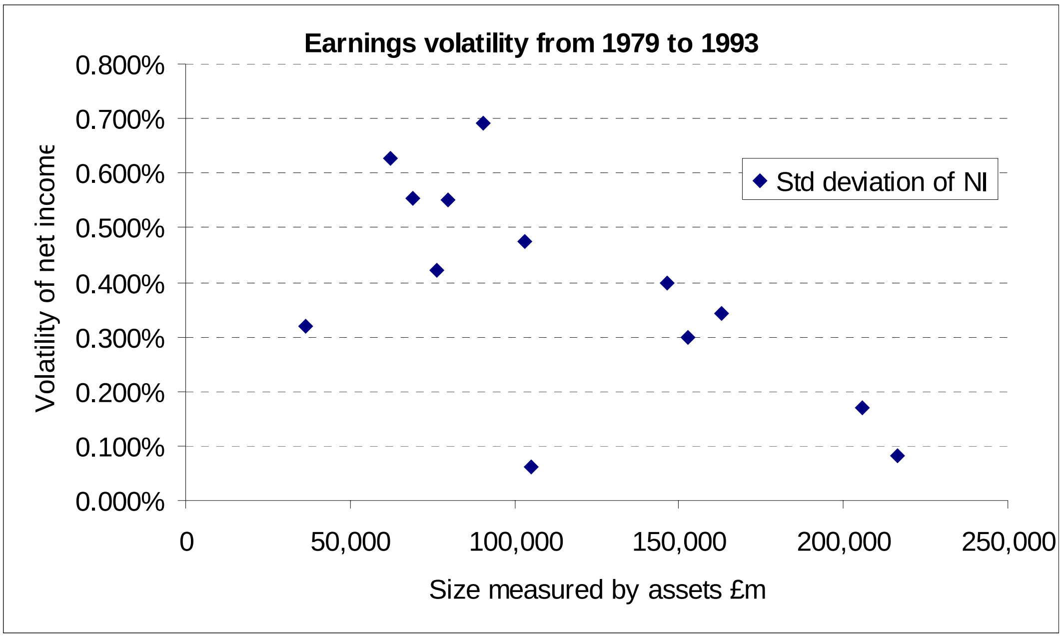
It might be argued that, on its own, greater size does not guarantee proportionally lower levels of risk. Theoretically this must be true. However, to the extent that greater size does not guarantee proportionally lower levels of risk, other readily detectable factors –for instance, external factors, material risk concentrations, or lack of experience in a given business line – may be monitored. This approach offers a more rational starting point; the alternative is to assume that becoming smaller necessarily reduces one's risk, which does not accord with either any conceptual rationale or empirical evidence.

It is also argued that there is evidence of different firms of varying sizes having similar amounts of economic capital for operational risk as a proportion of total economic capital. Aside from the pitfalls associated with such figures for economic capital for operational risk, which render them of little

value in calculating regulatory capital requirements[4], it is important to bear in mind that any such allocations of economic capital are made in the context of the calculation of credit and market risk economic capital, where non-linear portfolio models are used. For the percentage of economic capital allocated to operational risk to remain similar in firms of different sizes, therefore, suggests that there is a non-linear function for operational risk capital.

3. Volatility of earnings

Research carried out by member firms shows that volatility of earnings will tend to *diminish* as the size of the firm increases. The chart below analyses this relationship (using standard deviation of net income as its measure) for a number of firms over the period 1979-93 – naturally, this may include some diversification benefit, but as argued above, larger firms have more opportunity to diversify. This conclusion is also supported by a paper published by the Federal Reserve Board of New York in 1995[5].



The data plotted in the chart above, all taken from public accounts, is as follows:

	A	B	C	D	E	F	G
Assets (£m)	216,576	205,870	163,116	152,862	146,334	104,923	103,318
Net income σ (%)	0.083	0.171	0.344	0.300	0.399	0.061	0.474

	H	I	J	K	L	M
Assets (£m)	90,465	79,757	76,431	68,989	62,218	36,294
Net income σ (%)	0.691	0.549	0.421	0.554	0.628	0.320

Net income after tax, minority interests and exceptional items

[4] See section IV of the ISDA response for details on this.
[5] FRBNY Economic Policy Review, July 1995

4. Magnified distortions

A further consideration is that reliance on a linear function exacerbates the double-counting that exists elsewhere in the proposed Accord. It is beyond the scope of this paper to deal in detail with those double-counting effects but these have already been highlighted in public fora and the issue is expected to form a part of several responses to the current round of consultation. Among the effects is the inclusion of a 'W' factor for legal risks in relation to credit risk mitigation techniques in spite of the fact that legal risk is explicitly envisaged as included in the definition of operational risk.

Moreover, it is a stated intention of the Basel Committee to calibrate the operational risk charge conservatively in the absence of precise industry data. Given that the charge is also expected to be calibrated to an average, a linear function will amplify in an inappropriate way a charge that is already quite likely to be too high for some firms.

Many questions remain about the use of activity-based indicators. It is beyond the scope of this paper to go into detail on this. Ultimately, however, these are relatively crude proxies[6] and this therefore is another way in which the weaknesses of linear scaling will magnify risk-insensitivity in the Accord.

Similarly, because of the way the Stage II ('Standardised Approach' charge) is structured, a firm which does not correspond to the model average, with the relevant number of business lines in the proportions set by the weightings, will run the risk of a charge that is not consistent with the risks they really run. Also in relation to Stage II, the 'beta' factors entail an averaging effect which, when scaled up, will be magnified, potentially inappropriately.

As regards use of indicators, experience at some member firms has shown that, aside from the issues around the form of scaling and around the choice of particular indicators, scaling on the basis of any one factor grossly oversimplifies the picture, and would therefore constitute a further form of 'double distortion'. (An analogy for this phenomenon is healthcare, where it does not make sense to allocate spending on the basis of population numbers alone, and where it would be essential to take into account other factors.)

Taking the example of transaction volumes, while the *frequency* of loss may increase as some function of the *number* of transactions, the *severity* of loss would logically be a function of the *size* of those transactions. Although a larger firm will have a greater capacity for large deals, in practice most of the increase in business size at firms typically comes from an increase in the number of transactions, which might affect the frequency of loss but will not affect the severity.

It might be fair to say that, if a *larger* number of indicators all *simultaneously* suggested a greater level of risk, then the equation could be different. In that case, however, the function could equally well be non-linear in *increasing* proportion. However, this sort of circumstance is presumably precisely what 'Pillar II' of the new regime should be capturing. It is, in the Associations' opinion, instructive that EFIRM (the European Financial Institution Risk Managers' Forum) views size as of minimal relevance. Its June 2000 paper on risk mitigation for operational risk[7] is based on the clear understanding that other issues are dominant in assessing vulnerability to operational loss.

5. Incentives

It is appropriate when analysing the impact of scaling to examine not only the technical risk-sensitivity of the approach but also the likely effect on behaviour. Mis-specification of the sort identified would not provide the incentive for firms to grow, the *relative* advantage being in remaining small. Similarly, there would be relatively less incentive to invest in controls: although these would tend to reduce operational losses and thereby reduce the volatility of earnings, this

[6] For instance, use of gross income will be especially penal for high-margin firms.
[7] 'First Considerations on Risk Mitigation in the Regulatory Discussion on Capital Charges for Operational Risk'

earnings protection would not be rewarded in the capital treatment. And because there is no allowance for the risk and earnings diversification that is in practice achieved by larger firms, the incentive to run a diversified business would be greatly weakened.

These are at best questionable incentives. They are also effectively business decisions on behalf of firms, that help neither those that are already large nor those which might aspire to become large.

While diversification benefits should be recognised, it is equally important to ensure fair treatment of large yet specialised firms. The Associations strongly believe that any proposals, including scaling factors, should be tested for impact on such firms.

6. Statistical considerations

Strictly, there is no reason for the scaling function to be monotonic (ie, smooth), at least in relation to individual firms. When a firm reaches some given size, it becomes cost effective to introduce some extra form of control, which will actually result in a drop in losses, for example, implementing straight-through processing, or having a stand-by system ready to ensure that there is no break in system availability. However, as the size at which such changes are implemented will vary from firm to firm, there is really no practical alternative to a monotonically increasing function.

The intuitive and statistical conclusion is that the function will be curved and that even a square root function will be relatively conservative. Those responsible for database initiatives report that, based on research carried out to date, they would recommend a function significantly more favourable to larger firms, namely to the power of one-quarter[8].

As noted above, in modelling operational losses there is a distinction made between **frequency** and **severity**. *For the purpose of scaling*, the current proposals in CP2 do not make this distinction in any of the three stages. (Inclusion of the 'Loss Distribution Approach' would, of course, obviate the whole problem, as it would be based on true risk numbers.)

Severity

The study referred to in footnote 4 makes a strong case that *severity* of loss has a weak and diminishing relationship with size. Thus, for every hundred-dollar increase in indicators such as gross income, a firm's operational losses are only likely to increase by $\$100^{0.25}$.

As stated above however, even this relationship has to be seen in context. Regression analysis performed by the authors of the study on the relationship produced an 'R^2' statistic of around 5%. As the study makes clear, this means that "around 95% of the loss variability in the data is attributable to factors other than the independent variable [ie, size of firm]". The authors of this study add: "If the size of a firm is so weakly related to its size of loss, what are the causes of loss variability? We suspect that the vast majority of the variability is caused by factors such as inherent differences in risk (based on the type of business conducted), the competence of management, and the quality of the internal control environment." Insurance company experience leads to the same conclusion. As has been pointed out elsewhere, recognition of controls is an essential element, albeit difficult to incorporate into a capital structure.[9]

[8] In an article in 'Operational Risk' in January 2000, Shih J, A Samad-Khan and P Medapa propose the equation $L = R^{\alpha} \times F(\theta)$, where loss L relates to Revenue size R scaled by α. ($F(\theta)$ is the residual term not explained by any variation in size.) According to this study, α would be 0.25. The data used for the study were obtained from the PricewaterhouseCoopers OpVaR database of publicly reported operational losses, containing at the time of the study over 4700 lossses in excess of $1million. NetRisk report findings consistent with this.
[9] 'Operational Risk Regulatory Approach Discussion Paper' ISDA, September 2000

Frequency

As one OpRisk modelling expert[10] consulted by the Associations has pointed out, empirical evidence suggests that loss *frequency* appears to follow a Poisson process. In such a distribution, the mean number of losses is equal to the variance, the one defining the other. A consequence of this is that, if the probability of an event doubles, then the mean of the distribution (and hence the variance) will double; but, as risk is driven by the standard deviation (and since standard deviation is equal to the square root of variance), this increases in proportion to the *square root*. In fact, in such a distribution, the larger the mean frequency (for m>1), the smaller the ratio of the standard deviation to the mean, and the 'tighter' or less volatile the overall distribution. Even if mean frequency does bear a linear relationship to size – which is itself a questionable assumption – the frequency relationship at the confidence levels typically targeted for regulatory capital purposes would necessarily be non-linear.

It is impossible to disentangle the question of scaling from the question of 'expected' versus 'unexpected' loss. For expected loss, there continues to be a strong case that pricing/earnings should be taken into account and that, for the high-frequency-low-impact losses which undeniably constitute the richest data-set in regards to operational risk, the relevant question will be strength of earnings relative to such expected loss. As noted above, other things being equal, a larger firm will have stronger earnings, offsetting any increase in expected loss. (Earnings may go down in a recession, but so will business activity.) Severity data is the most clearly non-linear (as demonstrated in the article cited) and this is especially relevant to the question of unexpected loss (UL). In an operational risk context, UL is principally driven by low-frequency-high-impact losses – ie, occasional large losses, where assumptions as to severity are crucial and should be the ones that underpin capital requirements.

7. Summary / Proposal

In conclusion, the evidence that exists points clearly and consistently towards a non-linear function as the means to scale up or down capital requirements for operational risk. This would create incentives that are better aligned with business practice and be consistent with both theory and the experience of firms. Such an approach would also be a major component of a more risk-sensitive charge, as it would offset some of the approximations being made in other aspects of the charge. (A Loss Distribution Approach would go even further in this direction.)

The Associations believe that the scaling of operational risk capital charge is an issue of such magnitude that the approach should be amended in the final capital proposals and, in addition, should be reviewed post implementation of the rules. The Associations view this as an issue of capital allocation rather than calibration, and as such not an obstacle to progress on structuring a capital charge.

The Associations would accordingly like to propose that, in addition to immediate change to the proposals, further detailed research be done on this subject, in order to base changes on the greatest possible amount of evidence. The proposed research would take into account the experience of individual firms, data modellers and insurance practitioners. Collection of the necessary data would focus on data-rich areas, particularly in fields such as transaction processing, using in-sample and out-of-sample testing. (For instance, approaches could be made to central counterparties and message processors, in which case regulatory support would clearly be necessary.)

The Associations are willing to undertake this work with a view to reporting to the Basel Committee and the European Commission on its findings. This should be feasible within a time-frame of around six months, consistent with the continuing dialogue on the refinement of the operational risk capital charge.

---

[10] Ali Samad-Khan

Annex 2: The Treatment of Securities Financing/Liquidity Transactions under the new Capital Accord.

1. Introduction and general observations

The draft Accord states that the proposals set out to reform the capital rules relating to credit risk in the banking book, but it is not clear from either the paper or from discussions with regulators during the consultation period, whether there is any intention to apply the current Basel credit risk mitigation proposals to the trading book. To do so would seriously affect capital requirements and market liquidity, particularly for securities financing/liquidity transactions[11]. Even setting aside the potential market implications of applying the banking book treatment to the trading book, this option is misguided in principle: securities financing/liquidity transactions form a distinct class of activity and a regulatory capital approach appropriate to them needs to be developed from first principles.

If the Committee should decide that changes to the trading book treatment of these transactions would now be advisable, these ideas should be exposed through a follow-on consultative process separate from the one now underway. It would be procedurally inappropriate to make major changes to the trading book regime without a due period of consultation. We therefore recommend that to maintain the integrity of the consultative process and to achieve sensible risk-based capital treatment for financing transactions, regulators should not change the present trading book treatment for these transactions at this time.

If regulators wish to consider the development of a more robust risk-based approach to regulatory capital requirements for trading book financing transactions, the industry would be more than happy to work on this project as part of follow-on consultative process.

If however regulators were to implement new trading book treatment for financing transactions without due consultation, it should be recognised that there will be a serious risk of market disruption; to reduce the probability of such problems, we would recommend that national regulators be provided with broad latitude to approve risk-based internal methods of estimating capital requirements for these transactions. We would be concerned that the regulator’s flexibility is not excessively constrained in implementing the revised Accord by substantial qualitative or quantitative standards for these models. While not putting such standards in place runs some risk of a non-level playing field, this risk is modest as compared with the danger of hastily conceived standards leading to market disruption.

2. Market implications

Securities financing/liquidity transactions are broadly recognised - by both participants and regulators - as an important element of the infrastructure of securities markets. We cannot put it better than the regulators themselves, in the following extract from the 1999 IOSCO/CPSS report[12]:

> *Securities lending transactions* [which, in this context, includes repos and buy/sellbacks] *have grown very substantially in recent years. While such transactions have been important for some time in several national markets, their overall significance within the financial system has increased notably in the last decade. Today, securities lending is an integral component of nearly all active securities markets, both domestic and international.*

[11] By “securities financing/liquidity transactions”, we mean those transactions which consist of financing of, or by, securities positions; this category would include stock lending/borrowing, repos and reverse repo, buy/sellbacks and sell/buybacks, prime brokerage and margin lending activities.

[12] "Securities Lending Transactions: Market Development and Implications", Technical Committee of the International Organization of Securities Commissions/Committee on Payment and Settlement Systems, July 1999, section 5.1.

The cash-driven market provides a means for market participants to finance securities positions at rates generally below unsecured borrowing rates and gives cash lenders access to a flexible money market instrument. The securities-driven market increases the liquidity of securities markets by providing a means for participants to borrow securities on a temporary basis, usually against cash or other collateral. This reduces the potential for failed settlements. It also facilitates investment and trading strategies that would not be possible without a liquid supply of securities available for borrowing, including "fundamental short" strategies as well as market-neutral arbitrage strategies such as cash versus futures arbitrage, convertible bond arbitrage, or dividend-related arbitrage. In addition, many market participants now borrow securities to hedge offsetting positions they have taken on through derivative instruments.

In the most active markets, securities-driven lending is no longer a specialised activity, but is widespread among many different types of market participants. It allows portfolio managers and institutional investors to earn incremental income by lending out idle securities held in custody on a collateralised basis. This activity may also increase repo market activity since the cash collateral for securities loans is frequently reinvested in the repo market. Securities firms and their customers depend on the ability to borrow securities to hedge risks and to arbitrage price differentials across markets. The extent of this arbitrage has an important effect in increasing the efficiency of market prices and in increasing the linkage between securities markets and other markets, such as associated futures and options markets.

The growth of securities lending is attributable in large measure to the positive effects securities lending has had on both investment activity and securities settlement arrangements. These benefits should continue to promote the development of liquid securities lending markets. Other factors may also influence the rate of growth in securities lending … growth can be influenced significantly by the attitudes and policies of national market regulators, as well as by the approaches taken by market participants.

Overall, it is reasonable to expect that securities lending activity will become an ever more deeply embedded part of contemporary securities markets. The perceived benefits of securities lending are seen as important by most national regulators, and thus it is likely that most national and international markets will continue to see increased levels of activity.

Against this background, governments, central banks, supervisors and the industry have a clear common interest in ensuring that the regulatory environment for securities financing/liquidity transactions facilitates - or, at the very least, does not damage - this important element of the market infrastructure. We recognise, of course, that there are legitimate prudential concerns here, but it is essential that an appropriate balance should be struck and that the capital charges imposed should be proportionate to the risk.

Liquidity in the capital markets is essential to ensure that they function efficiently and thus aid the financing of the real economy. Liquidity also aids price stability by ensuring that shortages of stock are kept to a minimum and that there is a deep market where prices quoted are those at which transactions may be undertaken. These markets are the primary source of liquidity for most institutions, particularly in times of stress. In our view, and we believe also those agencies responsible for the safe functioning of capital markets, it is of extreme importance that care is taken not to impair the liquidity of the market which would serve to increase systemic risk. The attached annex discusses some of the issues related to this problem.

3. Principal features of Securities Financing/Liquidity Transactions Business

a) Transactions

The starting point for an analysis of the appropriate regulatory capital requirement for securities financing/liquidity transactions must be the features of the transactions themselves. We summarise them as follows:

- they involve the exchange of one set of assets (securities) for another (cash and/or securities) for a period of time (which may or may not be fixed). These two "sides" of the transaction are not the result of separate decisions but form an indivisible whole;
- they are undertaken for liquidity purposes (i.e. to finance trading activities and to meet short term cash or securities needs);
- in the overwhelming majority of cases, the assets involved are in the trading book and by definition meet the appropriate tradeability and valuation criteria.

From this position, the differences between a securities financing/liquidity transaction and a collateralised exposure are quite evident. The Basel Committee itself defines a collateralised transaction as "*one in which:*

- *a bank has a credit exposure or potential credit exposure to another party … and*
- *the exposure or potential exposure is hedged in whole or in part by collateral posted by the counterparty*"[13].

This definition rests on there having been two distinct decisions: first, to undertake a transaction giving rise to a credit exposure; and second, to take collateral against that exposure. In a securities financing/liquidity transaction, by contrast, the credit exposure at any point in time is not the gross value of the assets transferred to the counterparty but rather the net value of what has been exchanged[14]; in this sense, securities financing/liquidity transactions are closer to asset swaps than collateralised loans.

b) Market practices

The market for securities financing/liquidity transactions is above all an interprofessional one, where practices and procedures are well established and their robustness tested over many years. Defaults and disputes are extremely rare in this market. Even where defaults and disputes have occurred losses have been even rarer – to the extent that many market participants state that they have never incurred a loss in this area. These characteristics are a function of robust and disciplined market practices in relation to credit and documentation and the short term nature of these transactions – a high proportion of which are overnight. Specifically these market practices include:

Credit risk management practices:

- use of initial margin, sufficient to cover the liquidity, price volatility and close-out characteristics of the securities involved in the transaction;
- daily marking to market and re-margining;
- monitoring for potential events of default and prompt action on the occurrence of such an event.

Documentation standards:

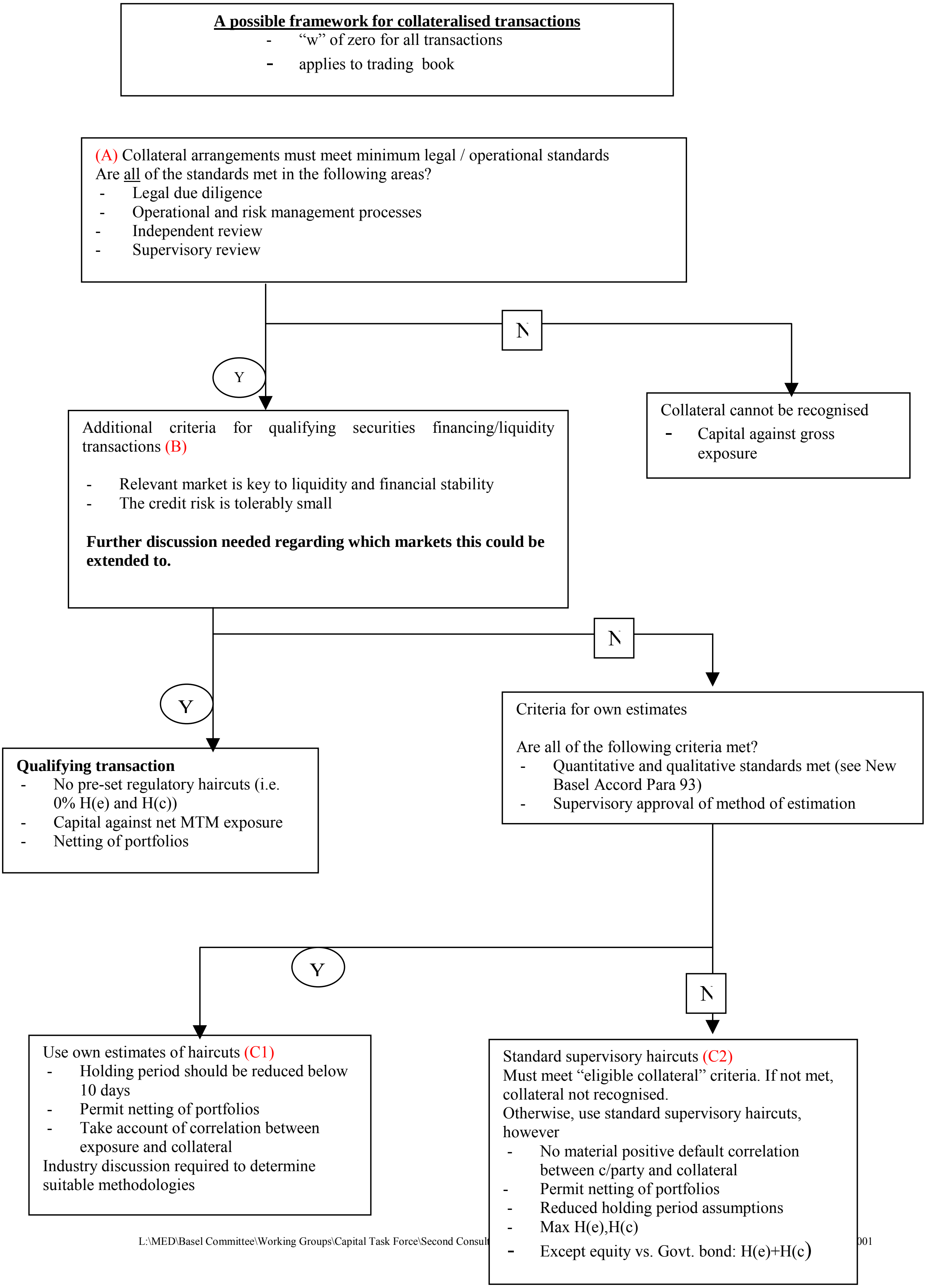
- use of long-standing, robust documentation, such as widely used master agreements which, inter alia:
  - include as events of default the counterparty's failure to re-deliver on termination or to meet margin calls;
  - give the non-defaulting party the immediate right to: close-out all transactions under the agreement and offset its claims against those of its counterparty; and seize the "collateral";

13 Paragraph 64 of the draft revised Accord

14 There is, of course, a need for minimum standards on legal robustness - see section below.

- confirmation that the documentation is enforceable.

4. A POSSIBLE REGULATORY CAPITAL FRAMEWORK



a) Definition and general rules

We acknowledge that this business is not risk free, and that credit risks remain. We have described in section 3 above the qualitative characteristics of securities financing/liquidity transactions which lead us to believe that this business should be subject to tailored capital adequacy requirements distinct from the normal rules applying to collateralised exposures. We recognise, however, that this approach will not be practicable unless a clear boundary can be drawn around the transactions to be included in such a regime. We believe this can be achieved in the setting of appropriate minimum operational and legal standards (see section below) which are to be applied to banks and securities firms participating in this market.

b)"w-factor"

We explain elsewhere in our submissions on the new Accord why in general terms we believe that the Basel Committee's proposed "residual risk" charge (the so-called "w" factor) is inappropriate for all transactions[15]. There are also some reasons specifically relating to securities financing/liquidity transactions as to why the "w-factor" is inappropriate.

One of the stated purposes of the "w-factor" is to provide against legal/documentation risks. The definition and minimum standards which we propose, are designed to provide supervisors with sufficient assurance about the legal robustness of securities financing/liquidity transactions. These transactions are undertaken under well-established documentation and we do not believe that there is any real degree of legal risk associated with them. In particular:

- even where there have been defaults/disputes, we have found no evidence to suggest that the enforceability of the agreements has been in doubt;
- where transactions are effected by outright transfer of title, we do not believe that there is any real risk of re-characterisation. We are aware that firms have obtained explicit re-characterisation opinions covering most major jurisdictions (Australia, Austria, Belgium, England, France, Germany, Hong Kong, Ireland, Japan, Netherlands, South Africa, Sweden and the United States) and there are moves to extend the industry-wide legal opinions on the standard master agreements in order to cover this specific point[16] (of course, transactions for which robust legal opinions cannot be obtained would fail the minimum standards and therefore be ineligible for a favourable treatment).

c) **Minimum standards for recognition of collateral**

[*See Flowchart reference A "Collateral arrangements must meet minimum legal/operational standards"*]

We recommend that securities financing/liquidity transactions should meet minimum documentation and other standards. We have considered whether the Basel Committee's proposed standards for collateral are appropriate and have concluded that they need some modifications[17] given the particular

---

15 Briefly: there is nothing fundamentally different or more risky about the legal documentation used for credit risk mitigation transactions as opposed to any other contract which an institution undertakes; the documentation used must be legally robust in order to meet the minimum standards; and the proposed operational risk charge is in any case supposed to cover any remaining documentation risk.

16 Within the EU, the Financial Collateral Directive will provide absolute certainty (where the counterparty is a core market professional) on this point in those jurisdictions where there may currently be at least any remaining doubts.

17 This is not intended to suggest, incidentally, that we think that proposed minimum standards are acceptable for collateral in general. We will comment on this elsewhere.

characteristics of these transactions. Our proposed minimum operational standards for securities financing/liquidity transactions are:

- *Legal due diligence:*
  - legal documentation and requisite procedural steps must have been taken which give the institution:
    - (i) ownership of the assets received subject to an obligation to return equivalent assets, where the return obligation can be set-off against the counterparty's obligation to the institution; or
    - (ii) rights in and to the assets received which are recognised, in the event of default by the counterparty and in the event of the counterparty's insolvency, in priority to rights of the counterparty and/or creditors of the counterparty (other than liens or similar rights arising by operation of law);
  - the institution must have conducted (or have had conducted on its behalf) a legal review which is sufficient, taking into account any multi-jurisdictional aspects, for it to have a reasonable basis for concluding that the above requirements are satisfied. There must be a process for reviewing at appropriate intervals whether there have been changes in applicable laws and, if so, for re-considering if the requirements continue to be met;
  - where assets are held by a custodian or by a financial intermediary, the institution must seek to ensure that that party ensures adequate segregation from its own assets;
  - the documentation must provide for daily marking to market and the institution must have the right to make daily margin calls;

- *Operational and risk management processes:*
  - there should be clear policies and procedures for securities financing/liquidity business covering, inter alia:
    - (i) legal and documentation requirements, including the circumstances in which any significant departure from standard agreements is permitted;
    - (ii) initial margin requirements: standard margins, procedures for approving any reduction for a particular counterparty, credit procedures for assessing whether margin requirements should be increased in relation to a particular counterparty;
    - (iii) marking to market and re-margining;
    - (iv) default and dispute resolution procedures;
  - systems should be capable of tracking assets given/received and outstanding/failed settlements.

- *Independent review:* the firm’s practices, procedures and control framework should be subject to independent scrutiny and review by a firm’s internal/external auditors and risk assessment division.

- *Supervisory review*: the relevant supervisory agency should assess whether a firm operates the minimum standards set out above, in accordance with the firm’s documented procedures. Regulators should be kept informed of material modifications to them.

d) Proposed regulatory capital treatment for securities financing/liquidity transactions

- *Qualifying transactions* [*See Flowchart reference B “Additional criteria for qualifying securities financing/liquidity transactions”*]

  1. In section 2 above we have described the importance of the securities financing/liquidity markets to liquidity and financial stability. We therefore support the proposal that there should be a subset of securities financing/liquidity transactions to which standard haircuts do not apply. We also agree with the Basel Committee's assessment that "the credit risk may be very small on well-documented repo transactions in liquid securities conducted

> with experienced counterparties and settled quickly across proven settlement systems"[18]. In situations where the credit risk is small, we believe that it is preferable not to impose haircuts where doing so would risk impairing the liquidity of an important market.

We recognise that further work is needed to determine the appropriate scope and criteria for this treatment, and we would like a continued dialogue with the Basel Committee and the Financial Stability Forum on this subject. Furthermore, we do not think that this capital regime should be restricted by reference to *domestic* settlement systems and documentation (if indeed such things exist in the today's market): such an approach would create pricing inequalities which could damage liquidity.

The current credit exposure in a securities financing/liquidity transaction is the net mark to market value, if positive. Therefore, for securities financing/liquidity transactions meeting the above criteria, the counterparty exposure should be calculated as the difference (if positive) between the mark to market value of the assets given and the mark to market value of the assets received. We believe that netting should be permitted on a portfolio basis. We recognise that this is a complex issue, but it nevertheless needs to be addressed and we would welcome a dialogue with the Committee.

- *Treatment of securities financing/liquidity transactions that do meet the criteria for 'qualifying' transactions*

1. *Haircuts:*

For transactions that do not meet the criteria for 'qualifying securities financing/liquidity transactions', we accept, at least in principle, that haircuts of some form represent a reasonable approach to estimating this risk, although we do not believe that the collateral haircuts proposed in the draft Accord are appropriate. Our reasons are the following:

- in the rare cases where defaults have been called on securities financing/liquidity transactions, the evidence suggests that standard industry margins - which are well below the proposed collateral haircuts - have in most cases been sufficient to cover the potential future exposure;
- there is no "grace period" in standard agreements, and in practice close-out/realisation will occur within a few days. A ten day holding assumption is therefore far too long for these transactions;
- liquidation occurs when the collateral is sold or hedged rather than at the point of settlement; after the trade, the market risk of the collateral has effectively been closed out;
- for risk management reasons, the assets exchanged will usually be positively correlated so that the price volatility of the transaction as a whole will be less than that of either side alone.

2. *Own estimation:* [*See Flowchart reference C1*]

Where the standards for use of own estimates for haircuts[19] have been met and the firm has received supervisory approval for its method of estimation, it should be permitted to use its own haircuts without eligibility restriction on the assets, given the trading book mark to market and tradeability criteria (although we also believe that this holds in principle for those using the standardised haircuts, we recognise that it may not be practicable to specify standard haircuts for a wider range of securities). For the reasons described above, the holding period assumption should be significantly reduced. Collateral should be recognised also when there is a positive default correlation between the counterparty and the collateral, since firms that have the modelling skills to estimate their own

[18] Paragraph 160 of the Supporting Document on "The Standardised Approach to Credit Risk".
[19] It would not be a prerequisite to have VAR model approval to use this option.

haircuts would be able to factor the positive default correlation into the size of the haircut. The counterparty exposure should be based on the net mark to market exposure.

The treatment of netting, correlation and portfolio effects for counterparties with more than one transaction also needs consideration. Although in its Internal Models approach under the comprehensive approach to collateral, the New Accord proposes to allow banks to use their own models to calculate haircuts at the individual instrument level, no attempt has been made to move towards a fuller recognition of the benefits of diversification between individual transactions and their associated risk positions which exists in a typical large portfolio of trades. Thus, even under the internal models calculation of haircuts separate values H_E, H_C, and H_{FX}, must be calculated and then treated the same way as in the standardised approach. We believe that it is time for a more modern approach to haircuts generally, in which banks with the appropriate sophistication in modelling market risks should be allowed to use well established modelling techniques to assess diversification and concentration when calculating haircuts at the counterparty level. In this context, BBA/LIBA draws the attention of the Basel Committee to Annex 1 of ISDA's response document, containing an analysis of the economically similar case of collateralised counterparty risk.

3. *Standard supervisory haircuts:* [*See Flowchart reference C2*]

For banks which do not meet the standards for use of own estimates for haircuts, and are therefore using the standard haircuts to determine capital charges, a 10 day close out period is too long and should be reduced by at least half.

TABLE: possible haircuts for financing/liquidity transactions (4 day, 99% confidence)

Issue rating	**Residual maturity**	**Sovereigns**	**Banks/corporates**
AAA/AA	≤ 1 year	0.2	0.3
	> 1 year, ≤ 5 years	1	2
	> 5 years	2	4
A/BBB	≤ 1 year	0.4	0.6
	> 1 year, ≤ 5 years	2	3
	> 5 years	4	6
BB	≤ 1 year	9	
	> 1 year, ≤ 5 years	9	
	> 5 years	9	
Main index equities		6	
Other equities listed on a recognised exchange		9	
Cash		0	
Gold		4	

The haircuts should distinguish between different instruments and be based on appropriate close out periods. We wish to continue the dialogue with the Basel Committee on what the appropriate haircuts and liquidation periods should be. These haircuts would of course need to be scaled up if the institutions did not remargin daily or there was the possibility of an automatic stay. The haircut would be based on the larger of the haircuts for the assets given and that for the assets received, unless the transaction involved equities against government bonds. In such cases, because of the lack of positive correlation, both haircuts might be taken – a simplified and conservative approach to the problem. In order for collateral to be recognised there should not be a material positive default correlation between the counterparty and the collateral. The counterparty exposure should be based on the net mark to market exposure.

In our view, netting of portfolios should be permitted also in this approach. We recognise that this is a complex issue and we wish to discuss this further with the Basel Committee.

Attachment to Annex 2

Impact of Basel proposals on the market

We commend the Committee for making significant efforts to align more closely regulatory capital requirements with actual risk; however we feel that any effort to impose the Credit Risk Mitigation proposals on the trading book would be conceptually flawed and could prove disastrous to the market. Securities financing is the foundation of liquidity in most securities markets, and the impact of such capital proposals on the securities financing market is of particular concern. Increasing capital requirements in such low margin, high volume markets will force participants to either exit such markets or charge a significantly higher price, thereby directly reducing market liquidity and operational efficiency.

The increase in capital requirements under the Accord is estimated to be in the order of 500% to 600% for an active market participant. Such an increase in capital requirements is completely inconsistent with the loss experience in these critical trading markets. One needs to examine carefully the benefits that active securities financing markets provide, especially in times of market disruption, versus the relatively small potential for loss in such transactions. For example, the US equity market dislocation experienced in 1987 resulted in significant liquidity, credit and settlement concerns. While one can speculate as to the driving force behind some of the selling pressure that arose during the crisis, it is instructive to look at the role securities financing transactions played in helping to resolve the crisis. Without the liquidity that such transactions provide, the resulting price dislocation would have been much more pronounced. Without the settlement facilities that such transactions provide (securities lending and repurchase), systemic risk may have caused significantly large losses across the markets. Similarly, the financial market events in Autumn 1998 (effective default by Russia) present a similar situation where securities financing transactions served to help resolve a severe market disruption in a controlled fashion. The effective default by the Russian government created a vacuum in which trading volumes contracted significantly and no effective price discovery existed. Securities lending and repurchase transactions enabled financial intermediaries to bridge the imbalance in supply and demand to encourage orderly price discovery.

In summary, we consider that the imposition of the current proposals would lead to:

- Decreased liquidity and higher capital costs: If additional and unwarranted cost or capital is imposed on a financing product, a pronounced impact results on those markets directly, as well as the markets that rely on such products. Specifically, we foresee lower liquidity and higher capital/financing costs of equity and debt. As a result, a significant knock-on effect will occur in the primary and secondary securities issuance and trading markets. The end result will be a negative impact on overall capital formation and economic growth.
- Decreased price transparency: As the costs to conduct market arbitrage increase, validity and availability of prices and liquidity in securities would be adversely affected leading to increased pricing discrepancies.
- Increased price volatility: Investors would not be assured of securities liquidity and would be exposed to higher levels of market risk.
- Increased settlement risk: The high interdependence between market participants requires liquid settlement systems. Any decrease in the ability to settle trades would increase credit risk dramatically.
- Increased transaction costs: Costs of various products offered to the markets would increase in order for market makers to make acceptable returns on their increased capital usage. This would again serve to reduce liquidity and increase overall market and credit risk for all participants.
- Adverse impact on credit and market risk management: The ability of investors and institutions to use such risk reducing tools would be significantly impacted as the cost of hedging transactions increases and the liquidity in these markets decreases. As a result, overall systemic risk would increase.

- Concentration of risk: Banks would primarily be the method used to place cash in the market since financing transactions would become uneconomical. Such unsecured transactions would increase systemic risk and overall capital costs.
- Reduced product innovation: Securities financing forms a vital part of hedging strategies for derivative transactions. Without a cost effective hedging mechanism, further risk mitigation product development would be adversely affected.

<u>**Annex 3: BBA Global Operational Loss Database**</u>

1. BBA Global Operational Loss Database (GOLD) Standard Data Fields

Initial Submission Reporting Form

Event ID Code	**Event Date**	**Headline Risk Category**	**Primary Risk Factor (‘Cause’) - 2nd Tier**	**Primary Risk Factor (‘Cause’) – 3rd Tier**	**Loss Description**	**Gross Loss (US $)**	**Primary Impact categorisation (‘Effect’)**	**Soft Loss**	**Business Activity**	**Geographical Region of Loss**
e.g. 12 **Internal Use Only**	dd-mmm-yy Date recognised internally	People Process Systems External		One Primary Risk Factor	**Optional Field** Could include: • A secondary risk factor • A brief description of the loss.	Direct financial loss above a minimum floor ($50 000 for Retail; $100 000 for Wholesale)	Primary impact only.	A subjective factor (0-5) expressing the relationship and reputational damage associated with the event.	The Business Unit which suffered the loss	

Revised Submission Reporting Form: material changes only (generally, once)

ID No.	**Event Date**	**Initial Gross Loss (US $)**	**Revised Loss** **(US $)**	**Movement**	**Reason for Revision**

X123 **Internal Use Only**	dd-mmm-yy Date recognised internally	Direct financial loss above a minimum floor ($50 000 for Retail; $100 000 for Wholesale)	Firm figure	(+ / - US $)	Drop down menu • Negotiated • Insurance • Recovery of loss • New estimate • Regulatory fine / penalty • Professional fees

Event ID Code
A unique event number will be assigned to each loss event. This is for internal use only, and will not appear on the report-back form.

Date
The date is the date a loss event is recognised internally. A day, month and year (dd-mmm-yy) will be recorded.

Headline Risk Category
There will be four headline risk categories: People, Process, Systems, and External

Risk Factor Factor ('Cause') – 2nd Tier
See Categorisation document, tier 2, for details.

Primary Risk Factor ('Cause') – 3rd Tier
See Categorisation document, tier 3, for details.

One primary risk factory is mandatory; members will have to option of reporting one secondary risk factor in the 'Loss Description' field.

Loss description
This will be an optional free-form field to describe the loss and/or detail one secondary risk factor. Members will be restricted to entering a maximum of twenty-five words.

Gross Loss (US $)
Loss will be confined to the gross financial impact of an operational risk loss event above a minimum threshold. The minimum loss amount for wholesale and retail was decided by vote: US $50 000 for Retail and US $100 000 for Wholesale.

Primary Impact Categorisation ('Effect')
In addition to size of the financial loss, it will be valuable to include information on the ***primary*** impact of the loss. Submissions should record the primary impact category:

- Accounting adjustment

- Assets stolen
- Compensation/restitution
- Damages awarded against participant
- Damage to physical assets
- Irrecoverable erroneous funds or asset transfer
- Professional costs / fees
- Loss on transaction or contract
- Lost income
- Other charge to profit and loss account
- Penalties
- Regulatory fines
- Unbudgeted staff costs

Soft Loss

The inclusion of a subjective factor (0-5) expressing the relationship and reputational damage associated with the operational risk loss event would provide valuable information.

Grade	**Defining factors – one or more of the below**
0	No external effect
1	No media coverage, increase in customer complaints
2	Limited local or industry media coverage, increase in customer complaints, possible account closure, no negative effect on share price
3	Limited national media coverage, large scale customer complaints, some customer loss, informal regulatory enquiry, potential negative effect on share price, possible senior management involvement
4	Sustained national and limited international media coverage, serious customer loss, formal regulatory investigation or enquiry, negative impact on share price, senior management involvement
5	Sustained negative national and international media coverage, large scale customer loss, formal regulatory intervention and fines, significant effect on share price, direct senior management/board involvement

Business Activity

In categorising loss events we will need to define what business unit suffered the loss.

Business Line	Detail
Retail banking	Retail lending / deposit taking; cheque clearing
Plastic cards	Debit, credit, Mondex

Mortgage lending	
Private banking	
Trade finance	
Corporate banking	Lending / deposit taking; leasing; project finance
Investment banking – Trading / Markets	Securities (bond & equities); money market & forex, derivatives & commodities
Investment banking – Advisory	Corporate finance; M&A; Structured finance; Project finance
Insurance	Life assurance; health & critical illness insurance; associated reinsurance; marine; aviation; motor; household; other associated reinsurance
Asset management	Unit trusts; OEICs; mutual funds; pension funds; venture capital & private equity
Banking support – Custody activities	
Banking support – Trust activities	
Banking support – Settlement & clearing services	
Broking	Securities broking; money broking; retail broking; insurance broking

Geographical Region of Loss

United States of America
South and Central America
Central and Eastern Europe
Western Europe (including the UK)
Asia
Commonwealth (South Africa, Australia, New Zealand, Canada)
Africa (excluding South Africa)

Reason for Revision (in revised submission form)

Material changes only (generally, once)

Negotiated
Insurance
Recovery of loss
New estimate
Regulatory fine / penalty
Professional fees

2. BBA Global Operational Loss Database (GOLD) - Loss Categories

People	Employee Fraud / Malice (criminal)	Collusion	involves more than one person, at least one of whom is an employee.
		Embezzlement	Obtaining money by deception; employee effectively steals from a client/customer e.g. raising false loans, altering cheques
		(Deliberate) sabotage of bank reputation	
		(Deliberate) money laundering	
		Theft – physical	e.g. computer equipment, cash, artwork
		Theft – intellectual property	e.g. deliberate theft of software
		Programming fraud	e.g. deliberate introduction of a computer virus, by an employee
		Other	
	Unauthorised Activity / Rogue Trading / Employee Misdeed	Misuse of privileged information	e.g. insider trading, front running
		Churning	Falsely inflating a deal for commission purposes
		Market manipulation	False/misleading statements; price manipulation
		Activity leading to deliberate mis-pricing	Unauthorised or other irregular activity which affects internal portfolio pricing.
		Activity with unauthorised counterparty	
		Activity in unauthorised product	
		Limit breach	Deliberate breach by employee
		Incorrect models (intentional)	Deliberately manipulating model; unauthorised changes to parameters
		Activity outside exchange rules	
		Illegal/aggressive selling tactics	Deliberately or negligently selling inappropriate product or dispensing incorrect advice.
		Ignoring / short-circuiting procedures (deliberate)	
		Other	
	Employment Law	Wrongful termination	
		Discrimination / equal opportunity	
		Harassment	

		Non-adherence to other Employment law	
		Non-adherence to Health and Safety Regulations	
		Other	
	Workforce Disruption	Industrial action	By firm's employees
		Other	
	Loss or Lack of Key Personnel	Lack of suitable employees	Suitable employees not available internally or in market place when needed
		Loss of key personnel	This may result in a loss of clients / business or the loss of a product line.
		Other	

Process	Payment / Settlement	**Input error or** failure of / inadequate internal payment/settlement processes	**i.e. back office errors.** *Not* due to IT system failure. Note that breakdown of IT system should be reported under systems (systems failure)
	Delivery Risk	Losses through reconciliation failure	
		Securities delivery errors	
		Limit breach	As a result of inadequate internal processes or employee error e.g. daylight risk
		Insufficient capacity of people or systems to cope with volumes	Caused by unexpected volumes and/or lack of resource (rather than lack of skills)
		Other	
	Documentation or Contract Risk	Document not completed properly	Includes not adhering to account opening procedures
		Inadequate clauses / contract terms	
		Inappropriate contract terms	
		Inadequate sales records	Inadequately documented advice
		Failure of due diligence	Generally relating to M&A
		Other	
	Valuation / Pricing	Model risk	Failure of model for intrinsic reasons e.g. inappropriate parameters, incorrect programming, invalid assumptions, mathematical errors

		Model input error	e.g. wrong data, incorrect input, incorrect mark to market **in front office**
		Other	
	Internal / External Reporting	Inadequate exception reporting	
		Accounting / book-keeping failure / inadequate data	
		Inadequate risk management reporting	e.g. poor, untimely management information
		Inadequate regulatory reporting	
		Inadequate financial reporting	
		Inadequate tax reporting	
		Inadequate stock exchange / securities reporting	
		Non adherence to Data Protection Act / Privacy Act / similar	
		Other	
	Compliance	Failure to adhere to internal compliance procedures	
		Failure of external compliance procedures	Excluding failures of reporting identified under Internal / External Reporting above.
		Breach of Chinese walls	
	Project Risk / Change Management	Inadequate project proposal / plan	
		New product process inadequacies	Failure to analyse and manage operational risks involved in new products e.g. capacity
		Project overruns	Costs associated with project Overruns
		Other	
	Selling Risks	Inappropriate product selection	
		Product complexity	Product complexity leads to claims from customers who have been unable to understand it.
		Poor advice (including securities)	
		Other	

Systems	Technology Investment Risk	Inappropriate architecture	e.g. IT integration (inherited through merger / take-over)
		Strategic risk (platform / suppliers)	e.g. incorrect decision with respect to build or buy
		Inappropriate definition of business requirements	Not correctly specified; supplier suggests inappropriate system; inadequate functionality

		Incompatibility with existing systems	
		Obsolescence of hardware	
		Obsolescence of software	e.g. supplier no longer supports current version
		Other	
	Systems Development and Implementation	Inadequate project management	with respect to implementation
		Cost / time overruns	
		Programming errors (internal / external)	
		Failure to integrate and or migrate with/from existing systems	
		Failure of system to meet business requirements	Either through failure to deliver specified system or through changed business requirements
		Other	
	Systems Capacity	Lack of adequate capacity planning	Volume and flexibility
		Software inadequate	
		Other	
	Systems Failures	Network failure	
		Interdependency risk	(of systems)
		Interface failures	
		Hardware failure	
		Software failure	*Not* to include interface software
		Internal telecommunication failures	
		Other	
	Systems Security Breach	External security breaches	e.g. breach of firewall
		Internal security breaches	
		Programming fraud	(by third party)
		Computer viruses	
		Other	

External	Legal / Public Liability	Breach of environmental management	e.g. waste disposal failure; asbestos; contaminated land / polluter
		Breach of fiduciary / agency duty	
		Interpretation of law	e.g. local authority swaps; new interpretation
		Misrepresentation	
		Other	
	Criminal Activities	External frauds / Cheque fraud / forgery	

		Fraudulent account opening by client	
		Masquerade	Criminal masquerade of a Bank or a banking channel
		Blackmail	
		Robberies (+ theft)	
		Money Laundering	i.e. victim
		Terrorism / bomb	
		Disruption to business	Civil disobedience / protests / riots; sabotage of system or service.
		Physical damage to property	Caused by vandalism
		Arson	
		Other	
	Outsourcing / Supplier Risk	Bankruptcy of supplier	
		Breach of responsibility (misuse of confidential data)	
		Inadequate contract	
		Breach of service level agreement	Failure to deliver to time, to quality
		Supplier / delivery failure	Failure to deliver
		Inadequate management of suppliers / service providers	May lead to delivery problems / quality problems
		Other	
	Insourcing Risk	Insourcing failure	Failure of firm as outsourcer for third party to comply with service level agreement
	Disasters and Infrastructural Utilities Failures	Fire	
		Flood	
		Other natural (geological / meteorological)	e.g. earthquake, volcano, hurricane
		Civil disasters	e.g. spills, collisions
		Transport failure	
		Energy failure	
		External telecommunications failure	
		Disruption to water supply	
		Unavailability of building	Denial of access for any other reason; landlord / third-party failure; e.g. asbestos, legionnaire's disease
		Other	
	Regulatory Risk	Regulator changes rules in industry / country	
	Political / Government Risk	War	
		Expropriation of assets	
		Business blocked	

		Change of tax regime	e.g. Withholding tax
		Other changes in law	
		Other	