The New Basel Capital Accord

Consultative Paper of Jan. 16, 2001

Comments

CREDIT SUISSE GROUP

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Part I: CONCERNS ON SYSTEMIC ISSUES

Credit Suisse Group (CSG) welcomes the revision of the Basel Capital Accord as it attempts a more risk-sensitive approach, especially in the area of credit risk – despite our view that the present calibration of risk weights are overly conservative. While we do not agree with the operational risk proposals, we fully support Supervisors' stated goals for the financial system and thank them for the considerable efforts made. We also welcome an open dialogue in finalising the New Capital Accord, both in regard to credit risk and operational risk.

Generally, we share the comments made by IIF and the Swiss Bankers Association in regard to Basel II; however, CSG might differ on specific issues and priority setting. Our observations and suggestions are meant to be constructive, as we are very concerned about many issues to be resolved on the January 16, 2001 proposals.

Our major concerns on systemic repercussions of The Accord are grouped into the following:

- Relevance (vis à vis goals)
- Credibility (of methods, tools, etc.)
- Simplicity (of approach, methods)
- Transparency
- Cost-effectiveness
- Level playing field (among banks and vis à vis non banks)
- Behavioural issues

while keeping in mind that The Accord targets the following goals:

- Safe and sound financial system
- Maintaining the current overall level of capital in the system
- More comprehensive risk-sensitive approach addressing risks
- Focus on internationally active banks
- Enhance competitive equality.

1. Relevance

The present proposal does not sufficiently take into account the growing importance of the following aspects in the financial system:

- Convergence of financial products, markets and players
- Replacement of savers with retail-investors
- Non-banking regulated and not at all regulated financial service providers (they represent as much a source of systemic risk as banks, while being either differently or not charged in terms of capital requirements)
- Non-G10 banks in the international financial system
- Central banks as crucial players in the payment system
- Much more pronounced checks and controls by stakeholders, including shareholders on a global scale

- Global competition with corresponding disciplinary consequences, including up to date risk management
- Already existing awareness, organisation, modern tools and reporting of banks as to risks
- Operational risk – context driven and dramatically different from credit and market risk – taken up as an issue of good management and not capital; operational risk losses as part of doing business, i.e. of expenses
- Great insecurity and concern in the global banking system on the handling of operational risk charges before workable definitions and sound methods are found
- Comparison of operational with the requirements for market and credit risks by the same regulators. Market risk management relies largely on third party daily prices of tens of thousands of stocks, bonds, FX etc. over many years (close to USD 40 trillion bonds/notes o/s). Credit risk management of over 30,000 banks are based on assets of estimated over USD 35 trillion), loss figures over dozens of years and many third party ratings of counterparties. In contrast to operational risk, market and credit risks are primarily driven by external factors
- Emergence of longer term incentive schemes in banks
- Ineffectiveness of capital as a tool to prevent major or systemic crises (e.g. Asia 1998, Barings, Yamaichi, etc.)

Safety and soundness of financial institutions and systems cannot primarily be based on capital. **Sustained, sound and diversified profitability is THE precondition for protecting creditors and avoiding systemic risks. The prime driver of profitability and earnings growth is good management, not capital.**

Growth and diversified earnings should thus be of prime concern for supervisors. For many equity analysts, diversification of earnings demands a “conglomerate discount”. If banks do not receive recognition for diversification of earnings by supervisors, banks “suffer” twice.

Consistency, growth and diversification of earnings are as much precondition for the building and protection of capital as the “static view” of capital on its own. Basel II is too “fixed” on capital. **We urge that the HIT ABSORPTION CAPACITY of an institution be included as an additional, pragmatic and simple dimension to The Accord.**

Suggested solution:

- *Phase out a Pillar I Operational risk treatment and regulate/supervise this risk dimension along Pillar II / III*
- *Introduce a “can-formula” for regulatory capital charges legislation during 2002/03 (rolling directive) while working with industry to agree on workable definitions, relevant databases, credible models and a process of continuous evolution*
- *By 2004, take 50% of the average pre-tax earnings over e.g. 5 years; if yearly average actual operational losses over e.g. 5 years were higher than this benchmark, require – based on Pillar II – additional regulatory capital up to the amount of the 50% pre-tax earnings benchmark*
- *Work on new level playing field legislation for non-banks with coinciding enactment of Basel II in order to ensure that the <u>systemic</u> risk as a whole be addressed*

2. Credibility

One cannot avoid the impression that the present Basel II proposal is oriented towards **the "black sheep" or worst behaviour benchmark**. The consequences for all banks are higher costs, lower earnings, less focus on "good risks" and reduced financial health of regulated institutions.

While some "black sheep" will always exist, the vast majority of players involved are "good citizens". Only very few select senior managers act consistently unprofessionally, criminally or with the intention to ruin the institution they are working for.

If e.g. for the IRB advanced approach, over 80 different compliance issues have to be "proven" to the supervisor, the latter will be overwhelmed and the bank's good risk managers will neither be very motivated nor during this time be able to do their job, i.e. managing risks (some outstanding risk managers will no longer want to work in this field).

The present proposal is overly influenced by stakeholders with vested interest for models – but with little responsibility for their results, interpretation and costs involved.

Progressive banks want to be in the forefront of modelling. They want to remain in this group as long as a model is credible, relevant and cost-effective. We maintain that operational risk cannot be modelled with one, catch-all and credible model. Sub-categories (e.g. trading related operational risks) can be modelled. The results of this exercise might be interesting as to their intellectual stringency. However, operational trading losses at CSG cover only 0.003% of total expenses. Thus, such modelling will not make any significant contribution to enhancing the safety and soundness of the financial system. The issue, however, is not the intellectual stringency of a sub-model but the **relevance** of the losses in the overall context. Also, the effort in terms of staff and IT costs, as well as foregone opportunity gains of such an exercise will be enormous.

Models are only as good as the quality of data and the underlying assumptions. Recent history shows that the market risk quants – with the most sophisticated models worldwide – can err dramatically because their focus is constrained to a specific area and lacks the helicopter view. **Common sense is just as important for a successful survival. A proper risk and control culture** – difficult if not impossible to quantify – is arguably more important than the most sophisticated models. Models – advantaged by the fascination of a curve or a number – can even provide illusionary precision and a false sense of security: they are always a reduction of complexity and bound to provide a partial reflection of reality.

Suggested solution:

- *If a bank proves to be lax in its standards or has misused supervisors' trust there is always Pillar II (or the threat of it)*
- *Supervisors should concentrate on fewer, really relevant "proofs" for a model*

- *Regulators should only ask for models – with quality data as a base – which are credible and relevant in the overall context. (see also CSG Oct. 2000[1])*

3. Simplicity

A roughly 600-page proposal for estimated 30,000 banks worldwide must be complex. However, complex solutions can create a false sense of thoroughness and even become the origin of a systemic risk. The real issue is not a capital buffer but the reinforcement of good governance.

While tackling several issues within one framework might be intellectually attractive, it disregards the prime rule of simplicity: breaking down complexity into individual components requiring tailored treatment.

Tackling credit risk and operational risk simultaneously inflates complexity. Time pressure to resolve several problems at once adds an additional element of complexity and a source for errors. It can also misdirect an industry.

Suggested solution:

- *Use the 20/80 approach*
- *Use the operational risk approach under point 1*
- *Simplify some product areas*

4. Transparency

Transparency is not a matter of data quantity per se. “Too much” is as bad as “too little”. Data which hurt the competitive positioning or reputation unnecessarily or which are irrelevant in the overall context and/or which add unnecessary additional costs destabilise the financial system.

The dynamics of the development of the financial services industry – including non-banks – should not be disregarded by relying on an incomplete view for disclosure rules.

Suggested solution:

- *Pillar III has to concentrate on the really relevant risk information, material in the overall context of the bank concerned; consistent with accounting standards*
- *If a bank is not forthcoming as to relevant transparency, the supervisors can force it to do so (the market will force it in any case)*
- *Co-ordinate with accounting standard bodies: do not create additional inconsistent or confusing new reporting data requirements which would pollute information transparency and add cost*

[1] Can be downloaded from the internet under: http://www.credit-suisse.com/en/csgn/operational_risk.pdf.

5. Cost

Supervisors should become more aware of the cost consequences for banks and taxpayers resulting from regulatory requirements. Today's expenses for specialised risk management already have become very significant. Supervisors' requests over the last 2-3 years added a considerable additional burden – sometimes of doubtful added value. To top it, Basel II implies additional considerably higher managing time, staffing and IT-expenses. As a consequence, non-banks appear increasingly more cost-efficient and attractive.

There are an estimated 30,000 banks worldwide with an estimated Total Tier 1 capital of USD 2 trillions. The losses of the Asian and Russian crises taken together ranged from USD 140 bn (for the angle of committed official support) to USD 350 bn (from the angle of investors' losses).

Assuming additional average cost of USD 15 mn per bank, this would amount to USD 2.25 trillions over five years. The precise additional cost of Basel II will no doubt be in the hundreds of USD billions for the banking community. If the benefits / risk mitigation number do not reach these figures, Basel II will have failed, especially in the operational risk approach.

Suggested solution:

- *See above and suggestions in the technical section, particularly regarding operational risk*

6. Level playing field

This major concern has two aspects, the level playing field:

- Between the same type of banks across countries and that
- Related to competition from non banks.

The "across countries issues" among banks have to be solved with better co-ordination and co-operation among the individual national regulators and supervisors.

Non-bank competition from investment banks, brokers, asset managers and finance companies etc. is an increasingly serious issue. These competitors are as much "systemic risk relevant" as banks, especially in the context of convergence of products, markets and clients.

Some aspects of the present proposals will effectively exclude important existing activities of banks in the future and thereby – if not changed – disrupt capital markets (particularly the repos and SLB market) and result in capital misallocation. To be more blunt, some proposals indirectly introduce a new "Glass-Steagall Act"; the present proposal makes the "de-banking option" increasingly attractive.

Suggested solution:

- *Strengthen co-ordination among national regulators/supervisors, led by home-country-supervisor*
- *No interference without knowledge of home-country-supervisor*
- *Disputes should have the chance to request an independent judgement by a specialised forum like the BIS. Establish an advisory committee consisting of 50% supervisors and 50% bankers. National court procedures would remain possible*
- *Harmonise the definition of banks and financial services providers across jurisdictions*
- *Change overall legislation for financial services, as the legislation in various countries has to be changed anyway*
- *If the two former bullet points are not feasible, revise the relevant Basel II requirements (some aspects of securitisation, collateralised lending – repos, trade finance, leasing, security lending – private equity, project finance, operational risk charge)*
- *Make it more attractive to be a “bank” and not a “financial institution” via a level playing field with non banks*

7. Behavioural aspects

Supervisors should be aware that standardised risk management worldwide tends to push the industry / regions / countries in the same direction. This will **enhance pro-cyclicality** and be detrimental to the stability and soundness of the financial system. Diversity in approach by contrast tends to mitigate such moves.

Basel II reliance on a unique standard method of risk assessment techniques in the area of credit risk within and for all banking institutions bears the very root of **herding behaviour**. This is especially the case vis à vis young and smaller companies, emerging markets, non-investment grade counterparties and tougher economic environments. The Basel II present proposals will most probably be viewed by politicians and by the wider public audience as damaging economic growth by strangling risk capital, hurting the weaker players in the credit market with its “harmonised preferences” and “anti-social” by forcing banks to ask for higher spreads, based on regulatory provisions including:

- The calibration of high risk grades in the IRB sanctions SME and Emerging Markets. Their access to capital from large institutions will be made significantly more difficult. Macroeconomically this will weaken two dynamic sources of employment and growth.
- The conservative treatment of collateral is making repos and SLB markets unattractive to banks.
- The lower risk weightings in the standardised approach as compared to the IRB approach for high risks will tend to expose weaker banks more to economic downturns, thereby accelerating the consolidation in the financial sector.

In addition, we are **concerned about the requirements for the adoption of the IRB approach across all exposures**. Different business areas require modelling techniques to be tailored to business features and commensurate with available

resources. *We believe that different parts of a banking group should be allowed different approaches.*

We are concerned that a standardisation of these techniques across an entire organisation will result in a number of simplifying/reductionist assumptions, which will deteriorate the quality of risk assessments. Large banking groups – combining a wide range of activities giving rise to credit risk, each having its peculiarities – would particularly suffer from such an undifferentiated standardisation of methods.

Suggested solution:

- *More differentiation for non-investment grade capital requirements*
- *More granularity of risk weights between rating classes for the standard approach*
- *No differences in risk weightings for same equivalent ratings between the standard and IRB approaches*
- *Beware of prohibitive risk weights for small and medium sized companies, venture capital, equity investment, emerging markets as these could be detrimental to macroeconomic growth, with corresponding "blame-the-other culture"*
- *Beware of prohibitive haircuts for risk mitigation*
- *Allow for a mix of credit risk approaches within an organisation – combining standard and IRB – subject to the supervisory validation.*
- *Exclude insurance business units of a banking group from the IRB rollout requirements.*

Part II: MAJOR CONCERNS

While we welcome the spirit of the revision of the Basel Accord, we have several major concerns regarding its present form:

1. **The present calibration of Pillar I risk weights is overly conservative for a minimum capital level (see also points 2 and 3)**.
   - Pillar I calibration is an amalgamation of individual credit approaches – each on its own conservative – added up conservatively and topped by an overly harsh operational risk factor
   - Pillar I should be calibrated to be a minimum capital level and not the economic level of capital – which would be better addressed via Pillar II.

2. **The calculation of the charge for operational risk** – topping other charges – endangers banks' viability.
   - In the standard and basic indicators approach the charge is not risk sensitive and bears a significant double counting with credit and market risk
   - The calibration of the above two approaches is far too conservative
   - In the internal measurement approach (IMA) the charge calls for a focus on irrelevant aspects and the use of a methodology which is not credible for modelling operational risk.

3. **The treatment of repos, securities lending, credit derivatives, collateralised lending and the calibration of the high risk weights under the IRB approach result in a significant increase of capital charges for credit risk alone and bear the potential of setting this business off limits for banks.**
   - The "w" factor of 15% for securities has to be dropped
   - The new haircuts for the value of securities is overly severe
   - The new risk weights for loans are overly sensitive to ratings for low quality assets
   - The charges applying to traditional unfunded products are particularly harsh

4. The new regulatory review process under **Pillar II results in specific and onerous requirements** rather than in general guidance. Also, the micro-management of banks by regulators results in new skills requirements and liabilities for regulators.

5. **The new disclosure requirements under Pillar III are incredibly detailed and onerous for banks** while remaining of limited use for the general public.
   - "Too much" is as bad as "too little"
   - More data does not per se lead to more transparency but certainly to more confusion

6. **The tight timing and implementation plan** is not conducive to a well founded framework for ensuring the safety and soundness of the financial system, particularly if several fully new considerations are taken up for the first time.
   - Undifferentiated modelling leads to misjudgements
   - Complexity leads to confusion
   - Haste leads to mistakes

Part III: TECHNICAL COMMENTS

1. Introduction

The technical comments review each individual section of the Basel Committee on Banking Supervision Consultative Document “The New Basel Capital Accord” (The Accord) in the sequence of The Accord.

First general comments are made and then specific comments discussed.

Suggestions / proposals are highlighted in italic in the text.

2. Scope

2.1 General comments

We feel clarifications are required as to which parts/Pillars of the Accord are applicable to 1) the banking group as a whole; 2) banking activities alone; 3) securities and other financial subsidiaries; 4) insurance subsidiaries; 5) significant minority-owned equity investments in non-insurance financial entities; and 6) significant investments in commercial entities. **If certain investments are to be deducted from capital, we assume that any risk borne by such entities are not part of any further provisions set out in The Accord.** Also we wonder to which extent the provisions on credit risk, operational risk, Pillar II and Pillar III should be applied to insurance subsidiaries, if banks' investment is not fully deducted from capital.

2.2 Specific comments

We feel that § 6 requires clarification regarding:

- The criteria which will be used to adjust the amounts of minority interests that may be included in capital in the event the capital from such minority interests is not readily available to other group entities; and
- Whether the criteria also apply to minority interests within the banking group.
- We suggest ***not deducting*** *group internal minority investments from capital.*

We feel that § 9 requires clarification regarding the treatment of a bank holding several insurance companies with regard to:

- Surplus capital
- Capital shortfall; and
- Deduction of banks' investment in such subsidiaries from capital.
- Practical aspects make a consolidated treatment complex. *Therefore, we suggest* ***employing aggregation*** *as proposed in the BIS paper of February 1999 on Supervision of Financial Conglomerates, "Capital Adequacy Principles".*
- *Also, we believe that – for a deconsolidated insurance subsidiary – a capital shortfall should only have to be deducted from the parent bank's capital if there is a legally binding and enforceable obligation of the bank to "bail out" such a subsidiary. We suggest explicitly including this specification.*

We feel that § 18 requires clarification as to the deduction of investments in deconsolidated entities with regard to the split between upper and lower Tier 2 capital and the deduction rules when not sufficient Tier 2 capital is available.

3. Pillar I: Credit Risk

3.1 General comments

The broader scope for a more differentiated treatment of credit risk provided for in The Accord is appreciated. We view the methodology suggested under the IRB foundation and advanced approaches as resting on sound theoretical foundations and providing the potential for an advancement of the industry towards best practice.

We accept that on a conceptual level it is correct **not** to distinguish between expected and unexpected losses, and therefore to include both in capital. However, it is also conceptually correct to offset all provisions and known future income which will be available to mitigate losses against capital. In some high margin business areas such as retail, losses at around the level described as expected loss are typically anticipated in pricing and provisioning, so that it is important the Committee consider the fairness of a treatment which includes expected loss but not the offsetting effects of pricing and provisioning. Also, general (capital) reserves for expected losses are not accepted under accounting rules (e.g. US GAAP). *We therefore suggest **ensuring consistency between The Accord and the accounting standard requirements,** e.g. excluding the expected loss component from the definition of credit risk and aligning Pillar III requirements on these standards.*

We anticipate that the current calibration of the IRB approach will need revision downwards to ensure that overall capital, including operational risk capital, does not exceed current levels in the banking system as a whole – noting supervisory commitment to this goal. We look forward to regulatory review of the QIS in this context and hope this will be undertaken with as much industry participation as possible.

We are concerned that the requirement for the adoption of the IRB approach across all exposures and business lines will result in a significant increase of operating cost. *We would urge the IRB requirements be applied in a manner commensurate with the business lines, allowing for approaches best suited for individual lines*.

3.2 Specific comments to the standardised approach

We understand that this approach is not intended to apply to complex groups such as Credit Suisse Group as a whole, but is intended for smaller banks. We would expect, however, to exceptionally be allowed to utilise the standardised approach for small subsidiaries having immaterial exposures in terms of size and risk profile. We believe that points made by the IIF and Swiss Bankers Association with regard to the standardised approach are constructive.

3.3 Specific comments to the IRB

The IRB risk weights are currently calibrated at exactly 150% times the theoretical capital requirement. We anticipate, based on remarks from several key institutions, that this calibration factor will need to be substantially revised downwards to achieve the

Supervisory objectives of maintaining overall capital and providing an incentive for using the IRB approach over the standardised approach. We anticipate that the results of the QIS will demonstrate these points (especially considering the introduction of a charge for operational risk) and a number of other changes in The Accord which tend to increase, rather than decrease capital requirements. Some of these are noted below.

- Despite apparent regulatory perception that The Accord brings a more lenient treatment of collateral, in fact in our experience there is a more conservative treatment of financing transactions with more severe limitations on permissible collateral;
- The removal of 50% risk weight cap for derivatives will result in a considerable increase in capital requirement for this portfolio;
- The credit conversion factor for undrawn commitments under the IRB approach is currently set at the punitive level of 75%, against 50% in the Standardised approach and the current Accord;
- The treatment of specifically provisioned defaulted loans will result in a significant increase in capital requirements for these assets.

3.3.1 Definitions

The risk characteristics of **project finance exposure** (§ 157) justify a distinct treatment from the other asset classes defined. Current practice, however, does not generally use a methodological setting comparable to the risk assessment techniques used with the other types of exposures. The definition of project finance requires **greater distinction between cash flow and asset-based finance**. *We believe that capital requirements should be determined by the underlying transaction structure including cash flow, amount of equity, recourse, point in project's life, and use of external rating were possible. Greater definition of the transactional elements indicated will allow more accurate risk assessment. We also endorse the proposals made by the IIF and ISDA regarding the treatment of project finance exposure.*

The risk characteristics of **equity exposure** (§ 158) justify a distinct treatment from the other asset classes defined. In our view, the definition of equity exposure requires **greater distinction between equity holdings held for long periods of time and those held for shorter periods of time**. *We believe that capital requirements for the equity holdings held for long periods should be determined along the lines of the IIF proposals and basing the EAD for these holdings on their book value (when acquired). For equity holdings held for shorter periods, we believe that capital requirements should be based on a market risk / stress testing framework instead of a PD/LGD/EAD framework, also as proposed by the IIF.*

The **definition of LGD** requires clarification. It should focus on the economic losses consequential to the default event. Administrative cost should be excluded from the scope of economic losses, as such costs reflect only a personnel shift from credit management to workout/recovery units. Also, all refinancing matters are handled in the asset and liability management departments. In practice, it is also difficult to allocate administrative cost to a loss event at the time of the event. We therefore suggest defining LGD as the **loss of principal**.

There is a need for defining **the "maturity" of variable (non-maturing) assets**, as these exposures do not have fixed/contractual maturity. Such assets include variable loans – e.g. mortgages or working capital current account loans for corporates – which are significant in retail business and the business with small and medium sized enterprises. *For such variable loans, we suggest relying on the* ***contractual cancellation period*** *after which the banks can take action, and not on an economic maturity concept which would be irrelevant from a risk perspective.*

3.3.1.1 Definition of default for corporate and retail exposures

On a conceptual basis there is no practical need for a detailed common default definition under IRB across all entities. It is much more important that such **a definition is consistent with internal loss data and / or the market practice as set by rating agencies**. ***We suggest having a much more general definition of default, covering what counts as a loss and some indicative events that could be counted as default, subsequent to an internal assessment.*** The focus should be on completeness (e.g. no material historic loss is not assigned to a default event in the database) and accuracy of the database used as a basis for IRB.

The Accord's definition of default is not consistent with the definition of default used by rating agencies. The inconsistency results from the first bullet point of § 272 and § 466 – i.e. "it is determined that the obligor is unlikely to pay its debt obligations (principal, interest, or fee) in full". This is broader than the definition of default used by rating agencies. This inconsistency could impinge on the applicability of mapping techniques as provided for under § 278. We, therefore, suggest ***taking out the first bullet point of § 272 and § 466***.

In order to allow banks which have been using such a broader definition of default to use their internal databases, we suggest *integrating the first bullet point of § 272 into § 273 and § 467*, respectively, which would then read: *"Banks can opt for using more conservative definitions of default, e.g. by considering unlikeliness of repayment of an obligor's debt obligations (principal, interest, or fee) in full as default. Banks must document the specific reference of default used internally."*

The definition of default is also not consistent between corporate and retail exposures. This inconsistency results from differing second bullet points of § 272 (corporate exposures) and § 466 (retail exposures). The formulation in § 466 – "any reaging of a facility (e.g. extending the life of a mortgage to reduce monthly payments) is regarded as a default event, so long as such reaging is undertaken in distressed circumstances to mitigate a default event" – appears impractical for the daily business and could potentially lead to arbitrage between the retail and the corporate portfolio. We ***suggest using completely identical default definitions in § 466 and § 272***. If this option for rewording were not considered, additional clarifications would be required as to the treatment of exposures going into recovery watch list, but not being provisioned for. We would assume that such exposures should not fall under the definition of default. Finally, we reiterate that our preference is for both retail and corporate default definitions to be set as guidance only, with the key supervisory issue being a consistent approach to provisioning and completeness in the capture of credit losses, rather than a strict definition of what constitutes a default event.

3.3.2 Eligibility

We are concerned about the requirements for the adoption of the IRB approach across all exposures (§ 159 and 160). *We believe that different parts of a banking group should be allowed different approaches*. Different business areas require modelling techniques to be tailored to business features and commensurate with available resources. We are concerned that a standardisation of these techniques across an entire organisation will result in a number of simplifying assumptions which will deteriorate the quality of risk assessments. Large banking groups, combining a wide range of activities giving rise to credit risk, each having its peculiarities, would particularly suffer from such an undifferentiated standardisation of methods. *We, therefore, suggest allowing for a mix of approaches – combining standard and IRB – subject to supervisory validation. We also suggest clarifying the criteria that make business units significant. Finally, we suggest* ***explicitly excluding insurance business units of a banking group from the IRB rollout requirements***.

We fully understand the cherry-picking concerns of supervisors. Nevertheless, there is a strong argument that, if the incentives set for moving from the standard to the IRB are appropriate, this concern – as well as the requirement to fully rollout the IRB – will become redundant. Therefore, we suggest *calibrating the standard approach against the IRB approach in such a way as to have higher risk weightings than in the IRB and substituting § 159 and § 160 by a reference to a supervisory validation requirement. At a minimum, we suggest that The Accord provides for an adequate plan and transition period for rolling out the IRB*.

3.3.3 Treatment of collateral

The IRB provides for several risk mitigation instruments: collateral, on-balance sheet netting, guarantees and credit derivatives (§§ 197, 230, 231). There is **no recognition of marketable physical collaterals, such as aeroplanes, cars, ships, trucks and other leasing objects, nor of tradable commodities, risk insurance and trade receivables**. These are widely used risk mitigation instruments critical for conducting various businesses such as leasing, trade finance, etc. Not recognising such risk mitigants would undermine the bases of such activities. We would suggest *recognising the listed instruments as eligible risk mitigation instruments not only under the IRB advanced, but also under the IRB foundation approaches*. We also fully support the IIF recommendations made with regard to collateral.

The *"floor" w factor* for collateral and credit protection in the comprehensive approach (§ 84 and §101) is wholly unjustified and *must be dropped*. We firstly note that *w* it is not merely a floor but effectively an additional haircut as the equations in § 84 show. The key markets to which the *w* factor would apply are respectively the securities financing and credit derivative markets. In each, the application of this aspect of the New Accord will result (in conjunction with the proposed haircuts) in very disruptive increases in capital requirements. The Committee should consider whether the resulting damage to liquidity and depth in these markets might not result in increased systemic risk in the banking system – the opposite of their intentions. Further, on reviewing the evidence of residual risks in the secured lending markets, we have found no evidence that any material risks exist in these markets that are not covered

elsewhere in the New Accord: in fact the secured lending markets' loss experience is exceptionally limited. In the credit derivatives markets, likewise no evidence pointing to risks beyond the normal contractual, litigation and basis risks inherent in all business has been noted.

The suggested standard supervisory haircuts (§ 88) require clarification. Under the comprehensive approach to collateral, haircuts may be calculated using a standardised approach. However, the standard supervisory haircuts supplied are for eligible collateral only. Haircuts are not supplied for other forms of exposure, which are also needed to calculate the adjusted value of the collateral.

Also, clarification as to the treatment of "joint and several guarantee" (i.e. Solidarbürgschaften) is needed. *We would suggest, treating them equally to guarantees, despite the fact that they are conditional, along the proposals made by the Swiss Bankers' Association.*

3.3.4 Retail exposures

The criteria listed under the **definition of retail exposures** (§ 156), particularly those referring to the low-value of individual exposure and the large number of exposures, will depend highly upon the size of the individual institution considered. Reliance upon such criteria would open the door for regulatory arbitrariness and further erosion of the level playing field in the banking sector. Two options could prevent such undesirable developments: 1) *considering criteria such as either a low degree of product/service complexity, or the degree of sophistication / standardisation of risk assessment of the counterparties rather than the value of singular exposure amounts*, or alternatively 2) fixing an amount for the maximal USD equivalent value of singular exposures classified under retail exposure which would be identical for all countries in The Accord. We prefer the first option.

We recognise that the simpler approach to retail exposure has been driven by pragmatic considerations. However, we believe that it would not be paying due consideration to the intentions of The Accord to force banks into a simpler framework if they already have in place a more advanced approach than the one provided for in The Accord.

We are concerned about the mandatory product segment approach suggested in §§ 443 to 453. Banks having the PD/LGD on the counterparty-level should not be prohibited from using these and instead be obliged to convert them into a product segment framework. The product segment framework would result in a loss of risk information for such banks, as counterparties can have exposure in several product segments. It is also notable that for such banks the issues on delinquency (§ 446) and on vintage (§ 447) would become redundant if PD/LGD were established on the counterparty-level. We would suggest ***not punishing better practice but rather providing for the ability to use a more refined counterparty PD/LGD approach for retail exposures*****.**

3.3.5 Computation in the foundation approach

The suggested minimum requirements for PD estimation (§§ 274, 342) relating to the relevance to current and foreseeable conditions bear the potential of aggravating the pro-cyclical moves of credit supply and anti-cyclical moves of capital requirements. Such a requirement calls for performing an adjustment based on the position in the business cycle. This would potentially make the task of regulators in determining the appropriateness of adjustments overly challenging and resource-intensive, particularly for internationally active banks, as business cycles tend not to be synchronised among countries. To do away with both these undesirable effects, *we suggest requiring PD estimation to be based on data covering an entire business cycle and not requiring an additional adjustment for the position in the business cycle.*

The suggested treatment of undrawn commitments bears little incentive to move from the standardised to the IRB approach. Under the standardised approach (*Standardised Approach to Credit Risk* document § 49), "the credit conversion factor for business commitments with original maturity up to one year will be 20%… The credit conversion factor for commitments with original maturity over one year will continue to be 50%." Under the foundation approach (*Internal Rating Based Approach* document § 110), "the Committee proposes to measure EAD on commitments and similar **revolving credits as 75%** of the off balance sheet amount. The 75% figure works in the same way as a credit conversion factor in the standardised approach." We believe that the larger factor under the IRB foundation approach looks anomalous. Unlike the standardised approach, maturity is not taken into account under the IRB foundation approach. *We suggest reviewing the calibration of the risk weight under the IRB foundation approach to at least ensure a similar treatment of undrawn commitments as under the standardised approach*. *We also suggest providing for a maturity adjustment under the IRB foundation approach*.

4. Pillar I: Asset Securitisation

While we support the disincentives to provide any kind of implicit support in the event of a subsequent deterioration of the credit quality of the securitised portfolio, we believe that the **penalties** foreseen for banks doing so **are so excessive** that regulators may not be able to use them in practice. As an alternative solution to this issue, we propose that:

- *Offering banks are prohibited from removing assets from their balance sheet for a fixed period, rather than indefinitely, and*
- *Off balance sheet status may be retained for those assets for which the bank has not provided support*.

We note that the onerous capital treatment for originating banks and servicing banks sponsoring their own securitisations represents a strong incentive for them to arrange for third party credit and liquidity support. We believe that the treatment of first loss credit enhancement as a deduction from capital is risk insensitive. *We suggest that the capital set against such credit enhancement should be no higher than if the underlying assets were on balance sheet*.

We note that more restrictive requirements for structuring – clear distinctions between origination, servicer obligations, liquidity support, credit enhancement and enhanced disclosure requirements – are likely to result in more transparency.

4.1 Treatment of originating banks

We note that stringent clear break conditions have been introduced, designed to ensure that a full risk transfer has occurred. In this connection and in view of § 518 a), we feel that from the point of view of the transferring bank it would appear to be of much higher importance that the investors in the SPV are not in a position to claim for support in case the SPV is in financial distress.

We doubt that the use of US-GAAP terminology is fully adequate for worldwide use of regulations (e.g. qualifying special purpose vehicles).

We are surprised to note that “The Committee does not want banks to use the IRB approach for measuring the credit risk relating to asset securitisations”. *We believe, that as long as the methodology of an IRB approach used by a bank is approved by the auditors and the supervisor in accordance with the rules outlined in Pillar II, the utilisation of this methodology for positions related to asset securitisation should be allowed*.

4.2 Treatment of investing banks

We believe that the provision made under § 527c) “without undue reliance on any reinvestment income” will most likely prohibit replenishment structures.

4.3 Liquidity facilities

We believe that the proposal to apply a 20% conversion factor to liquidity facilities does not reflect:

- the rarity of draw downs on these facilities (during the 1998 liquidity crisis no draw down occurred on such facilities in Credit Suisse Group), and
- the active policy by conduit administrators to manage their programs to avoid the need for cash liquidity in the case of asset backed commercial paper conduits.

We are convinced that, as discussed in The Bond Market Association (TBMA), a conversion factor of at most 10% would be a more appropriate reflection of the risk involved and should be applied in addition to the risk weighting based on the credit rating quality of the underlying assets.

4.4 Synthetic securitisation

We believe that in a synthetic securitisation, the originator remains party to the transaction. Therefore, the paper issued will not be rated more highly than the originator.

5. Pillar I: Operational Risk

5.1 General comments

We thoroughly investigated the challenges of managing and measuring operational risk in 2000. The results of this investigation have been available since October 2000 in the research paper "*Operational Risks in the Financial Services*".[2] Three notable conclusions of this research are that **operational risk:**

- **has no clearly delimited definition in contrast to credit risk and market risk.** Significant confusion prevails as to which dimension – management, event, cause, impact, frequency – is most conducive to a workable delineation and delimitation from other risks and to provide a basis for a credible and relevant quantification for operational risk**.**
- **Is fundamentally driven by the quality of the control environment of a firm.** It is not necessarily related to the level of the firm's or the industry's historical losses. The issue with operational risk is thus to **ensure appropriate control mechanisms and responsible management not provided for by a capital charge. We believe that the quality of the forward-looking control environment is more relevant than historic losses in determining the level of operational risk.** Any framework for the calculation of operational risk capital would need to recognise this.
- **Has very different characteristics from credit and market risk**. In contrast to these risks, operational risk is primarily internal, context-dependent, highly multifaceted, interdependent and not market driven nor remunerated through market pricing. Some of its components – primarily those which are not loss relevant in the overall context (e.g. high frequency low impact cases) – can be modelled in a credit risk framework at very high cost. **The most relevant operational risk components for management – high impact, low frequency events (i.e. unexpected catastrophic losses) – lie beyond the scope of regulatory capital. The frameworks used for modelling credit and market risk are not well suited for modelling such events.**

The operational risk section of The Accord contains both positive and negative proposals. The **positive points** include:

- The exclusion of reputation and strategy risks from operational risk
- The Committee's intention to publish "*Operational Risk Sound Practices*"
- The flexibility to allow the mix and match of the different approaches (Basic indicator, Standardised and Internal measurement approaches), provided that this does not result in incentive inconsistencies.

The **negative elements** include:

- **Conceptual issues** still needed to be sorted out together with the industry, including:
  - o **Scope** aspects. It is not clear what the charge is to cover and where the boundary between expected and unexpected losses is set. The first **loss**

[2] See http://www.credit-suisse.com/en/csgn/operational_risk.pdf

absorption capacity of a bank, i.e. pre-tax income, is relevant when taking adverse hits and not capital charges.
  - **Definitional** aspects. Many of the concepts and terms used in The Accord that are without definitions or explanations and should be clarified. *We fully support the IIF recommendations made in this regard – also concerning the exclusion of latent losses, contingent losses, near misses.*
  - **Methodological** aspects, given the very **different nature of operational risk** as noted above in the results of CSG research. This risk requires a different approach to market and credit risk, **more focused on tracking its changes over time via key risk indicators** than identifying its absolute level.
  - **Data on operational risk events are highly context dependent** – even within the same organisation (e.g. introduction of a new IT system or new management). The relevance of using historical and external data for quantification/modelling purposes is thus very questionable.
  - Potential **double charge** situations with credit and market risk
  - Until these issues are resolved, **any calibration will lack credibility and relevance.**
- The **shortness** of the consultative period, especially given that operational risk is at too early a stage to permit meaningful capital calculations. *We suggest that it is in the industry's **best interest to conduct an additional round of consultation beyond this original deadline.***

Therefore, we question the practicality of the fundamental approach of calculating an operational risk level based on a framework combining a probability of event, a loss given event and an exposure at event. We are sceptical about the relevance of a distribution function of loss probabilities populated by historical operational loss events, given that these are highly context dependent. In addition, we question whether there is sufficient firm and industry loss data available to attempt to model the tail of the loss distribution with any degree of accuracy (compare requirements for credit and market risk with much more third party "objective" data).

5.2 Major Concerns

5.2.1 Conceptual framework

We have **reservations** about some fundamentals in the conceptual framework of the operational risk charge as follows:

- **Scope of the charge** – It is not clear as to what the proposed charge is to cover. This lack of clarity stifles both the conceptual and detailed development of The Accord. We strongly disagree with the assumed linear and constant relationship between EL and UL by simply multiplying EL with gamma. *We therefore recommend that the Committee publish a full definition of their intended scope of operational risk.*
- **Independent diversified earnings streams** – The proposals do not recognise that large firms have strong independent income streams. The existence of these income streams provides a considerable and effective buffer against potential operational risk losses and therefore reduces the need for capital to protect against such losses. *Supervisors should take into account both the effect of independent income streams and **the hit absorption abilities** of large diversified banking groups in determining*

the capital charge. Rating agencies consider the risk mitigating effect of the number and size of the independent income streams in determining credit ratings, which indicate that this is a significant risk mitigant.

- **Boundary issues between credit risk and operational risk** – *We strongly believe that operational risk-related elements of credit losses should not be disaggregated from credit data*.
  - The operational risk-related elements of credit losses should be viewed as contingent operational losses – which can only be crystallised following a credit event. Furthermore, the conceptual framework underpinning the IRB approach for credit risk already fully takes account of such “contingent” operational losses. Any proposal to treat them separately would be in conflict with a technically sound approach. All risks, including relevant operational risks, contingent on a credit event are correctly included within the loss given default (LGD) parameter of the IRB approach and the volatility of LGD assumptions inherent in the granularity adjustment.
  - For a practical point of view, a disaggregation could only be performed once a credit (or market) loss event materialises. It would require arbitrariness in the allocation of the shares of the loss to credit, market and operational risk. This process would also require significant resources.
- **Double counting** – Documentation risk is a constituent of operational risk. Therefore the introduction of an additional charge – **w (in the credit risk section)** and the use of a regulatory multiplier in connection with internal market risk models results in double-counting. *Moreover, some business lines, which are treated as equity participation for capital adequacy purposes, should not be charged twice for their activities*.
- **Calibration** – There is no empirical basis for assuming that operational risk accounts for 20% of the current minimum regulatory capital. The 20% assumption in The Accord is based on surveys on “other risks” which include reputation and business strategy risks, as well as operational risk. *In addition, the formulation of the operational risk charge should not be carried out in isolation of, but in conjunction with, those for market and credit risks.*
- **Floor** – Supervisors should recognise that the presence of a floor may unduly restrict the incentives for banks to invest in risk management to satisfy the various levels of qualifying criteria.

5.2.2 Quantification

We are very doubtful as to the relevancy of modelling alone as the main determinant of the operational risk charge. Giving priority to quantification over sound risk management may give rise to perverse incentives. The main reasons for our **reservation** are:

- **Direct parallel from Market/Credit Risk** – We strongly believe that operational risk is fundamentally different in character to market and credit risks. Hence it follows that the management of operational risk (including capital management) should be treated differently than market and credit risks. This would ensure the most relevant treatment and containment of potential operational risk exposure. ***Any operational risk capital calculation should directly reflect the state of the control environment/good management***.

- **Inherent difficulties in estimating probability and severity** – The inherent difficulties in predicting the probability and severity of context-driven, large operational risk losses in banks, particularly in view of the very limited relevant loss data available in the industry, impede the development of operational risk quantification within the current consultative timescale.
- **Data** – The supervisors should recognise the **limitations of operational risk data both in terms of availability and the relevancy** as a basis for the calculation of an operational risk charge. Data availability is likely to remain a challenge for the industry for some time. **Even when sufficient data is available, their limited relevancy may invalidate any simplistic applications of current quantification attempts.**
- We do not believe that the use of historical loss data will provide a suitable basis for the calculation of a forward-looking charge, and have concerns regarding the stability of the resulting charges derived from such.
- **Linear function** – The exposure from operational risk is not a linear function of the size of a bank. Recent published research indicates that the size of operational risk loss bears little relation to the size of the institution. In our view, the larger a bank, the smaller the applicable percentage of capital charge. ***We support the use of a square-root function (as proposed by the IIF) on both the Option 2 and Option 3 formulae to provide the required level of non-linearity.***
- **Business Units/Business Lines (BU/BL)** – The categorisation of banks into BU/BL needs to allow for flexibility so that banks may define their own BU/BL in agreement with the relevant regulator.
- **Indicators in the Standardised Approach** – The indicators proposed may not be the most relevant for all business lines. This is not in line with the supervisors' stated intention to move toward risk-based regulations. *An average of the last three to five years of Exposure Indicator would provide a more stable basis for a charge*.

5.2.3 Recognition for Risk Management

Given that it is the supervisors' intention to reward good risk management practices, we are surprised not to find a **direct capital discount for prudent and sound risk management practices**. On the contrary, the charge formulation is overly focused on loss history. This lack of recognition in the charge formulation of sound risk management practices would stifle continuous investment and improvement in this area.

Our view is that the quality of the control environment and risk management practices are significantly more relevant to the level of operational risk than a bank's or the industry's historical loss history. *Therefore we would support an approach that is predominantly focused on the assessment of the control environment.*

- ***Sound risk management practices*** – ***Banks should be given direct capital discount for sound risk management practices*** *such as:*
  - *Top management focus on risk governance*
  - *Issuance and enactment of policies and frameworks for operational risk management*
  - *Organisation structure and dedicated risk management staff*

- *Financial resources / investment in risk management infrastructure (including MIS)*
- *Appropriate risk reporting across the hierarchy of the organisation (including various relevant risk committees for risk review, limits approval, credit management, escalation and oversight)*
- *Effective operational risk methodologies*

These sound practices above would be recognised in the capital charge in the Scorecard Methodology suggested by the IIF.

- ***Risk transfer/Insurance** – Whilst we welcome the principle of risk transfer and insurance being endorsed by supervisors, we would like to see a direct capital discount for such effective risk mitigation. For example, the supervisors may consider the following:*
  - *Direct capital discount within Pillar I. This should be a reasonable percentage of the insurance/risk transfer coverage, especially for contracts that cater to low probability/high impact events. This percentage deduction should take into account the potential lack of standardisation of operational risk insurance contracts. As the industry and the regulators become comfortable with insurance/risk transfer, this discount factor could be adjusted.*
  - We believe that concerns raised by the regulatory community about the recognition of insurance offsets in the capital framework can be resolved as follows:
    - Transfer of operational risk to credit risk: Insurance industry is adequately capitalised and able to withstand very high losses without solvency issues. Limits to cap the maximum exposure with each insurer could be imposed.
    - Speed of payment: Policies can be constructed (and some have been) to provide prompt provision of capital pending final settlement.
    - Scope of coverage: Standardisation of policy wording, and development of policies with few exclusions as in development by the industry currently would address this point.
    - Moral Hazard: High attachment points, thereby reducing earning smoothing would reduce Moral Hazard.
    - Policy Limits: The insurance industry has sufficient capacity to provide limits in excess of USD 1bn.

5.3 Suggested approach

In view of the above, we believe that approach of The Accord is overly crude to effectively enhance the awareness and quality of operational risk management. It bears significant potential for misinterpretation, perverse incentives and for creating an unsatisfactory system legacy. Given the conceptual and quantitative challenges ahead, we believe that time pressure is not conducive to producing a well-founded and matured framework paying due regard to operational risk. *We therefore suggest a **four-step approach to move ahead toward identifying a risk sensitive operational risk framework***:

5.3.1 Can formulae

We suggest the use of a ***"rolling directive" – including a "can- formula" for a regulatory operational risk charge – in order to provide more flexibility in the national legislative processes.*** This approach will allow for a potential ("can formula") regulatory capital charge for operational risk, if and when a matured approach has been found and generally agreed upon. It will also permit the incorporation of industry developments. This would enable both supervisors and banks to conduct vital studies and consultations before settling upon a charge formulation.

5.3.2 Pragmatic capital charging mechanism

We suggest the use of a **pragmatic and risk sensitive operational risk charging mechanism** *until a solid, relevant, credible, simple and cost effective method for the measurement of the level of operational risk is identified.* These include the IIF suggestion for basing the operational risk charge on the hit absorption and the suggestions of London based asset managers as highlighted below:

- ***Hit absorption*** *– By 2004, construct the operational risk charge based upon a stable earnings benchmark: 50% of a bank's average pre-tax earnings over e.g. the five last years.*
  - *If yearly average actual operational losses over e.g. 5 years were higher than this benchmark, require – based on Pillar II – additional regulatory capital up to the amount of the 50% pre-tax earnings benchmark*
  - *If, on the other hand, current year's total effective operational risk loss were below this benchmark, no operational risk capital would be required.*

- ***Asset managers' alternative to the Standard Approach*** *– Keep it simple, ensure risk sensitiveness and incentives (conceptually this could be applied to each individual business lines):*
  - *Floor: Minimum capital requirement for asset management business line of Euro 50,000*
  - *Progression: Plus a requirement of 2 basis points of assets under management (a sliding scale could also be considered) up to a*
  - *Cap: a maximum capital requirement for individual business lines of Euro 10 mn.*

5.3.3 Develop conceptual framework

We support industry initiatives to **develop alternative approaches** *to deriving the capital charge such as e.g. the Scorecard Methodology investigated by the IIF.* We recommend that a supplementary paper on operational risk be published as a result of new insights and findings from these further consultations.

5.3.4 Data collection

We are sceptical about the relevance of operational loss databases, given the high context dependency of operational risk losses. *However, we support* ***conducting industry-wide and institution specific operational risk loss collection exercises*** *during this transition period* (and beyond if they prove useful) to assist regulators in

identifying the relevance/irrelevance of such losses and whether an industry-wide calibration is possible, sensible, relevant and cost-effective.

6. Pillar II: Supervisory Review Process

6.1 General comments

We welcome the implicit recognition by Pillar II that the risk profile cannot be reduced to quantitative measures as provided by Pillar I – even when the most sophisticated measurement methods are used – and that **management aspects** play a crucial role. We regret that this seems somewhat in contradiction to the weight given to Pillar I in The Accord document.

We are concerned that, while The Accord provides **very far-reaching authorities to national supervisors**, the criteria for exercising these authorities are formulated in a manner leaving significant room for interpretation and diverging national practices. *We suggest clarifying control criteria. We believe that:*

- *The criteria upon which management will be judged by supervisors need to be specified more explicitly and **harmonised across jurisdictions**.*
- *Control mechanisms **protecting banks' rights** are required for the competencies of national regulators.*

We note that Pillar II bears a potential of double counting with operational risk. According to § 616 "supervisors should also consider the extent to which the bank has provided unexpected events in setting its capital levels [...]." The minimum capital requirement, as outlined in the operational risk section of Pillar I, should have already covered such unexpected events. *We therefore suggest considering either dropping this consideration under § 616 or treating operational risk exclusively under Pillar II*.

We understand that Pillar II would not cover insurance subsidiaries of banking groups, as The Accord is not specifically addressing risks related to the insurance business. We also assume that Pillar II will not cover non-consolidated majority-owned securities and other financial subsidiaries. *We would suggest making this explicit in The Accord. Also, we would urge the Committee to consider the limitations of harmonisation of sectoral rules and avoid placing insurance subsidiaries belonging to a banking group at a competitive disadvantage against other insurance firms*. In this context, we reiterate that earnings diversification is in the interest of the safety and soundness of the financial system and should not be sanctioned.

6.2 Specific comments

The proposed new rules set the supervisor in a position to increase a bank's capital requirement arbitrarily if it is not satisfied with the way the bank currently manages or measures its capital adequacy. Various soft criteria according to which the banks are to be reviewed are mentioned.

We are concerned that the listed criteria (e.g. in §§ 602, 614, 615, 617, 623, 624) leave non-negligible room for interpretation. Further, if a supervisor is not satisfied with a bank's adherence to the rules, the size of the buffer a supervisor can require a bank to

maintain appears to be completely discretionary. *We would suggest determining the boundaries of this discretion in The Accord.*

We are extremely concerned that no provision is made to secure an internationally harmonised practice for exercising the far-reaching authorities among national supervisors. This again bears not only the potential of **deteriorating the international level playing field among banks and vis à vis non-banks,** but could give rise to regulatory arbitrage. *To ensure a level playing field, further guidance in this respect should be developed. We suggest that The Accord* ***spells out detailed operational criteria applicable for all national supervisors*** *when exerting the authorities provided by Pillar II. These criteria should ensure that minimal room is left to national supervisors' for diverging discretion in applying Pillar II (this calls for a rewording of § 628)*.

We respect that regulators will always have and use discretionary powers. However, we would expect that it should be clearly stated in and required by The Accord, that *such powers should: 1) only be used in respect of the principle of level playing field; and 2) be subject to legally enforceable rights of recourse to a court. We suggest considering establishing an advisory college of supervisors for this purpose – consisting of 50% supervisors and 50% bankers – under the aegis of the Committee. We also support the IIF recommendations made in this regard.*

We wonder whether such extensive authorities and controls are realistic in view of supervisors' resources – in terms of staff and budget – and whether the **legal liability consequences for supervisory authorities exerting a direct influence on a bank's business decisions were taken into account** when drafting the document. *We would suggest giving these matters serious consideration*.

We believe that under Pillar II banks should be encouraged to use risk management techniques ***commensurate*** *to their activity, even if this does not always correspond to best practice. We would suggest including this consideration under Pillar II.*

7. Pillar III: Market Discipline

7.1 General comments

We support **Pillar III**, which should lead to greater transparency in the market. We also gladly disclose the requested information to our supervisors, given their high understanding of the overall situation and the context to which this information applies. However, more information should not be confused with more transparency when referring to the broad public.

- **More information could contribute to less transparency, if its quality diverges**. Comparing and benchmarking financial information where underlying methodology and scope of definition differ is like comparing apples with oranges. The content under a given definition often varies from firm to firm, given different time series, bank specific judgemental inputs, model assumptions and interpretations. This is most likely to result in more confusion for the specialists reading the data outside of its foundational context. **It can give rise to significant interpretation distortions, result in misleading market signals and providing banks with an incentive not to use conservative model approaches.**
- The volume and level of **detail of disclosure under Pillar III is targeted at highly specialised professionals**. It is questionable whether it could be digested and understood by a large part of financial institutions' shareholders and the general public. Thus, while calling for a near doubling of the extent of financial reporting, the requirements would only benefit a very limited number of recipients. The additional disclosure burden, particularly for banks using the IRB, could result in reverse incentives for the evolutionary approach. Therefore, we suggest ***aligning Pillar III requirements to the requirements of accounting standards***.
- Technical information on models does not change very frequently and may serve experts. **Saturating a broad public** with such information could be counterproductive to enhancing market discipline. Although we are prepared to disclose such information, we do not necessarily believe that it should be published in detail in the annual report and financial information with high periodicity.
- A boundary exists between necessary openness and the point at which a **liberal information policy turns against the institution and the stability of financial markets**. For example, disclosing prudent provisions for pending legal cases may be **misconstrued as admission of guilt** and would send out the wrong signals for market discipline.
- **Too much information can harm competition**. For example, disclosing strategies would make them accessible not only to the broad public, but also to competitors and would speed up the erosion of competitive advantages.

Public disclosures are determined by accounting standards (IASC, FASB, etc.). Doubling reporting formats is more a contribution to confusion than to transparency. We do not believe that the development of a stand alone disclosure standard by the Committee exclusively for banks will contribute to enhancing transparency. We believe instead that the Committee should trust the accounting specialist and accept their standards, also given that these have found an almost worldwide acceptance. *We would, therefore, suggest that instead of setting new disclosure requirements, The*

*Accord **lists existing and upcoming accounting standards**, which are acceptable to allow beneficial capital treatment pursuant to The Accord*. On the basis of the disclosure requirement of these different accounting standards, the Committee might find it necessary to request **limited** additional disclosures – qualitative or quantitative.

Pillar III provides for possible **sanctions** if banks do not meet disclosure requirements. This is a cause of concern, particularly because the disclosure requirements are very far-reaching. Banks were invited to articulate their specific concerns in this regard. It is very difficult to point out specific cases in an *ex ante* perspective. In general, however, we would be concerned about:

- The present lack of details about and boundaries of the considered sanctions
- Sanctions not commensurate to the failure of not complying to all disclosure requirements
- The potential repercussion of sanctions on market perception, e.g. reputation risk.

7.2 Specific comments

The **characteristics of the disclosure are not specified**: it is unclear whether the information should be included in shareholder's' letters, annual reports, press releases or if the release of the regulatory reporting document could also be considered. Regulators already require the submission of periodically established capital adequacy calculations in a predefined format. These, however, might not be comparable if regulators make use of their discretion and rightly treat different banks differently. *We would suggest **standardising the regulatory reporting formats, at least for banks supervised by several regulators***.

According to Pillar II of The Accord, it is the task of the auditors and the supervisor to review the soundness of a bank's risk assessment. It should not be the purpose of the disclosure requirements to demonstrate the correctness of specific key figures. The public should rely on the work done by the above-mentioned specialists, including rating agencies. *Therefore, we suggest **limiting present Pillar III requirements to regulatory reporting.*** **It would be at the discretion of the regulator to require a bank to publish such information to a broader public**.

7.2.1 Scope of application

In general, it is our understanding that the same consolidation principles for the consolidation of a group's financial statements should also apply for the consolidation of the capital adequacy calculation. It would be confusing to consolidate a group for capital adequacy purposes using a different scope than for consolidation in the financial statements through application of the disclosed accounting rules. *It would be more meaningful to disclose any exceptions or departures from consolidation in the financial statements rather than to repeat these principles as required by § 642*.

In the appendix to the scope of application a further definition of supplementary disclosures related to the inclusion of commercial entities is given without defining the term of commercial entity. If commercial entities are excluded from the consolidation and as a result, deducted from tier 1 and tier 2 capital, the supplementary disclosures

then require that a statement should be given whether such subsidiaries (commercial entities) meet their regulatory capital requirements. But how can the capital requirement for such entities – if not financial institutions – be measured? *We suggest that an institution applies the same consolidation principles as disclosed in the consolidation of its financial statements*. Any more extensive disclosure on commercial entities, without defining this kind of subsidiary, should not be required.

7.2.2 Qualitative disclosures

In our view, it is **very questionable to make internal strategies, tactics and objectives public**. § 650 b) asks banks to publish such strategically vital information in their future plans. Whether auditors or regulators could verify such information would also be doubtful.

§ 651 a) requires details regarding the ECAIs used. It is very likely that supervisors will require banks to use only certain ECAI. It is then the task of the supervisors or the auditors to make sure that banks have followed the rules as specified in Pillar II.

The information regarding default rates of rated and non-rated loans recommended in § 651 c) is useful for the public. However, *we doubt that the other disclosures recommended are really of any interest, since – according to Pillar II – supervisors or auditors should have already covered issues such as:*

- Changes in the list of rating agencies used;
- Translation of specific issue into borrowing ratings;
- Transfer of specific issue rating onto banking book assets.

According to § 652 a) banks must disclose their supervisor's acceptance of their IRB approach. *We believe it should **not be necessary to disclose** additional qualitative information such as:*

- *Whether own estimation or a supervisory vector for LGD and/or EAD are used,*
- *Methods for estimation and validation of PD;*
- *Required data for estimation of the model;*
- *Responsibility for and independence of the rating process;*
- *Relation between internal and external ratings;*
- *The process for managing and recognising credit risk mitigation*.

Since a bank has been reviewed by its supervisor and auditor, the public should be confident that:

- The management of collateral;
- The recognition of collateral;
- The monitoring the continuing credit worthiness of protection providers and the administration of guarantees and credit derivatives

are handled in a correct manner. *Such information, as required under § 655, should not be disclosed*.

Most accounting standards have strict rules which specify conditions have to be met in order to net on-balance sheet transactions. It can be assumed that the financial statements of banks comply with these standards because external auditors have reviewed them. *Therefore, we believe it should not be necessary to disclose the overall strategy of netting as recommended in § 657*.

7.2.3 Quantitative disclosures

§ 650 c) recommends disclosing credit risks being transferred into securitisation vehicles. Such information should be obtained by reading the section dealing with asset securitisation (§ 659). Information regarding credit protection purchased using credit derivatives is available in the credit risk mitigation section (§ 656).

According to § 656 a bank must provide information on the type of regulatory calculation methodologies that it has selected with regards to the credit risk mitigation techniques. *As long as auditors and the supervisor have approved the methodologies applied, such information should be irrelevant to the public*.

§ 658 recommends that banks applying credit risk mitigation techniques disclose the types of eligible collateral by geographical grouping. For banks applying the IRB approach this information brings no additional benefit to the public as explained above. The same paragraph also recommends that banks disclose their main guarantors/protection providers. *If this information were material, it would have to be disclosed already according to § 650* (significant concentrations of credit risk).

According to the section dealing with asset securitisation (§§ 659, 660 and 661) a high degree of the disclosure is required on a detailed transaction level. *Showing this data only on an aggregated level should be sufficient for the public*.

According to § 663 banks are required to disclose movements of portfolios between the standardised and internal models approach. As long as all assets are classified correctly – which both the supervisor and the auditors have approved – *such movements should be irrelevant to the public*.

The disclosure on interest rate risks (§§ 667 to 669) would be derived from stressing the relevant books under given scenarios. *A common definition of such scenarios is needed; otherwise, sensitivities among banks could not be compared.* ***In addition, the shocks underlying the scenarios should be in line with sensitivity analyses already required under various GAAPs (e.g. US GAAP / SEC, where at least 10% shifts, for each market risk exposure category, have to be applied)***.

7.2.4 Comparability

In § 640, banks are encouraged to use the templates provided in the *Supporting Document Pillar III: Market Discipline* in order to enhance comparability. These templates leave a lot of room for interpretation.

The geographical regions, counterparty types, industry sectors, PD and LGD grades in these templates required by § 650 are, however, not defined. Each individual regulator

will probably come up with different break-up requirements, thus making it difficult for the public to compare the status of different banks.

§ 650 requires banks to break down their credit exposures into:

- Loans, commitments and other non derivative exposures;
- Securities;
- OTC derivatives.

A definition for these types of exposures is not provided. If banks rely on their different national accounting standards for the break down, the comparability of the information in the template will suffer due to the different national regulators' break-up requirements. *Therefore, **The Accord should list existing accounting standards which are acceptable to allow beneficial capital treatment pursuant to The Accord, instead of setting new disclosure requirements**.*

It is not clear from § 650 how the credit exposure of traded options and futures should be classified.

7.2.5 Operational risk disclosure

We believe that disclosure in the annual report should be limited to control mechanisms and procedures; expected operational losses should not be required to be published.

- Public disclosure of loss data – We are willing to disclose our operational risk data including losses to regulators, rating agencies or our insurance underwriters, but feel that indiscriminate loss data disclosure will result in imprudent increase in reputation risk for banks. Naturally, any really significant losses with material impact on earnings should be publicly disclosed.
- Public disclosure of detailed provisions – Particularly in the case of pending litigation, indiscriminate publication of prudent provisions may be misconstrued as implicit admission of guilt.
- Potential and unnecessary reputation threat – One unhealthy development may be the exaggeration and sensationalising of such details by the media, particularly if those are taken out of the overall context in term of volume, frequency or size.

8. Cost benefit considerations

8.1 Pillar I

The eligibility requirements for the use of IRB have wide-ranging implications for management, staff, training and IT systems. These implications are further exacerbated if an identical approach would have to be used across an entire organisation – particularly for units using solutions tailored to their specific business. The precise cost evaluation is only possible based on the individual organisations' gap analyses regarding: 1) credit risk assessment procedures; 2) credit risk pricing mechanisms; 3) credit risk data population and segmentation; 4) credit risk data loading procedures and quality; 5) credit risk data evaluation in terms of PD, LGD, EAD and reporting; 6) credit risk data modelling; etc. Smaller, less diversified, institutions using less sophisticated methods will bear only a small fraction of such cost (and thus have little incentives to use such methods). Finally non-banks will incur no cost at all.

Similar comments apply to the use of the IMA for operational risk. The gap analysis is most likely to reveal that many institutions will need to perform IT-systems investments similar to those required for the use of internal market risk models. In addition, given that operational risk is a genuinely bottom up issue requiring a decentralised organisation, significant personnel resources would have to be devoted to the collection of data. Here again, smaller institutions using the basic indicator or the standardised approach will bear only marginal additional cost, if at all. Finally non-banks – despite the fact that they run operational risks – will neither be required maintaining capital nor will they bear any cost.

8.2 Pillar II

The Pillar II supervisory requirement will **require available bank management resources** to explain their rigorous process to their supervisor. Additional opportunity risks will be taken as the resources supposed to manage risk will be diverted away from their prime task towards regulatory reporting. **The new management and business understanding skills requirement imposed on supervisors will result in non-negligible cost increases on their side**. The large number of smaller banks potentially to be reviewed under Pillar II will exacerbate these. Depending on the national setting, **these cost will be carried either by the taxpayer or, as in Switzerland, by banks**. Here again, non-banks will not bear any additional cost.

8.3 Pillar III

The level of detail and frequency of disclosure under **Pillar III will result in additional management, staff and IT requirements for reporting purposes**. The data is not always stored in such a fashion that it can be easily aggregated, e.g. varying industry codes. Often manual adjustments are necessary in order to be able to complete the various forms required by regulators. This is particularly a problem for internationally active banks, with individual entities often being required to produce the same kind of report twice or more for different regulators according to different accounting or regulatory standards.

Also, much of the information required to be disclosed relates to one specific day. The burden of information to be disclosed may decrease the timeliness of publication of the report, therefore diminishing the relevance of disclosures.

We would, therefore suggest, that regulators and standard setters agree on more uniform and relevant standards for the disclosure in order to increase the reliability and speed of reporting and decrease the time and cost burden required for such disclosure.

8.4 Summing up

Supervisors should become more cost-aware of the consequences for banks and taxpayers resulting from regulatory requirements. Today's expenses for specialised risk management have already become very significant. Supervisors' requests over the last 2-3 years constitute a considerable additional burden – sometimes of doubtful added value. Basel II implies yet higher staffing levels and IT-expenses. As a consequence, non-banks appear increasingly more cost-efficient and attractive.

There are an estimated 30,000 banks worldwide with an estimated Total Tier 1 capital of USD 2 trillion. The losses from the Asian and Russian crises taken together range from USD 140 bn (committed official support perspective) to USD 350 bn (investors' losses perspective). Below we present an illuminating sensitivity analysis as to the assumed additional average cost of Basel II for these 30,000 banks and, indirectly, for the taxpayers of their host countries.

30,000 Banks worldwide with additional Basel II Cost: Sensitivity Analysis

Assumed additional average cost per bank USD mn		Number of Banks		Cost for 1 Year	Over 5 years
USD 500'	x	30,000	=	USD 15 bn	USD 75 bn
USD 1 mn	x	30,000	=	USD 30 bn	USD 150 bn
USD 5 mn	x	30,000	=	USD 150 bn	USD 750 bn
USD 10 mn	x	30,000	=	USD 300 bn	USD 1,500 bn
USD 15 mn	x	30,000	=	USD 450 bn	USD 2,250 bn

Assuming additional average cost of USD 15 mn per bank amount to USD 2.25 trillions over five years. It is anyone's guess as to the precise additional cost of Basel II. To be sure, it is in the hundreds of USD billions for the banking community as a whole. If the benefits / risk mitigation number do not reach these figures, Basel II will have failed, especially in its approach to operational risk.

Suggested solutions:

- *Refer to specific suggestions above, particularly those regarding operational risk*
- *Pillar II should not be automatic but rather only be triggered by evident mismanagement*
- *Disclosure requirements should base on prevailing accounting standards*