CONTENT

INTRODUCTION

The Dutch Banking Federation (Nederlandse Vereniging van Banken, NVB) would like to begin by clearly indicating its appreciation for a number of the merits of the current 1988 Accord:

- it has ensured an adequate level of capital in the international banking system to withstand the recent financial crises,
- it created more equal terms of competition between regulated internationally operating banks,
- it helped to ensure the availability of bank services to support economic growth,
- it significantly improved the protection of bank clients, depositors and creditors.

The NVB wishes to bring to the attention of the Basel Committee on Banking Supervison (The Committee) that, in the opinion of the NVB, the strengths of the current capital framework, that not only achieved certain regulatory goals, but also resulted in broad acceptance of the regulatory standard setting outside the international banking sector, were:

- the simplicity of the framework (i.e. without unnecessary, or only marginally contributing, complexity),
- an easily understandable framework (by supervisors, banks, bank clients, depositors, external auditors, analysts and investors),
- an adequate balance between costs and benefits (for the banks as well as for supervisors).

Of course, the NVB also has observed some conflicts that arose – in particular challenges from the non banking sector in some markets where regulated banks are active - and understands and supports the need in a rapidly changing environment to resolve unwanted consequences of the “one size fits all” 1988 Accord. Even if changes to the current Accord would result in a more complex and, as a consequence, less accessible framework:

- the NVB is of the opinion that the proposed revision of the Basel Capital Accord forms a well considered remedy to a number of weaknesses in the 1988 Accord which have come to light over the past years: the lack of differentiation between obligors of different credit quality, which forms an incentive for banks to move down the credit scale;
- the absence of a capital charge for undrawn commitments under one year, which has led to a dangerous reliance of corporates on short-term funding and a concentration of liquidity risk in the financial sector;
- an almost exclusive emphasis on credit (and market) risk with too little attention for other risks such as interest rate mismatch and operational risk;
- a need to terminate the consequences of the “OECD club rule”.

The NVB is encouraged by the fact the (second) Consultative Paper clearly addresses the above mentioned issues. The newly proposed framework addresses many other issues given its comprehensiveness. Related to many items and issues the newly proposed framework offers highly specific rules, worked out in very fine detail. For many of these specific rules, the response of the Dutch financial community to the Consultative Paper is simply supportive.

The NVB recognises that for some other issues and proposed rules there is an almost unanimous request from the banking community for certain adaptations. We trust the Basel Committee will be able to deal with these requested changes and finalise the rules within the next few months without the need for much further consultation. This category of adaptations includes such focused requests as:

- removal of the “w-factor” in particular for guaranteed exposures. Introduction of the “w-factor” favours lending to a parent company that on-lends the money to the corporate over direct lending to a corporate guaranteed by its parent. The banks’ position in the latter situation (lending with a guarantee but also with access to the corporates’ assets) is often better. However, under the current proposed rules it would be punished with a higher capital charge;
- recognition rated tranches in securitised transactions should have a capital charge depending on the Probability of Default associated with the tranches’rating, not on the originator of the underlying assets nor on the fact it concerns a tranche in a securitised structure or synthetic version thereof;
- a better calibration of the Maturity Correction in the Advanced IRB, as the current formula appears to form an incentive for Foundation banks to lend long and Advanced banks to lend short;
- removal of the –on a cumulative basis effectively- more than 50% surcharge from the Risk Based Weighting formula;
- determination of interest rate mismatch “outliers” based on the concept of duration of the fair value of the capital rather than on the hybrid concept of fair value sensitivity divided by book value of equity;
- removal of the interest risk in the Trading Book already covered by the Value at Risk (VatR) based capital charge from the calculation of the duration of equity.
- the removal of 50/50 split of capital deduction for deconsolidated entities over tier 1 and tier 2 capital elements.

The NVB strongly recommends the Basel Committee to consider the above mentioned adaptations to current proposals in the second Consultative Paper. The supportive arguments are clear and the NVB is of the opinion that a positive decision on the recommended adaptations can be taken.

There is however also a number of issues where the Consultative Paper is still exploratory and open-ended, and the response of the financial community is likewise looking for focus, while at the same time the discussion among the regulators moves on along parallel tracks that are not fully aligned. These type issues include:

- the inclusion of Expected Loss in the Capital Charge without addressing the process of reserving for expected credit losses and/or provisioning for deteriorating credits. The new Capital Accord thereby on the one hand enters the loss reserving field, while on the other hand leaves resolution of these issues to local regulators and accounting bodies, thereby confusing all concerned and upsetting the level playing field;
- the recognition of granularity in portfolios (although at the expense of enormous data gathering effort) while giving no recognition for the diversification of credit portfolios over countries and industries which bankers and others experience as relatively much more significant in determining the overall risk profile of a global portfolio;

- the lack of calibration for Small and Medium sized Enterprises and non-acceptance of the type of physical collateral which underlies this entire business segment;
- the lack of calibration for Asset Backed Commercial Paper Conduits and the various levels of asset risk and credit enhancement types which play a role there, leading to a one-size-fits all charge for liquidity facilities of 20% which will itself lead to new arbitrage incentives;
- the lack of clear recognition of the difference between exposure to a sovereign or corporate entity in its own currency and exposure in foreign currency;
- the lack of precision in establishing capital rules for equity holdings in the banking book;
- the search for the treatment of and lack of calibration for project finance debt;
- a one-size-fits-all approach to undrawn commitments with a Credit Conversion Factor of 75% while in actual practice much attention is given to covenants preventing drawdowns when credit quality deteriorates;
- in the area of Operational Risk an increasingly intense debate has arisen about quantitative operational loss events from the past and qualitative operational control assessments for the future;
- the disclosure requirement which on the one hand will be almost impossible to meet against reasonable cost, while at the other hand causing an information overload which obstructs transparency rather than enhances it.

The NVB is aware the above mentioned category of issues is recognised as problematic by the Committee as well as the banks discussing their collective response. Both parties currently develop their thoughts and not much convergence is visible as yet. It does not seem reasonable to expect that the Committee, digesting the response of the financial community and comparing this with the approaches developed by the regulators' working groups in the meantime, will in all cases be able to formulate a rational compromise which is ready for acceptance and implementation.

Therefore, while we believe the timing for finalization and publication of the the revised Capital Accord can stand in the second half of this year, the NVB requests the Basel Committee to plan for each of the still largely open-ended issues category a final third consultative sub-paper. In the paper, these issues can be written down in a focused way so the financial community can respond with a focused reply, upon which the Committee can close the debate for these tough issues.

SUMMARY OF COMMENTS

General

1. The NVB proposes to revise the calibration of the risk weights of the IRB methods because the incentives in the proposed second consultation document are insufficient or even prohibitive to move from the Standardised approach to one of the IRB approaches or from the Foundation to the Advanced IRB approach. Furthermore, the NVB proposes the Committee lowers the proposed floor for the Advanced IRB to 75%, (ref: page 10).

2. The NVB proposes a flexible approach to mergers and de-mergers when it comes to applying the IRB approach for credit risk. The NVB proposes that partial use is allowed of all three approaches within one bank, each for different well defined portfolios. (ref: page 10-11).

3. The NVB proposes to install a "supervisory platform" to ensure equal interpretation and treatment as the NVB is concerned too much room for national supervisory discretion may result in unwanted unequal terms for maintenance of a level playing field, (ref: page 11).

Scope

1. The NVB encourages the Committee to widen the proposal's scope of application to include domestically active but "significant" banks. This would benefit both a world-wide level playing field and the integrity of the financial markets in which domestically active banks also play an important role, (ref: page 12).

2. The NVB strongly proposes the recognition of guarantees from one bank to another bank in the same consolidated banking group. Starting point should be that the capital adequacy of the bank guarantor is tested on a fully consolidated basis and the guarantee does not have to be tested on a stand-alone basis, (ref: page 12).

3. The NVB proposes that sub-holdings, that do not engage in any banking activities themselves, should not be tested for capital adequacy on a stand-alone basis, (ref: page 13).

4. The NVB strongly opposes the proposal to mandatory divide the deduction for deconsolidated entities from capital on a 50/50 basis over Tier1 and Tier 2 capital elements, (ref: page 13).

Pillar 1

1. Beneficial risk weights are applied to lending extended to local sovereigns using local currency and local funding in the standardised approach. Likewise, under the IRB approach different probabilities of default and risk weights should be applied to sovereigns in local and foreign currency. Corporate obligations should be rated based on debt ratings in local currency. Transfer risk applies equally to all corporates in a certain country and therefore should be recognised as a separate risk factor. Lending to local

borrowers in local currency by definition is less risky than lending to such borrowers using foreign currency.
The NVB recommends that the new capital framework recognises local currency ratings in both the Standardised and IRB approaches for the purpose of setting regulatory capital risk weights for obligations in local currency.
Transfer risk should be addressed separately on a country-by-country basis not on a obligor basis, (ref: page 14-15).

2. The NVB supports the use of a continuous risk weight function, although the NVB proposes the risk weight formula be adjusted to exclude the expected loss-part and the conservative add-ons, (ref: page 16).

3. The NVB proposes a lower CCF than 75% will be applicable for committed facilities, that is consistent with the percentages of the Standardised approach. For example a lower generic CCF of 20% for commitments with a remaining maturity up to one year and 50% for commitments with a remaining maturity over one year. Consideration should be given to apply a reduced CCF for commitments that are cancellable upon breach of predefined covenants, (ref: page 17).

4. The proposed maturity factor in the IRB approach could potentially lead to market distortions. The regulatory capital charge for loans with a maturity shorter than 3 years will be significantly lower for banks using the Advanced IRB approach than for banks using the Foundation IRB approach. For loans with a maturity longer than 3 years the capital charge for banks using the Foundation IRB approach will be lower. The implication is that Advanced IRB banks will have a competitive advantage for shorter term loans and Foundation IRB banks for longer term loans. Competitive forces will thus drive banks out of certain market segments, not because of differences in capabilities, risk management practices or risk preferences, but because of regulations, (ref: page 17-18).

5. The NVB strongly recommends to exclude the granularity factor being of less importance than other diversification factors (country and industry). The NVB would propose to consider a simplified approach for these more important risk factors without relying on full credit risk portfolio management techniques (ref: page 18-19).

6. The NVB proposes to eliminate the “w-factor” as the NVB is of the opinion that the assumed residual risks, if any, are covered by over-collateralisation and/or capital charges for Operational Risk, (ref: page 19-20).

7. The NVB is of the opinion additional types of physical collateral should be recognised in the Standardised and Foundation IRB approach. Exclusion of real risk mitigating collateral would be especially detrimental to lending to small and medium sized enterprises (SME). SME’s may be confronted with less access to fair priced credit under the new framework. The risk of less access to fairly priced long term credit increases further in combination with too conservative treatment of maturity, (ref: page 20-21).

8. The NVB also proposes to assign the LGD of 25 % if the collateral value of CRE to the nominal value of the exposure exceeds a level of 140%. Moreover the NVB proposes that revaluation requirements for CRE be formulated more flexibly to allow prudent risk management to be combined with cost efficiency, (ref: page 21-22).

9. The NVB supports in general the approach taken by the Basel Committee for retail, but proposes that for segmentation purposes by borrower characteristics also behavioural scoring should be allowed. The NVB also proposes to widen the scope of the definition of retail to include portfolios that are managed on a statistical basis, (ref: page 25).

10. The Basel requirements to classify a portfolio of loans as retail should only be of a qualitative nature (the way in which pools of loans are managed internally). The local supervisor should assess whether a portfolio of loans that a bank qualifies as retail (including SME's) comply with the qualitative Basel requirements.

11. The NVB proposes that Project Finance is not a separate class from corporate credits. Banks with project finance ratings aligned to expected loss should be allowed to translate their ratings into a PD/LGD-framework similar as is applicable to retail credits, (ref: page 24-25).

12. The NVB proposes to revise the treatment of credit risk related to derivatives, (ref: page 25-26).

13. The NVB is of the opinion that for Equity exposures which are valued at market value, a market risk or stress testing approach seems the most appropriate. Equity exposures which are valued at cost (or lower market value) should in general be treated as debt exposures, (ref: page 28).

14. The NVB does not support an *ex ante* minimal capital charge for Securitisation transactions to address implicit and residual risks. In the view of the NVB these risks apply to all complex financing products and therefore we propose to incorporate a capital charge in the general operational risk charge, if any, (ref: page 30).

15. The NVB proposes that second loss enhancements in Securitisation that have a sufficient (eligible) rating should be treated within the PD/LGD framework, rather than lead to capital deductions, (ref: page 30-31).

16. The NVB proposes to consider more granularity in the definition of the proper risk weight of a Liquidity facility, leading to risk weights anywhere between 0% and 100%. Furthermore, the NVB is of the opinion it would make sense to make the general risk weighting of Liquidity facilities dependent on the underlying assets, as well as the presence of any credit enhancements. Whether the assets are originated by the liquidity provider should not make a difference, (ref: page 31).

17. The NVB proposes to include a form of qualitative assessment of the bank's internal organisation and control environment in the calculations of a capital charge for Operational risk in both the Standardised and the Internal Measurement Approach. A good score on quality of controls should lead to a reduction of the operational risk capital charge. A bad score should lead to an increase of capital. A floor and a cap should be formulated in order to mitigate severe consequences for outperformers and to stimulate comparability, (ref: page 33).

18. The Basel Committee states that the capital charge for Operational risk should cover direct as well as *certain* indirect losses. The NVB is against the incorporation of near losses, latent losses or contingent losses under the capital charge for operational risk as currently proposed by the Basel Committee, (ref: page 34).

19. The formulae used for Operational risk capital calculation are all lineair. Both the complexity of a product or process and the organisational ability to handle a given business volume play a role in determining the relation between exposure indicators and Operational risk. Therefore, the NVB expects relations between financial indicators and Operational risk to be non-linear and proposes the use of a non-linear factor in all three approaches of the spectrum. For example, the use of a square root can be considered, (ref: page 36).

20. The NVB proposes to leave space in the Basel regulations in order to be able to make adjustments as soon as test results are available on the relationship between exposure indicators and Operational risk, (ref: page 38).

21. Operational risk is present in all activities of a financial institution. The risk of overlap in definitions of risk types is therefore high. When choosing indicators and using data, the possible overlap should be taken into consideration, (ref: page 38).

Pillar 2

1. The NVB supports full detailed disclosure to their supervisor(s), but strongly objects against public disclosure of proprietary information.

2. The NVB recommends that possible extra capital requirements should, in principle, be limited to a maximum amount prescribed by the Capital Accord and it should not be required or "strongly recommended" to publicly disclose such extra capital requirements.

3. The NVB supports the proposed "outlier" definition with regard to the treatment of interest rate risk, although it contains some inconsistencies. (ref: page 42)

4. The NVB supports the treatment of interest rate risk in Pillar 2. Applying uniform model-assumptions in Pillar 2 would give negative incentives to the development of asset and liability management, (ref: page 43).

5. Interest rate risk in the trading book is currently covered by the Second Capital Adequacy Directive (CAD-2) of the EU. The new Capital Accord should only cover the banking book and leave the trading book rules unchanged from the existing regulation.

Pillar 3

1. In general the NVB understands and supports the wish of the regulators to enhance the role of market discipline as a part of the new Capital Reform. The NVB also understands the request for more transparency to help enhance the market discipline. The NVB also supports generally comparable and consistent disclosure of relevant information on

banks' capital and risk. However the NVB questions whether the proposals for public disclore in the second consultation document will really contribute to achieving the regulatory goals. The NVB believes the currently proposed level and type of public disclosure will be counterproductive and may result in potential financial instability. Additionally, the costs of disclosure seems not to be in relation to the benefit, (ref: page 44).

2. The NVB strongly recommend to distinguish between fully detailed disclosure to supervisors and a more condensed focused disclosure of key information to the public, (ref: page 44).

3. The NVB is of the opinion that the recommendations with regard to disclosure on minimum regulatory requirements and risks should be aligned and consistent with national GAAP to prevent unnecessary double reporting and as a consequence extra costs and ambiguity. The NVB strongly recommends the Basel Committee to use their authority to stimulate convergence according to IAS, (ref: page 44)

4. The NVB does not support supplementary disclosure of actual operational losses (per business line), as the general public can easily misunderstand disclosure of operational loss figures , which might create unjustified damage that may not be in the interest of the protection of the clients. If disclosure still becomes a requirement, the NVB strongly urge the Committee to provide the industry with clear and tight definitions and a fixed confidence level for calculations. Uniformity in disclosures on Operational risks is regarded as highly important, (ref: page 45).

OVERALL COMMENTS ON THE BASEL PROPOSAL

General

Incentives

Basel proposal

The Consultative Document *Overview of the New Basel Capital Accord* states that the IRB approaches provide capital incentives relative to the Standardised approach.
For the Foundation IRB approach in the aggregate, a reduction in risk-weighted assets of 2% to 3% has been estimated (par. 48).
During the first two years following implementation the Committee proposes a floor on the Advanced IRB approach equal to 90% of the capital requirements which would result under the foundation IRB approach (par. 49).

NVB comment

In general, the NVB supports the evolutionary approach as proposed by the Basel Committee. It should be noted that the results of preliminary calculations by the majority of major - not only Dutch - banks indicate that moving to the standard approach and from the Standardised to the Foundation IRB approach results in an increase in regulatory capital.
However even in the case of corrected calibration the NVB is of the opinion that the above mentioned incentives are insufficient to prompt banks, especially smaller ones, to move from the Standardised approach to one of the IRB approaches or from the Foundation to the Advanced IRB approach.

The NVB realises that for some banks the benefit of moving to the foundation IRB approach could be more than a 2-3% reduction in risk-weighted assets. But assuming that on average the 2-3% reduction in risk-weighted assets and the resulting regulatory capital reduction is correct, this will be more than outweighed by the average cost of improving current IT systems and risk rating models in order to qualify for the Foundation IRB approach.

NVB proposal

The NVB proposes a larger incentive between the Standard and the Foundation IRB approach

The floor of 90% in the first two years following implementation of the Advanced IRB approach unnecessarily impedes banks to move to this approach.

NVB proposal

The NVB proposes the Committee lowers the proposed floor for the Advanced IRB to 75%.

Adoption of the IRB approach

Basel proposal

The proposal states that a banking group must adopt the IRB approach across all exposure classes and across all significant business units within a reasonably short period of time (par. 159). Some exposures in non-significant business units that are immaterial in terms of size and perceived risk profile may be exempt from the above rule. Capital requirements for such operations will be determined according to the standardised approach (par. 160).

NVB comment

The NVB trusts that the supervisors will treat the above-mentioned rule sensibly.

NVB proposal
The NVB proposes to clearly define the procedure with regard to an IRB bank in the following cases:

a. the bank acquires a major financial institution which uses the Standardised approach
b. the bank introduces new financial products
c. the local regulators require a bank to use the Standardised approach for parts of its portfolio

The NVB also proposes partial use is allowed of up to all 3 approaches (ERB, IRB Foundation and Advanced) within one bank, each different, well- defined portfolio's.

Multiple (Local) regulators
Basel proposal
Internationally active banks may face supervision by a multitude of banking supervisors, supervising separate legal banking entities in multiple jurisdictions.

NVB comment
The NVB is of the opinion that supervisors should co-ordinate their approaches to regulatory capital calculation for internationally active banking groups. It is not in the interest of these banking groups that some regulators will not allow IRB approach immediately, while other regulators will. It is also not in the interest of these banks that different regulators test the same rating models and may come up with different requirements or recommendations.

NVB proposal
The NVB proposes that supervisors should consider to install an institutionalised way to co-ordinate their approaches to the implementation of the regulatory capital calculation and prevent unnecessary reporting burden for internationally operating groups and also to lower the cost of supervision by increased efficiency.

"Cherry picking"
Basel proposal
The proposal states that banks must agree to an aggressive, articulated plan to adopt the IRB approach across all exposure classes and business units with the home supervisor. No capital relief would be granted for intra-group transactions between the IRB bank and a business unit on the Standardised approach. This includes asset sales and guarantees (par. 159).

NVB comment
The NVB does not agree with the above; it should be possible to have all 3 approaches in place within one banking group (please refer to our comment number 2 in this section). The

NVB proposal
The NVB proposes that regulators require an additional capital charge through Pillar 2 when they suspect "cherry picking", instead of using the automatic assumption mentioned in par. 159.

Scope

Scope of application

Basel proposal

The scope of application will be extended and include on a fully consolidated basis holding companies that are parents of banking groups in order to ensure that all risks within the banking group are captured.

NVB comment

The NVB urges that any overlap with other supra supervisional institutions needs to be avoided. The same applies for insurance, securities and other financial subsidiairies, included in the consolidation of a banking group, which are regulated by a different supervision regime.

The NVB recommends that adequate communication between these supervisors takes place in order to prevent administrative burdens resulting from being regulated by more than one supervisor.

Consolidation

Basel proposal

The Accord will be applicable to all internationally active banks at every tier within a banking group on a consolidated basis. However, supervisors should test that individual banks are adequately capitalised on a stand alone basis.

NVB comment

Although stated that the supervision is executed on a consolidated basis, individual banks need to be adequately capitalised on a stand alone basis. The NVB believes that if an individual bank is guaranteed by a bank within a banking group and is consolidated within that bank guarantor, the requirement of being adequately capitalised on a stand alone basis is no longer relevant. A basic requirement is that the bank guarantor be adequately supervised on a fully consolidated basis. Given the supervision of the bank guarantor, the individual bank's solvency is strengthened.

NVB proposal

The NVB proposes that in this respect a sub-holding that it self is not engaged in banking activities, should not be tested on a stand alone basis. We acknowledge that the above comment is only valid if both the bank and its guarantor are part of the same, or well co-ordinated regulatory environment.

Insurance subsidiaries

Basel proposal

Insurance subsidiaries are not in the scope of this Accord. However, surplus capital in an insurance sub may be allocated to the bank's capital, subject to regulator's approval. The information needs to be publicly disclosed. On the other hand the bank supervisor needs to ensure that the insurance sub is adequately capitalised to reduce losses to the bank.

NVB comment

The NVB recommends that adequate communication between regulators takes place in order to prevent the bank from administrative burden resulting from being supervised by more than one regulator.

Minority owned equity investments

Basel proposal

Significant minority owned equity investments in non-insurance financial entities need to be deducted from the banking group's capital base. The threshold for significance is determined by national accounting or regulatory practices.

NVB comment

In order to have a level-playing field the NVB recommends that the Committee sets the threshold for these capital deductions.

Investments in commercial entities

Basel Proposal

Significant minority and majority investments in commercial entities, which exceed 15% of the bank's capital for individual investments and 60% of the bank's capital for the aggregate of such investments, will be deducted from the banking group's capital base.

NVB comment

The NVB agrees that investments in a commercial entity may have a higher risk profile than loans to a commercial entity and might therefore be subject to a higher capital charge than loans. An investment exceeding 15% of the bank's capital for individual investments is a large amount.

NVB proposal

In the opinion of the NVB a full capital deduction is too strong and the NVB proposes to introduce a risk weighting in line with the implied credit risk. Also for 60%, noting that in the opinion of the NVB it will be rare that such large concentrations would exist. This type of concentration risk should be dealt with under Pillar 2.

Deduction from capital

Basel proposal

All deductions of investments in de-consolidated entities will be 50% Tier 1 and 50% Tier 2.

NVB comment

This is a major change from current practice in The Netherlands.

NVB proposal

The NVB proposes not to include the mandatory division deduction over Tier 1 and Tier 2 capital.

Pillar 1

Credit Risk

Rating Criteria
Basel proposal
The bank must demonstrate that its rating criteria cover all factors that are relevant to the analysis of the borrower. Minimum factors are stipulated. (par. 264, 265)

NVB comment
The NVB agrees that banks should demonstrate that its rating criteria cover all factors that are relevant to the analysis of the borrower. However supervisors should restrain themselves from imposing very detailed requirements that are or should be subordinate to the ultimate goal of integer and validated credit ratings. The minimum rating criteria mentioned are such a too detailed requirement. First, they are not always applicable (e.g. access to equity markets in case of small and middle-sized business lending) or relevant (e.g. project finance rating criteria cannot be based on historic data, but other criteria than mentioned are most relevant).

NVB proposal
The NVB proposes that the only rating requirements should be those directly instrumental to the integrity and validation of the credit ratings. Requirements that are not a necessary condition to integer and validated rating should be formulated as guidelines (e.g rating criteria, reporting to senior management).

Transfer risk and sovereign ratings
Basel proposal
As a minimum, a bank should look at each of the following factors for each borrower: (..) the risk characteristics of the country it is operating in, and the impact on the borrower's ability to repay, (including transfer risk) where the borrower is located in another country and may not be able to obtain foreign currency to service its debt obligations. (par. 265)
Sovereign rating criteria should include amongst others transfer risk. The different loss characteristics of domestic and foreign currency lending to sovereigns should be assessed separately (separate LGDs in the Advanced approach). (par. 490, 494)

The requirements for own-estimates of LGD stipulate that any currency mismatch between the underlying obligation and the collateral must be considered and treated conser vatively in the bank's assessment of LGD. Transfer risk must also be treated accordingly. This is particularly crucial for sovereign exposures – as such, a bank must also assess the potential impact of foreign exchange risk on its loss severity, as this is likely to be a primary driver of a bank's loss severity when a sovereign defaults on its obligations. (IRB support doc, par. 380)

NVB comment

Beneficial risk weights are applied to lending extended to local sovereigns using local currency and local funding in the standardised approach. Likewise, under the IRB approach different probabilities of default and risk weights should be applied to sovereigns in local and foreign currency. Corporate obligations should be rated based on debt ratings in local currency. Transfer risk applies equally to all corporates in a certain country and therefore should be recognised as a separate risk factor. Lending to local borrowers in local currency by definition is less risky than lending to such borrowers using foreign currency. The NVB recommends that the new capital framework recognises local currency ratings in both the Standardised and IRB approaches for the purpose of setting regulatory capital risk weights for obligations in local currency. Transfer risk should be addressed separately on a country-by-country basis not on a obligor ratings.

Data collection and IT systems

Basel proposal

In the IRB approach, it is stipulated that banks must collect and store data on key borrower characteristics (not further defined) and facility information. These data should be sufficient to allow retrospective re-allocation of obligors to grades (par. 287).

NVB comment

The NVB supports that, as a guidance, banks should collect and store data on key borrower characteristics and facility information which are used to rate a borrower and/or facility. This helps to determine ex post that ratings have been assigned correctly. The stipulated goal is that it should also allow retrospective re-allocation of obligors to grades in order to refine rating systems. However refinements of rating systems are frequently achieved by including new, different and often not quantitative information (e.g. because of changing environment or new insights). Imposing the storage of key borrower data for retrospective re-allocation of ratings is thus a costly and probably ineffective way for refining rating systems. It is also not in line with the specific requirement for the use of statistical default models, that only states that banks must demonstrate that the population of the borrowers represented in the data is representative of the bank's actual borrowers (par. 282). Sample testing could and should thus also be accepted practice.

NVB proposal

The NVB proposes that banks may use samples to improve rating systems and re-allocate obligors to grades only for the test and validation sample. These samples should be constructed on a statistically sound basis. Banks will not be required to re-rate past ratings of obligors.

Data for the validation of bank's estimates of LGD and EAD

Basel proposal

The observation period for estimates of LGD and EAD should ideally cover a complete economic cycle, but must in any case be no shorter than a period of 7 years. (par. 342, 379)

NVB comment

It is noted that for the estimation of Probability of default the period should at least consist of 5 years. Also a transition period of 3 years is allowed in the Foundation approach. It is not clear why in the Advanced approach the Basel Committee proposes two different data periods to be used for PDs and LGD/EAD (5 and 7 years respectively). It could eventually lead to a structurally distorted parameterisation.

NVB proposal

The NVB proposes to use the same data period of 5 years in the Advanced approach for PD and LGD/EAD-estimates.

Calibration of risk weight formulas.

Basel proposal

In the IRB approaches the risk weights are determined on the basis of a continuous function with variables: PD, LGD and M (Maturity), (par. 171-177 for corporates, par. 424-430 for retail).

NVB comment

The NVB supports the use of a continuous risk weight function. However the level of the risk weights as well as the underlying principle give cause to comment.

1. The inclusion of expected loss in the formula is contrary to the principle that capital serves to cover unexpected loss only. Although we recognise that part of the regulatory capital consists of general provisions this is contrary to the principle that banks should properly provision their expected losses. For retail credits often the turn over is such that losses are taken continuously through the year and written off against the credit income earned in that period.
2. Implicit in the risk weight function is an add-on of 50% apparently to cover errors in the estimation of PD (20%) and for reasons of conservatism (30%). The conservatism leads to the undesired result that regulatory capital will be higher than economic capital thus creating an incentive for arbitrage. Also the regulatory capital will likely for many, if not most, banks be higher in the IRB approach than in the Standardised approach. This also leads to an undesired disincentive to adopt the IRB approach.
3. The formula implies a strict relationship between the EL components (PD and LGD) and unexpected losses. This strict relationship may not hold equally for all portfolios (especially retail portfolios) and also it may cause pro-cyclical capital requirements when expected losses increase in an economic downturn and not only provisions, but also capital requirements will increase significantly due to the imposed (assumed) relationship. This pro-cyclical effect should be taken account of in the calibration of the risk weight functions. The stress tests that banks are required to perform to be eligible for the IRB approaches will serve to indicate the additional capital required to whether an economic downturn. This is part of Pillar 2 Supervisory Review.

NVB proposal

The NVB proposes that the risk weight formula is adjusted to exclude the expected loss-part and the conservative add-on applied. Only capital for unexpected losses would then be held, which is more in line with the methodology banks use for credit risk. Because this has not been done, the NVB proposes that in the disclosure part banks can disclose which part of their capital is needed to cover unexpected losses and which part is needed to cover expected losses.

Exposure at Default/ Credit Conversion Factor

Basel proposal

In the Foundation approach the standard credit conversion factor for unused part of committed facilities is 75%. (par. 232)

NVB comment

The 75% credit conversion factor (CCF) is much higher than the current CCFs or those applicable in the Standardised approach. The difference is not accounted for in the proposal. However the impact on regulatory capital can be dramatic and may prove to be a disincentive for the Foundation approach.

Especially certain type of facilities may be penalized more than is warranted (e.g. liquidity back up facilities). The CCF of 75% does not seem to take into account the risk mitigating effect of amongst others covenants, which may in fact limit the use of the facility or terminate its committed nature. As a consequence the committed facility may often be reduced well before the borrower defaults. Also for lending to SMEs applies that credit limits may in fact be reduced or cancelled because of loan covenants and/or deteriorating credit quality. Studies calculating the Exposure at Default do not always contain the original data of these facilities that are cancelled well before default. However applying the standard EAD-numbers also to these facilities clearly overstates the risk of drawing of these facilities. This observation is also, be it indirectly, confirmed when comparing differences in market pricing between the used and unused part of these facilities.

NVB proposal

The NVB proposes that a lower CCF than 75% will be applicable for committed facilities, that is consistent with the percentages of the Standardised approach. For example a lower generic CCF of 20% for commitments with a remaining maturity up to one year and 50% for commitments with a remaining maturity over one year. Consideration should be given to apply a reduced CCF for commitments that are cancellable upon breach of predefined covenants.

Maturity

Basel proposal

In the Foundation a standard assumption of three (3) years is used. In the Advanced approach two maturity adjustment factors are proposed based on MtM or Default Model assumptions. Both adjustment factors are regulator prescribed. Feed back is asked from the industry with respect to what would be the right adjustment factor and whether there is a danger of distortions on financial markets.

NVB comment

The impact of maturity on risk is not uniform across financial product and markets. Therefore any standard or prescribed approach will have deficiencies.

The risk weight function as proposed by the Basel Committee has used a MtM formula for adapting the formula to the assumed average three-year maturity. It is therefore logical that if a maturity factor is introduced the same approach is taken. If the Committee would deem it more appropriate that another maturity factor is used then also the risk weight formula itself must be made consistent with this factor.

Because the maturity factor is significant (especially for the MtM approach) and restricted to banks applying the Advanced approach the NVB believes there to be a real danger of market distortions. In the Basel proposal the regulatory capital charge for loans with a maturity shorter than 3 years will, all else being equal, be significantly lower for banks using the Advanced approach than for banks using the Foundation approach. For loans with a maturity longer than 3 years the capital charge for banks using the Foundation approach will be lower. The implication is that Advanced banks will have a competitive advantage for shorter term loans and Foundation banks for longer term loans. Competitive forces will thus drive banks out of certain market segments, not because of differences in capabilities, risk management practices or risk preferences, but because of regulations. For example the interbank market with primarily short-term loans would be dominated by Advanced banks, whereas mortgage lending would be dominated by Foundation banks. This is not desirable.
This deficiency cannot be corrected by applying crude correction factors reflecting the actual average maturity of the exposures, because the incentives per transaction are not changed by crude over the board correction factors. In principle, provided it is consistent with the overall framework, all regulatory prescribed parameters should be available to all banks, irrespective of the approach, and only for bank's own estimates of parameters should banks fulfill certain strict requirements.

NVB proposal
The NVB proposes to apply a maturity adjustment factor that is consistent with the risk weight function in general. In order to avoid competitive distortions all banks should be able to apply the regulatory prescribed maturity adjustment factor. Because the maturity adjustment factor is regulatory described there are no hurdles to be taken by banks, which could be a reason to exclude less sophisticated banks.
The Basel Committee should consider whether in the Advanced approach banks should be allowed to assess their own maturity adjustment factor in recognition that this factor may be different for different credit portfolios.

Granularity
Basel proposal
A granularity adjustment factor is proposed for the internal ratings based approaches, Foundation and Advanced, in order to capture the risk of a large non-diversified idiosyncratic risk, because of coarse granularity. (par. 503-515)

NVB comment
Although the NVB recognises the type of risk and the theoretical justification for its inclusion in the framework it has severe reservations. The first is that it measures the risk that is in part already captured by the Large Exposure Regulations as imposed by the EU, but fails to capture the far more important concentrations by industry and country that banks are exposed to. Few banks have been brought into a state of financial distress by single borrower concentrations, but far more by country or industry concentrations. The adjustment factor thus captures the least of the different types of concentration or diversification benefits a bank is exposed to. This is all the more relevant, because although the Basel Committee claims that the granularity adjustment factor should be easy to calculate, it is likely that the associated cost for banks are significant especially when compared to the (for most banks) minor quantitative impact on their regulatory capital.

As the granularity adjustment factor requires banks to assemble and report credit data of individual credits an issue might be the bank secrecy acts of certain countries that restrict the cross border transfer of client data within the banking group. The NVB assumes that the Basel Committee will take account of any legal issues related to the introduction of the granularity adjustment factor.

Finally an additional practical issue is the non-linearity of the adjustment factor. As international operating banks can be required to calculate their minimum regulatory capital not only at the consolidated level, but also lower levels, this implies that the sum of the minimum regulatory capital of the individual parts is not equal (i.e. higher) than the minimum regulatory capital level at the consolidated level. This because the granularity of the lower level entities will be more coarse than at the consolidated level. If a granularity adjustment factor would be introduced this issue would need additional attention.

The risk weight formula assumes an asset correlation of 20% for corporate and 8% for retail portfolios. To incorporate the diversification effect of country and industry, the Basel Committee could consider establishing a regulatory determined correlation matrix. On the basis of this matrix and the exposure size per country and industry banks could calculate their portfolio specific, regulatory determined, correlation which could be a parameter of the risk weight formula determining the risk based capital applicable for that bank.

$RBC = \sqrt{\sum_{i=1}^{n}\sum_{j=1}^{n} rho(i,j) RBC_i RBC_j}$, where RBCi equals RBC per country, per industry.

and rho=100% if i = j

<u>NVB proposal</u>
The NVB proposes to abolish the granularity factor. The Large Exposure Rule already covers part of the concentration risk regarding exposures on groups of related borrowers. The diversification between industries and countries is considered far more important to establish the risk of a loan portfolio.

Guarantees and w-factor
<u>Basel proposal</u>
In the Foundation approach the PD should be calculated as the weighted average of the PD of the borrower and that of the guarantor. The weight (w-factor) of the borrower is 0% if the guarantor is a bank, central bank or sovereign. In all other cases the weight is 15%. For credit derivatives the weight is irrespective of the protection provider 15% (181-190). In the advanced approach the w-factor is 0% provided the requirements mentioned in 403-419 are met.

NVB comment

The NVB is of the opinion the approach for guaranteed exposures to be flawed. Especially the w-factor is unjustified and is likely to have undesirable effects that could lead to new forms of arbitrage. First, the w-factor discriminates direct lending to a corporate guaranteed by its parent when compared to lending to the parent who lends the money on to the group company. The bank's position is in the first instance (lending with a guarantee) not worse, but often better. However it would be punished with a higher capital charge. Second, the w-factor is introduced to capture some remaining legal or operational risk inherent to all forms of collateral. However this risk is captured in the operational risk capital charge (assuming it is not de facto captured in the LGD-estimates and thus in credit loss). Third, the different treatment of guarantees and credit derivatives unjustly does discriminate against the latter. Fourth, the additional requirements for applying a 0% w-factor in the Advanced approach will normally already be met in the Foundation approach and thus there seems to be no additional reason not to apply the 0% w-factor of the Advanced approach in the Foundation approach as well.

NVB proposal

The NVB proposes to abolish the w-factor. The NVB believes that guarantees are often good lending practice and should not suffer from disincentives. However if it is still deemed necessary to introduce the w-factor this should not discriminate against credit derivatives. Also if the w-factor is maintained then the treatment in the Advanced approach should also be applicable in the Foundation approach as no material new requirements are imposed.

Recognition of collateral

Basel proposal

In the Standardised and Foundation approaches Commercial Real Estate can be recognised by supervisors if certain strict requirements are met. No other physical collateral is recognised that is not already recognised in the current Basel Accord.

NVB comment The NVB regrets that no new types of physical collateral are recognised in the Standardised and Foundation approach. This is especially detrimental for lending to small and medium sized enterprises (SME). The NVB recognises the difficulty facing the regulator formulating requirements for collateral recognition that are applicable world wide. Nevertheless the requirements mentioned for Commercial and Residential Real estate should be generalised in order to be applicable to other asset classes as well.

As an example of an asset class that could fulfil all reasonable requirements the NVB mentions personal cars. Cars fulfill the following conditions:

1. they can easily be identified and often there is a national central administration;
2. cars can be legally pledged and often the bank is even the owner of the car;
3. insurance contracts are reasonably standard and can provide full coverage;
4. the market value of cars can be determined relatively easily and objectively;
5. the market of second hand cars is liquid and prices are relatively predictable in time with small variations;
6. car fleet lenders have often long-term data available regarding market prices, lending policies and loss experiences. The latter are often very low, because of the value of the collateral.

Other types of assets that could potentially fulfill strict legal, operational and credit loss requirements are (some types of) airplanes, ships and specialized receivable financing (known as “factoring” or “asset based lending”).

NVB proposal
The NVB proposes that the Basel Committee makes clear the general requirements that must be fulfilled for collateral to be recognized in the Standardised and Foundation approach. The NVB believes that cars are a good example of collateral that fulfills all possible requirements.

Commercial real estate
Basel proposal (par. 207, footnote 30)
In the Foundation approach capital relief can be obtained if Commercial Real Estate (CRE) and Residential Real Estate (RRE) is taken as collateral and the minimum requirements are met. These requirements are summed up in paragraphs 310 to 321, but an accompanying footnote (# 30) refers to another footnote (#14) where the requirements under the Standardised approach are mentioned.
Exposures where the ratio of collateral value (of CRE or RRE) to the nominal exposure exceeds the threshold value of 140%, would be assigned an LGD of 40%. (par. 210)
The bank is expected to monitor the value of the collateral on a frequent basis and at a minimum once every year. More frequent monitoring is suggested where the market is subject to significant changes in conditions. The valuation should take account of national jurisdictional issues and/or bankruptcy code or adjudication process issues. In addition, the property should be evaluated periodically by a qualified professional; this evaluation should be conducted no later than three years from the date of the last professional valuation, or when a maturity event (renewal, default or refinance of the underlying facility) occurs. (par. 319)

NVB comment
The NVB supports the recognition of CRE in the Standardised and Foundation IRB approach. The NVB appreciates the Basel Committee’s view, that CRE is not recognised as collateral for corporate loans in case the risk of the borrower is materially dependent upon the performance of the underlying property. In the Foundation approach the eligibility criteria are targeted to real estate pledged by SMEs (including farmers).
The eligibility criteria for CRE in the Foundation approach refer to paragraphs 310-321. However the added footnote 30 concerning the eligibility of CRE in the Foundation approach, refers to footnote 14 of paragraph 38 of the Standardised approach. Its wording could be misinterpreted as if all eligibility criteria of footnote 14 are also valid for the Foundation approach. One of the eligibility criteria is that on a country level several conditions must be met, which should not be the case in the Foundation approach.

The impact of RRE and /or CRE collateral is limited to the reduction of the LGD factor from 50% to 40%. This impact is significantly less than in the Standardised approach where the risk weight is reduced by half (from 100% to 50%).

The frequency of a reassessment every three years is a too rigid requirement in view of the combination with the requirements that if the market has fallen significantly (> 10%) the value must be reassessed. For example general revaluation techniques such as indexation should be allowed for revealing the necessity of a professional revaluation versus maintaining the original appraisal. Also loans with an amortisation schedule appropriate to the type and the remaining economic lifetime of the property should be excluded from the periodic revaluation requirement.

NVB proposal

The NVB proposes that the referral to footnote 14 in footnote 30 be deleted. Furthermore the NVB proposes that where the collateral value to the nominal value of the exposure exceeds a level of 140% an LGD of 25% may be assigned.
Finally the NVB proposes that revaluation requirements for CRE be formulated more flexible to allow prudent risk management to be combined with cost efficiency.

Maturity mismatches and On Balance Sheet Netting

Basel proposal

It is proposed that for on-balance sheet netting the treatment for maturity mismatches is that hedges of less than one year will not be recognised. (par. 115, 148)

NVB comment

It is noted that for lending activities where on balance sheet netting is applicable is primarily short term lending. The non-recognition of maturity mismatches with a remaining maturity of less than one year thus reduces the benefit for on balance sheet netting significantly. However the IDNA (Interbank Deposit Netting Agreement) and the legal opinions that support this document support netting with maturity mismatches. It is noted that for off balance sheet netting such a maturity restriction is not applicable.

NVB proposal

The NVB proposes to apply the on balance sheet netting treatment also if a maturity mismatch exists less than one year.

Default definition

Basel proposal

Basel proposes the following default definition:
"A default is considered to have occurred with regard to a particular obligor when one or more of the following events has taken place:

(a) It is determined that the obligor is unlikely to pay its debt obligations (principal, interest, or fees) in full;
(b) a credit loss event associated with any obligation of the obligor, such as charge-off, specific provision, or distressed restructuring involving the forgiveness or postponement of principal, interest, or fees;
(c) the obligor is past due more than 90 days on any credit obligation; or
(d) the obligor has filed for bankruptcy or similar protection from creditors."

NVB comment

The proposed definition is flexible enough for most banks to align their internal default definition with. However the same flexibility may endanger the international level playing field as banks their assessments (criterion a) and their moment of provisioning (criterion b) may differ. Especially banks that provision relative early should not be penalized by the default definition and the associated higher default probabilities. In this respect the NVB also refers to the relation with the risk weights applicable for defaulted credits (see below).

NVB proposal

The NVB proposes that national supervisors should have the discretion to allow banks who provision their riskier credits relatively early not to report all provisioned credits as defaulted.

Risk weights for defaulted credits

Basel proposal

For unsecured part of credits that are 90 days past due a risk weight of 150% is applicable in the Standardised approach (39). The Committee invites comments on the treatment of defaulted credits (par. 188, IRBA supporting document).

NVB comment

The PD/LGD approach used in the IRB approaches is not well applicable for defaulted credits. For PD is by definition 100% and the uncertainties regarding the LGD-estimate of non defaulted credits is materially different after the defaulted credit has been provisioned for.

In the Foundation approach the highest risk weight is 625% for senior loans. Although defaulted credits are credits where the risks have materialized such a high risk weight for the not-provisioned part of these credits is not justified. First, as credits are considered to have defaulted when a bank allocates a provision to it this would punish prudent banks twice: once by taking the loss early and second by assigning a higher regulatory capital than for non-defaulted credits. Second, if a realistic provision has been allocated the remaining balance should be considered “secured”. Basically any risk weight for the not-provisioned part should be related to the risk that the bank has underestimated its losses and thus its loan loss provision. One would expect that the provision is related to one of the determinants of expected loss before default (i.e. LGD), but as the reason for default will be known a much more precise estimate will be possible. It is not likely that the unexpected loss of the not-provisioned part, i.e. the risk that the bank sets a specific provision too low, is related to the earlier LGD-estimate. Risk weight formulas for defaulted credits incorporating the earlier LGD-estimate before default are thus in all likelihood wrong.

The appropriateness of banks their provisioning should be part of Pillar 2 Supervisory review.

NVB proposal

The NVB proposes that for defaulted credits that have been scrutinized by the bank whether, and if so to what extent, a provision should be allocated a general risk weight of 150% is applicable. This is the same as in the Standardised approach. As the risk weight is lower than the highest risk weight for non-defaulted credits in the Foundation approach this provides a balanced incentive for prudent provisioning. If a defaulted credit has not been scrutinized by the bank for provisioning then the highest risk weight for non-defaulted credits should apply. The NVB believes that such a treatment recognizes the wish of regulators to assign a risk weight to the not-provisioned part of defaulted credits, while at the same time avoiding overly complex rules that try to treat defaulted loans in the PD/LGD framework for which this framework is not well suited.

Lending to Small and Medium Sized Enterprises

Basel proposal

No specific proposals are made for lending to SMEs.

NVB comment

Lending to SMEs is characterised by lending to borrowers with a higher default probability which risk is mitigated by taking collateral. Also the many similar sized credit facilities ensure that risks are reasonably spread. In the Advanced approaches banks can take account of the collateral and accordingly have capital requirements that are reasonably aligned with economic capital and capital requirements for large corporates and retail. However in the Standardised and especially the Foundation approach the very limited recognition of physical collateral means that the capital requirements for lending to SMEs are too high especially when compared to large corporates and retail credits.

NVB proposal

The NVB proposes that capital requirements do not discriminate against SME lending. This can be resolved by more recognition of physical collateral and/or a special risk weight function for SMEs with a correlation factor in between those for corporates and retail.

Project Finance

Basel proposal

Banking-book exposures should be classified in six broad classes amongst which project finance (150). The Committee invites feed back on industry practices and views regarding the challenges identified by the Committee. (par. 421, IRBA supportive document)

NVB comment

Although the issues identified by the Committee that distinguish project finance lending from corporate lending are fair they often are a matter of degree. As an example the fact that projects are separated in a Special Purpose Vehicle (SPV) does not prevent that lenders have recourse to other parties than the SPV. Often the contracts the SPV has with other parties, which contracts are pledged to the lending banks, ensure that recourse provisions are defined in such a manner that all type of risks are allocated to the party willing and able to bear the risk. Thus sharp division lines cannot be drawn easily with respect to recourse and non-recourse.

The NVB notes that rating agencies like Standard&Poor's have indicated that their credit ratings for project finance are an indication of their probability of the (non) timely payment of debt obligations. Thus a PD/LGD-framework as is applicable for corporates can in principle also be applied for project finance. The specific risk assessment issues should be incorporated in the rating methodology, but no other treatment or requirements should be considered let alone imposed.

The issues relating to LGD-estimates as mentioned by the Basel Committee are in the Foundation approach not applicable. The 50% standard LGD is considered to be very conservative already, also in the (pre-)construction phase where often recourse provisions give banks (some) protection. In the Advanced approach the burden of proof for a realistic estimate rests with the bank and no further requirements are necessary in this respect.

Some rating agencies and banks may have chosen to align their ratings for project finance on expected loss. In the Foundation approach this can be translated into the PD/LGD-framework by applying (assuming) the standard 50% LGD and calculating the implied PD.

NVB proposal
The NVB proposes that project finance is not a separate class from corporate credits. The PD/LGD-framework should be applied. Banks with project finance ratings aligned to expected loss should be allowed to translate their ratings into a PD/LGD-framework similar as is applicable to retail credits.

Retail credits
Basel proposal Banking-book exposures should be classified in six broad classes amongst which retail credits (150). A definition for retail credits, a risk weight function and specific requirements amongst others segmentation are proposed (par. 422-478). Feedback on these issues is sought.

NVB comment
NVB generally supports the approach taken in the proposals regarding the treatment of retail exposures. The NVB specifically supports:
1. treatment of retail exposures as a separate exposure class with its own risk weights
2. risk weights that depend either on PD and LGD or on the expected loss (EL) of the exposure, but are independent of maturity. With respect to the risk weight function the NVB refers to its comments made on the calibration of the risk weight functions
3. the proposed approach that prescribes segmentation by product and borrower characteristic, recommends segmentation by delinquency status and vintage and allows other techniques of segmentation. However for borrower characteristics not only application scoring, but also behavioural scoring should be allowed to be the basis for segmentation. That behavioural scoring should be used for reassessing the estimated loss associated with each segment, as stated by the Committee, is a too limited view of the function and value that behavioural scoring may have. Also application scores may become outdated, while behaviour scores are continuously refreshed.
4. the flexibility in the retail definition to include portfolios that are managed in a similar, standardised, manner. However the restriction with respect to individual persons may be too strict as many small businesses have chosen a separate legal status for tax or other reasons.

The NVB proposal
The NVB agrees in general with the approach taken by the Basel Committee. The NVB proposes that for segmentation purposes by borrower characteristics also the behavioural scoring should be allowed. The NVB also proposes to widen the scope of the definition of retail to include any portfolios that are managed on a statistical basis.

EAD for OTC derivatives
Basel proposal
Under the new proposal banks subject to the Standardised and Foundation approaches would be subject the existing methodology applicable to OTC derivatives activities. More sophisticated techniques and methodologies to calculate credit exposures would only be permitted for which the advanced approach has been approved.

NVB comment
The most important reason is that only by use of a full swing simulation it is possible to measure counterparty exposure accurately taking into account the legal status (netting, collateralisation) and the exact timing of cashflows (portfolio effects).

An argument for allowing internal models for measuring counterparty exposure is that no credit events need to be modeled. Therefore the regular's current resistance related to portfolio modeling for regulatory purposes should not apply in models for counterparty exposure calculations. For calculating counterparty exposure only the underlying market rates need to be modeled. This can be compared to calculating a market risk VatR for which banks are already allowed to use their models under certain restrictions.

An important issue in allowing banks to measure counterparty exposure using their own simulation models is that the regulator has to explicitly indicate which exposure quantity should be calculated (see draft paper of the ISDA working group on counterparty exposure). In that paper it is proposed to base the capital charge for counterparty exposure on the *average expected exposure* (not on a high percentile (95% or 97.5% or whatever) of the exposure distribution). The ISDA paper explains why expected exposure is preferred over "worst case" exposure. The reason is that by taking the expected exposure, the derivatives can be "translated" into loan-equivalent exposures with the same amount of *expected* exposure. The big advantage of this approach is that in the following steps for determining the regulatory capital related to credit risk, derivatives can be treated the same as loans.
By calculating the derivative exposures using a high percentile of the exposure distribution (on a counterparty level), you would combine worst case with worst case (worst case on a counterparty level with worst case on a bank level: credit VaR).

Internal models may vary at both ends of the sophistication spectrum banks may have:
1) Static percentages applied against notional amounts to measure the PFE portion (Potential Future Exposure) of the credit equivalent amount.
2) Full Valuation Monte Carlo simulation: Simulating all underlying market variables simultaneously (taking correlation into account) and using these to value the whole portfolio for different moments in the future. Result is a probability distribution of exposure for different moments in time.

Further:
a) The current MTM values should be offsetting (when applicable) the PFE portion where credit exposures for a portfolio of transactions would no longer be the max{0;MTM}+PFE but the max{0;MTM+PFE}.
b) Track exposure profile over time instead of taking the maximum exposure of the remaining time-to-maturity. Although this is an improvement on individual trade level, it is only effective on a portfolio level when different trades reach their peak at different moments in time.
c) Netting: If the legal documentation (e.g. ISDA) is in place and is considered enforceable, negative exposures should be offsetting positive exposures within a counterparty's portfolio. This implies that credit risk system must reflect the conclusions generated following an appropriate legal due diligence.

NVB recommendation
The NVB recommends that, considering the spirit of the proposed capital framework which aims at aligning regulatory capital measurements with economic capital, the more sophisticated technique and methodology be also allowed for banks subject to the Standardised and Foundation approaches. Hence NVB support the recommendation to allow banks to use their own models for measuring counterparty exposure.

Use of credit risk models

Basel proposal

The Consultative Document *Overview of the New Basel Capital Accord* states that the Committee is stopping short of permitting banks to calculate their capital requirements on the basis of their own portfolio credit risk models (par. 12).

NVB comment

It is not clear to the NVB when these models will be appropriate for regulatory capital calculation purposes. The NVB recommends the Basel Committee to continue doing research on the use of credit risk models for regulatory capital purposes after the new Capital Accord will have been published at the end of 2001.

The implementation process and audit aspects

Basel proposal

Frequency of internal audit review

The proposal states that internal audit must review annually the bank's rating system, including the quantification of internal ratings. Areas of review include adherence to all applicable minimum requirements. Internal audit must document its findings (par. 253)

NVB comment

The proposed frequency of the internal audit review of the IRB system differs from the frequency of the review required for the internal model for market risk (*regular basis*). The NVB is concerned that performing annual reviews of the IRB model, systems, processes and financial data may be extremely cumbersome.

The NVB would instead suggest that the annual audit of the IRB environment is limited to the accuracy of financial information and to the consistency of the rating assignment process across portfolios. The NVB believes that the audit assessment of the IRB system and model (which also includes a review of the PD estimation process and the integrity of the risk rating database) should be carried out only on a "regular" basis, leaving the internal audit to determine the most appropriate frequency. This degree of flexibility would allow the internal audit function to achieve an effective allocation of audit resources and to adequately address the risks undertaken by the institution.

Equity

Different exposures
Basel proposal
The Committee sees the need for more approaches for equity exposures.

NVB comment
The NVB agrees with the Committee that for equity exposures more than one approach is needed because equity exposures differ in terms of purpose (strategic versus capital gain driven), intended holding period (indefinitely versus medium term) and liquidity (either or not listed/quoted). The NVB is of the opinion that for equity exposures which are valued against market value, a market risk or stress testing approach seems the most appropriate approach . Equity exposures which are valued at cost (or lower market value) may in general be more treated as debt exposures .

Definition of equity exposures
Basel proposal
The Committee has defined equity exposures as ownership interests in a corporation, partnership or other business undertaking.

NVB comment
In order to allow multi-approaches, each equity type should be clearly defined in order to minimise grey area types which could be arbitraged between the various approaches. The Committee should clearly define which equity exposures are part of pillar 1 (credit risk) against those which are part of the trading portfolio or which are taken into account by the scope of application. This is especially needed for grey areas between capital gain types of equity exposures and

a) equity exposures in the trading book (defined by holding period, to include equity derivatives, repo's etc) and,
b) debt exposures with an equity feature in the bank book (convertible debt, leveraged loans with an equity kicker, equity loans). In this respect NVB is of the opinion that cumulative preference shares and debt claims with interest payments linked to dividends or profits should be treated as debt exposures.

Insurance affiliates
Basel proposal
Equity exposures are sometimes held by insurance affiliates of banks.

NVB comment
The Committee should assure that a level playing field for equity exposures will be maintained between the insurance and the banking industry

Risk weighting of equity exposures
Basel proposal
Under the Standardised Approach, equity exposures would have a 100 % risk weighing albeit that local supervisors could impose higher weighing factors.

NVB comment
NVB disagrees with such an approach because it may negatively impact a level playing field. If a differentiated weighing would be considered then this should be applicable uniformly. In this connection NVB also opposes to a special treatment for e.g. post WW-2 equity exposures which would otherwise also impact the level playing field. NVB does not favour an approach where the weighing factor increases with the size of the equity exposure as part of a banks total exposure.

Strategic equity exposures
Basel proposal
Under the IRB approach the Committee proposes a PD/LGD approach to strategic equity exposures.

NVB comment
NVB supports this approach which would require refinements for PD (should be PL) and for LGD (100 %). Since equity default is very difficult to define with reference to default on financial claims one could suggest to define default as "filing for protection under bankruptcy laws" especially if the LGD would be set by default at 100 %. This approach should also be applied to"subsidiaries without influence".

Capital gain equity exposures
Basel proposal
For capital gain equity exposures the Committee proposes a market risk or stress testing approach.

NVB comment
NVB is of the opinion this to be the most suitable approach because it implicitly takes into account the upside value potential of equity exposures which is an important mitigant for losses on other equity exposures. Especially for portfolios with a wide spread of equity exposures between company stages, sectors and geographies , substantial capital relief could be realised. Also long dated investments tend to have more unrealised value than short dated investments. Unfortunately the development and testing of required models is still in an early stage. Lack of sufficient performance data hinder the validation of models by individual financial institutions. For unquoted investments in mature companies, quoted companies could be used as proxies, however for early stage and development stage investments such proxies are not available. For the latter catagory one could consider to establish a confidential data exchange.

Asset Securitisation

Clean break requirements
Basel proposal
When the 'clean break' requirements between the originating bank and the SPV are met, the originating bank is allowed to remove the securitised assets from the calculation of its risk-based capital ratio. The 'clean break' requirements that are proposed in the Consultative Document are directly derived from the US accounting standards (FAS 140). The requirements relate mainly to legal isolation of the assets, a qualifying SPV and the control over the assets.

NVB comment
In essence the 'clean break' requirements in the consultative paper are comparable with the current requirements for 'true sale' of the Dutch Central Bank and the bankruptcy remote requirements by the rating agencies.

NVB proposal
NVB proposes to grandfather securitisation transactions which passed the “true sale” requirement in the past.

Ex ante operational risk charge
Basel proposal
In the Document the Committee expresses its concern over implicit and residual risks. To address the risk of banks giving implicit support to 'their' transactions, in the consultative paper severe punishments are proposed to banks helping 'their' transactions beyond the contractual obligations. For both implicit and residual risks the Committee considers an ex-ante capital charge.

NVB comment
The NVB strongly opposes an *ex ante* minimal capital charge for securitisation transactions to address implicit and residual risks. It is the view of NVB that these risks apply to all complex financing products.

NVB proposal
The NVB proposes therefore to incorporate such a capital charge in the general operational risk charge under pillar one. (see appendix A)

Risk weighting second loss with rating
Basel proposal
Under the standardised approach it is proposed that if second loss credit enhancements are not provided by a third party, but by the originator, that this will automatically lead to a deduction from capital.

NVB comment
In our view second loss enhancements that have a sufficient ECAI rating should benefit from risk weighting against the face amount, without the requirement for third party first loss coverage. This is similar to what the FED has proposed. (see appendix B)

Added value IRB approach

Basel proposal

The Basel Committee recognises that additional work has to be done on the IRB approach. For now it is proposed to follow a PD/LGD framework, where the PD is derived from the ECAI ratings and the LGD is (conservatively) set at 100%.

Comment NVB

In the current wording the IRB approach does not offer much added value compared to the standardised approach. Especially the fact that initially the LGD will be set at 100% is supportive of this view, although we understand that due to a lack of data (not much defaults) it is difficult to come up with better alternatives. (see appendix B)

NVB proposal

The NVB strongly requests to publish Working Documents for public discussion.

Risk weighting liquidity facilities

Basel proposal

In the Consultative Document, two main types of liquidity facilities can be identified. First, liquidity facilities that satisfy the 'liquidity criteria' and which are eligible for a 20% credit conversion factor. Second, liquidity facilities that do not satisfy these criteria and which would fall under the 100% credit conversion factor.

Comment NVB

In our view there should be more granularity in the definition of the proper risk weight of a liquidity facility, leading to risk weights anywhere between 0% and 100%.
Furthermore, according to the working group it would make sense to make the general risk weighting of liquidity facilities dependent on the underlying assets.

Treatment of Liquidity Facilities for own assets versus third party assets

Basel proposal

It can be concluded from the Consultative Document that the supervisor intends to continue making a distinction between a liquidity facility on assets originally coming from the sponsor’s balance sheet and a facility on assets coming from a third party’s balance sheet. The given rationale for this is that if the liquidity facility relates to the sponsors' own assets, this could conflict with the 'clean break' requirements.

NVB comment

The fact whether a liquidity facility backs assets coming from the sponsor’s balance sheet or from a third party’s balance sheet should have no effect on the treatment of the liquidity facility.

The NVB is of the opinion that an institution has more control over it's own assets is already sufficiently addressed by the proposed penalties for implicit recourse. (see appendix C)

Rated credit enhancements ABCP conduits

Basel proposal

The Committee holds to the view that first-loss credit enhancements provided by a sponsor must be deducted from capital.

NVB comment

If the sponsoring bank of an ABCP conduit provides credit enhancement to the conduit and this credit enhancement has an external (shadow) rating, then the risk weighting should be based on the weighting factors as determined for the Standardised/IRB approach. In this instance, in the view of the working group the bank is acting as an investor. (see appendix C)

Synthetic securitisation

Basel proposal

In the consultative document the Basel Committeee admits that it is not yet in a position to propose a well-defined framework how synthetic securitisations should be treated. The Committee intends to finalise its work on this issue in the near term.

NVB comment

The Basel Committee's thoughts on synthetic securitisation have hardly evolved since the previous consultative document. Given the fact that the market volumes for synthetic securitisation are catching up rapidly with cash securitisation, clarity is required both for regulators and participants. With a relatively small amount of work this area could be developed to a point where there is a clear environment for all banks to work within (see appendix D).

Grandfathering of existing securitisation structures

Basel proposal

It is expected that the new Basel Accord will be fully implemented as of 2004. In the document no specific comments are made on how to treat of existing structures.

NVB comment

Although it is recognised that the new Basel Accord will supersede all previous regulatory sign-offs, we would not agree if the new rules would result in a situation where the structure of an existing securitisation transaction would no longer be deemed acceptable. For the remaining term of existing structures we therefore argue that the structure itself needs to be grandfathered. For ABCP conduits we argue that after the implementation of the new Basel Accord a minimal grandfathering of the structure of two years is reasonable. (see appendix E)

Operational risk

Attention for qualitative elements

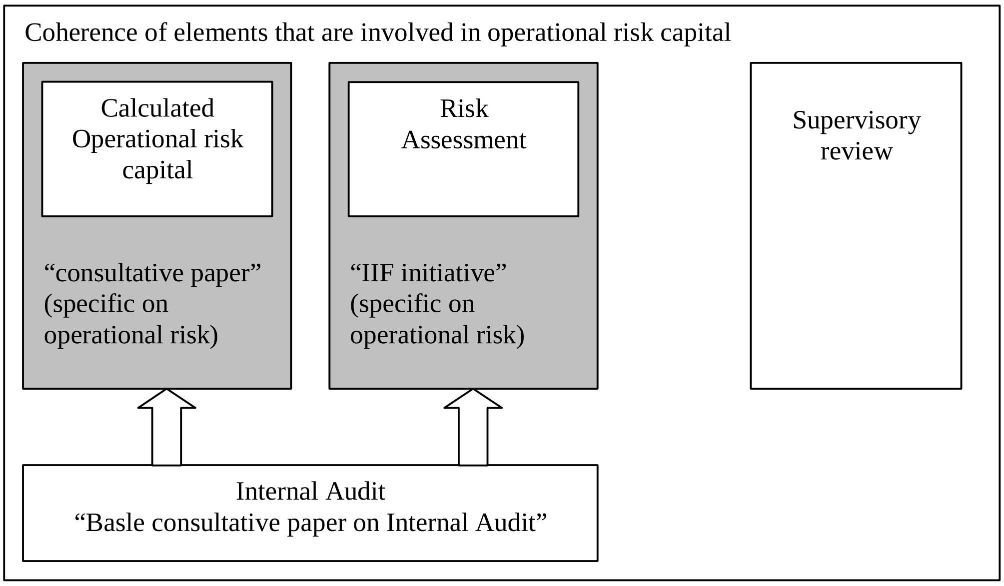
Basel proposal

The sections 41-44 on qualifying criteria are the only sections that deal with qualitative elements. However, these criteria do not lead to capital adjustments.

NVB comment

The most important remark of the NVB is the lack of attention for the quality of the internal organisation/control environment. The importance of risk assessments and high quality of controls is not explicitly mentioned. Neither has it been recognised as a risk measurement tool or as a tool within the operational risk capital calculation approaches. The NVB proposes to include a form of qualitative adjustment based on risk assessment in the calculations of a capital charge in *both* the standardised and the internal measurement approach. The NVB feels that a qualitative adjustment factor is an essential part of the Internal Measurement Approach. In the Standardised Approach is a qualitative adjustment an opportunity to make this approach more risk sensitive.

The qualitative adjustment can be comprised of risk assessments performed by the business (assisted by risk professionals). A possible solution could be using scorecards with closed questions. Followed by validation of the provided answers by internal audit as presented in the figure below. The scorecard method should not only address the presence and working of controls, but also the presence and quality of risk management methodologies in the lines of business.



A good score on quality of controls should lead to a reduction of the operational risk capital charge. A bad score should lead to an increase of capital. A floor and a cap should be formulated in order to mitigate severe consequences for outperformers and to stimulate comparability. Furthermore the NVB expects the regulator to take into consideration the existence, appropriateness and well functioning of the bank's risk management structure as a qualitative adjustment element.

Role of internal audit

Basel proposal

One of the qualifying criteria for the standardised as well as the internal measurement approach is an independent internal audit function (section 43). In the rest of the document, no specific attention is paid to the role of internal audit.

NVB comment

The opinion of the NVB is that internal audit should be recognised and emphasized more, especially related to the documents already issued regarding the independent audit function. In the Basel paper on operational risk internal audit is mentioned as one of the qualitative criteria, whereas in the consultative paper on Internal audit the role of internal audit towards risk managment is explained. The NVB has worked out a detailed paper on the position of internal audit.

Overlap of operational risk with credit or market risk should be prevented

Basel proposal

In the document on credit risk(par. 406), a w-factor is introduced.

NVB comment

Operational risk is present in all activities of a financial institution. The risk of overlap in definitions of risk types is therefore high. When choosing indicators and using data, the possible overlap should be taken into consideration.
In the credit risk proposals, a w factor is introduced to cover risks, which are part of operational risk. The NVB is against this w factor, as double counting should be prevented. Positive and clear definitions of all risk types (market risk, credit risk and operational risk) will further reduce the risk of double counting. Furthermore, operational risk loss types should be clearly defined. Though clear definitions are needed, this might result in a re-arrangement of all current databases. It might appear that some operational risk losses are recorded in credit or market risk databases.

Definition of operational risk

Basel proposal

In section 6, operational risk is defined as 'the risk of direct and indirect losses resulting from inadequate or failed internal processes, people and systems or from external events'. Strategic and reputation risk is not included in this definition.
In section 7, the Basel Committee adds that the capital charge should cover direct as well as *certain* indirect losses

NVB comment

The NVB is against the incorporation of near losses, latent losses or contingent losses as this is theoretically incorrect, unsound and will in practice not be workable and controllable (level playing field). In the calculation of credit risk, near defaults are excluded also.
In the current definition strategic and reputation risks are exclude, which we agree upon as these should not attract capital.

Definition of operational risk losses

Basel proposal

In section 8, the Committee states that it is cognisant of the difficulties in determining the scope of the charge and is seeking comment on how to better specify the loss types for inclusion in a more refined definition of operational risk.

NVB comment

For banks to be able to build databases that fit the new regulations, it is of great importance to decide on the short term upon the definition of operational risk losses. There should also be clarity upon what to register: operational risk events-type based (e.g. execution failure, illicit conduct) or financial effect-type based (e.g. write-down).

There is much emphasis on building databases, but no clarity on how it should look like. As many banks are aiming to qualify for the internal measurement approach, they aim to start with the registration on events in a proper way as soon as possible. However, they are still waiting for clear definitions. A general industry standard is also required when industry wide databases should be fed and when disclosure of operational risk is required.

We are pleased to see that both issues 4 and 5 have already been addressed in the period after the publication of CP2.

Risk transfer products

Basel proposal

Section 49 generally discusses risk transfer products and mitigation. The Committee expresses its concerns whether the control (e.g. risk transfer programs) really reduces risk or merely transfers exposure from the operational risk area to another business sector.

NVB comment

The Basel Committee did not give a clear statement on the recognition of operational risk transfer products. Risk transfer or insurance might indeed lead to a counterparty risk. This justifies that risk mitigation techniques will not lead to a 100% recognition in the reduction of operational risk capital. The FBE wrote a paper on operational risk mitigation[1] and proposes a way to integrate these into the capital framework. They propose to give a capital discount dependent on the type of risk transfer contract, the credit rating of the company to transfer, the amount of money to be paid out, speed of payment etc.

The method described by the FBE takes away most disadvantages of recognising operational risk mitigation techniques. NVB advised the Basel Committee to seriously consider these kinds of alternatives developed by the industry. By doing so the bank's burdening by expenses on risk mitigation and capital charges can be appropriately treated.

Capital level

Basel proposal

In section 21, the Committee explains why operational risk will be approximately 20% of current regulatory capital. Besides it has been said that the total amount of capital should not decrease on average in the industry (Section 46 in the document 'Overview of the New Basel Capital Accord').

NVB comment

The Basel Committee aims at an operational risk charge that will in average be 20% of total capital charges in the industry. However, what happens if some institutions move towards a more sophisticated approach of operational risk calculations? Will the beta factors in the standardised business line be increased when many institutions move on or will the total capital for operational risk vary?

We are not ready to form an opinion on the adequacy of the 20% figure as we await the outcomes of further quantitative impact studies.

[1] Operational risk mitigation, a discussion paper from the European Banking Federation, October 2000

Basic indicator approach; Size of α

Basel proposal

In section 23, the Committee states that α will be set at around 30% of gross income. This percentage is calibrated on a limited amount of data. In addition, the section argues that this percentage might even be higher in order to provide an incentive to move towards more sophisticated approaches.

NVB comment

The NVB regards 30% of gross income as relatively high. Within the Netherlands, there are major differences when 30% of gross income is compared to 20% of current capital charges. Some banks benefit highly, others have a major disadvantage. As the basic indicator is the basis for the floor, these big differences might put pressure on the level playing field.

Standardised approach

Linear relations

Basel proposal

In section 27, the formula for operational risk capital in the standardised approach is presented. Within each business line, the capital charge is calculated by multiplying a bank's broad financial indicator by a 'beta' factor.

NVB comment

Both the complexity of a product or process and the organisational ability to handle a given business volume play a role in determining the relation between exposure indicators and operational risk.

The NVB expects relations between exposure indicators and operational risk to be non-linear, though data to prove this is lacking. In order to prevent the level playing field from being distorted, the NVB would like to ask the Committee for some space in the proposal in order to be able to make adjustments as soon as test results are available.

NVB proposal

The NVB proposes the use of a non-linear factor in all three approaches of the spectrum (Basic Indicator, Standardised and Internal measurement). For example, the use of a square root can be considered.

Private banking as separate business line/included in retail banking/included in asset management?

Basel proposal

In footnote 11 on page 19, the Committee states that it intends to consider whether private banking should be placed under asset management instead of retail banking.

NVB comment

The NVB would like to underline that from a risk management point of view it is not in favour of treating private banking similar to the asset management business line as the Operational risks of these two activities are not comparable.

Indicators

Basel proposal

In section 26, the proposed indicator per business line is presented. For corporate finance, trading and sales and retail brokerage, gross income is proposed; Retail banking and commercial banking get annual average assets as financial indicator; Payment and settlement get a capital charge related to the annual average settlement throughput and asset management is charged for the assets under management. Besides, in footnote 12 on page 19 it is stated that the payments and settlement losses related to banks own activities should be incorporated in the loss experience of the specific business line.

NVB comment

In the standardised approach, all indicators are related to balance sheet and P&L except for the business line payments and settlements. The indicator mentioned for this business line will be more difficult to obtain. Separate reporting schemes need to be set up to keep track of this indicator in an audible manner. It is also not clear to us what is exactly meant with footnote 12 on page 19 on payments and settlements.

A second observation is that all indicators are size or money driven. There is no clear relation between these indicators and operational risk. For example one transaction of 500 million does not have the same risk as 250 transactions of 2 million.

Corrections could be made based on risk profile of the institution and the quality of internal controls.

The NVB want to express its doubts on the assumption of linear functions, which can lead to outcomes being completely out of bounds. Operational risk of a 2 billion volume business XY is not necessarily twice as high as a 1 billion volume business XY. Square roots or other forms of degressive functions would be conceptually better and are also easy to implement.

Qualifying criteria

Basel proposal

Qualifying criteria are defined on risk management and measurement methods (par. 41-44). One of the qualifying criteria for the standardised approach is the requirement to start with the registration and reporting of operational risk loss events in a structured way.

NVB comment

1) If the standardised approach is the intended end station of an institution, there is no direct need for gathering internal data in a structured way.
2) No attention is paid to the qualitative measurement methods. The assessment of the quality of internal controls can also be regarded as a measurement tool.
3) The criteria as well as the business line approach in itself implicitly show a tendency towards more centralised organisation structures. This implicitly supposes that decentralised risk management structures are less effective. The NVB questions whether this is the case.
4) The formulation of the qualifying criteria is vague and can be interpreted in different ways.

NVB proposal
The NVB proposes to weaken the criterion on gathering data on a structured way or take it out of the qualifying criteria for the standardised approach. Furthermore the NVB proposes to formulate qualifying criteria on qualitative measurement methods. To prevent the level playing field from being disturbed, the NVB urges the Basel Committee to pay much attention to clarity and definitions. Sections 41-44 describe the qualifying criteria for the different approaches. One of the qualifying criteria for the standardised approach (section 43) says ‘banks must begin to systematically track operational risk data by business line across the firm’.

Internal measurement approach
In our opinion more space should be created to use qualitative adjustments (like risk assessments and audit results) in the internal measurement approach. In this stage it is at least undesirable and maybe even dangerous to restrict the development process of operational risk measurement tools in such a way. Currently there is a heavy focus on the gathering of data on operational risk losses.

Focus on gathering data on operational risk losses
Basel proposal
The internal measurement approach is based on internal data and in the second bullet of section 39, the Committee requests the industry to accelerate industry efforts to pool loss data. All elements in the internal measurement approach will be based on these data.

Comments NVB
For market risk already discussions have been going on whether models are reliable. Another issue often discussed is the question whether history is a good basis for predicting the future. For operational risk these problems might be even bigger. There is much less data available and it will take many years to collect enough to be statistically reliable. Besides, it should be easier for a bank to prevent operational risk events from happening (again). A big operational risk event will stimulate an improvement in risk management and controls, but at the same time lead to an increased solvency requirement.

In the standardised approach, operational risk capital is measured with the use of risk indicators per business line. The Basel Committee recognises that the relation between risk indicators and loss data is not proved yet (annex 3). The NVB questions the validity of basing regulation on an assumed but unproven relation between certain risk indicators and yet emerging loss data. The current level of specifics does not allow Basel to adjust its stage 3 to the fast track of emerging techniques. Three years of development will have shown inevitable changes in the state-of-the-art. Basel should allow for flexibility within the new Capital Accord to adjust to this process.

Criteria on history
Basel proposal
In section 44 on qualifying criteria for the internal measurement approach, the Committee states that banks need to have an operational risk loss database extending back for a number of years for significant business lines (measurement and validation, bullet 3)

Comments NVB

To be able to qualify for an internal measurement approach, an undefined number of years of historical data are required. Which number of years should we expect?

The NVB is of the opinion that banks are given little time to build their loss databases if the implementation date is 2004. Currently, the Basel Committee still doesn't provide the industry with the definitions needed to gather data in a way that fits the new requirements. From the NVB's point of view, it is not realistic to require more than two or three years of internal data.

Industry gamma and major losses

Basel proposal

In section 36, the committee proposes an industry gamma that will be applied to a banks specific expected loss. Each combination of business line and loss type will get a fixed gamma, set by the regulator. The expected losses of each institution that uses the IMA will be multiplied by the industry gamma.

Comments NVB

If one institution faces a major loss, which is captured in its internal loss database, this one loss might have a major impact on the capital charge for operational risk. If an industry gamma is introduced, major losses should adjusted for the internal loss database. This can be done by qualitative adjustments[2].

Insofar as Supervisory approval is required to enter into the advanced stages of the Evolutionary Framework where these adjustments would take place, the standards and methodology governing such adjustments would require institution specific review and approval by the relevant regulatory authority. This would prevent misapplication of the mechanism and promote consistency.

Furthermore, large losses often provide the advantage that the sense of urgency to improve the control structure increases. Management tends to take control structures more seriously after incidents. The chance that such a loss will occur again within that individual financial institution in such cases is therefore subsequently much reduced. Recognition of improvements in control structures would be an important incentive to these financial institutions, as the regulatory capital impact of the large loss would then be mitigated more rapidly.

To summarise, under the current proposal when a bank experiences a large loss it will be required to hold more capital. While some increase in capital may be appropriate for a period of time (in recognition of new risks or control weaknesses), in practice management will almost always take a variety of (costly) mitigating actions with the intention of reducing the risk profile. We believe that such changes to the risk profile should also be reflected in the capital charge to the maximum extent possible.

A practical approach to the adjustment for large and highly infrequent losses could be that in the IMA-approach banks are allowed to recognise extreme losses (e.g. in the top x percentile) to a maximum only. This will in practice imply that banks are allowed to include severe losses for a lower amount in their database than the actual loss according to GAAP. These adjustments should be subject to the implementation of adequate mitigating actions limiting the risk to an acceptable level. These mitigating actions need to be demonstrable and verifiable in a for the regulators acceptable manner (e.g. audit opinion).

[2] The NVB is referring to a document of IIF's Task Force on Qualitative Adjustments

Floor concept

Basel proposal

In section 46 two concepts to introduce a floor are introduced. One possibility is to relate the floor to the outcomes of the standardised approach. The capital level in the IMA will minimally be a fixed percentage of the standardised approach. The other possibility is to determine an industry wide floor for each of the elements in IMA, based on industry wide data.

Comments NVB

More clarity is required on the way a floor is set (individual banks/industry, rigid/sliding scale).

If the floor is based on the outcomes of the more simple approaches, the level playing field will be put under pressure, as described in our comments on the basic indicator approach. There is also a significant risk that using internal data might lead to a higher capital requirement compared to the standardised approach. If this is the case, no one institution will develop internal measurement approaches. The Capital Accord then will turn out to be contra-productive.

In general, the NVB would like to state that if a floor is set, also a cap should be considered. The NVB proposes to use the outcome of the Standardised Approach as a cap for the Internal Measurement Approach. Besides, a confidence level should be set for operational risk calculations based on internal or external data.

Pillar 2: Supervisory review

The way we understand this paragraph is that additional capital charges for Operational risk under pillar 2 are based on supervisory review only (=outlier approach). The NVB appreciates that the Committee writes that it will come up with a sound-practise paper. When is this paper to be expected and what is the context to the discretion of the local regulators?

Pillar 3: Market discipline

The Committee distinguishes Core disclosure requirements and Supplementary disclosures. The Core disclosures are 'requirements' and the supplementary disclosure items are 'strong recommendations'

- The core disclosure relates to the stage and the set up of operational risk management in the bank (policies, structures, risk reporting system, documentation and independent review). The NVB supports these core disclosures.
- Supplementary disclosure is proposed of actual operational losses (per business line). We believe that the general public can easily misunderstand disclosure of loss figures, which might create unjustified damage. If disclosure becomes a requirement, the Basel Committee should provide the industry with clear and tight definitions and a fixed confidence level for calculations. Uniformity in disclosures is regarded as highly important.

Trading Book Issues

Basel proposal

Supervisory authorities expect the following valuation adjustments/reserves to be formally considered at a minimum: unearned credit spreads, close-out costs, operational risks, early termination, investing and funding costs, and future administrative costs and where appropriate, model risk (par. 578)

Valuation adjustments must impact regulatory capital (par. 580).

NVB comment

Only those valuation adjustments/reserves can be considered that are consistent with present and future international accepted accounting standards. Examples of valuation adjustments/reserves which are not consistent with present international accounting standards are operational risks, future administrative costs, close-out costs and early termination. Furthermore it is not clear what the (580) statement implicates.

NVB proposal

The NVB proposes that valuation adjustments/reserves have to be in accordance with international accounting standards. Therefore the NVB proposes to skip paragraph 3 “Valuation adjustments or reserves”.

Pillar 2

Interest rate risk

The NVB supports the January 2001 consultative paper with respect to:

Pillar 2 treatment
<u>Basel proposal</u>
Although no mandatory capital charges are proposed all banks must have enough capital to support the risks they occur including interest rate risk. Supervisors should particularly attentive to the capital sufficiency of "outlier banks".

<u>NVB comment</u>
Treatment of interest rate risk in pillar 1 would demand for an unnecessary harmonization of calculations. Different from the valuation of market risks, the valuation of interest rate risk in the banking book is influenced by clients' behavior. Of course, clients' behavior differs substantially from country to country, as well as product to product. Applying uniform model-assumptions, rather than relatively safe standards set by a national supervisor, would give negative incentives to the development of asset and liability management.
Furthermore the NVB do not believe that a standard capital rule for interest rate risk in pillar 1 would be compensated by a lower rule for credit risk.
We are very pleased with the concept that the supervisor starts setting capital rules whenever a bank enters a "danger zone". The NVB pleaded for this concept in January 2000.

The outlier definition
<u>Basel proposal</u>
"Outlier banks"are defined as banks whose interest rate risk in the banking book leads to an economic value decline of more than 20% of the sum of Tier 1 and Tier 2 capital following a standardised shock.

<u>NVB comment</u>
The construction of the outlier definition shows some artificial combinations. The stress test applies to the fair value of equity. The resulting mutation in the equity's fair value is then related to the book value of the firm's solvency capital, which consists of both equity and subordinated debt.
Given a shock of 200 bp the mutation in the equity's fair value may not exceed 20% of the solvency capital's book value.
This definition seems to implicitly assume a duration of 10 (for book value). However, banks with higher fair values and banks with lower subordinated debt would become an outlier far under a duration of 10.
Although there may be a Dutch bank that touches the bounds of the outlier-definition because of conservative calculations, the NVB thinks this absolute, uniform limit of 10 is acceptable.

Internal modelling for valuation
<u>Basel proposal</u>
Banks must have adeqaute information systems for measuring interest rate risk exposure and should utilise generally accepted financial concepts and risk measurement techniques.

NVB comment
The NVB pleaded for valuation through internal models in 2000 and is delighted to see this result in the newest consultative paper.

The NVB would suggest an interest rate shock to be centrally calculated and published by the BIS, probably different for different currencies and G10 and non-G10 countries, for example the proposed shock for G-10 countries and a highly inverse yield curve for emerging markets.

The NVB would like to give the following suggestions for improvement:

1. Interest rate shock for calculation purposes (pag 35)
   The proposed interest rate shock for calculation purposes makes a distinction between G10 and non-G10 countries, which must be a political compromise.
   The NVB would suggest an interest rate shock to be centrally calculated and published by the BIS, probably different for different currencies and G10 and non-G10 countries.

2. Exclusive judgement of the banking book
   The NVB has been explaining the double rules for interest rate risk in the trading book ever since the ideas for a new Capital Accord were conceived. Interest rate risk in the trading book is covered by the Second Capital Adequacy Directive (CAD-2). The Capital Accord should cover only the banking book and leave the trading book rules to other existing regulation.

Pillar 3

Disclosure

Introduction
The NVB supports the objectives of the Committee and agrees that the new capital regime should be supported by adequate disclosures on capital, risk exposures and the description of risk management in a bank.

More detailed comments on the specific disclosures are specified in the appendices to this memo.

General comments
The proposal is to publish the data prepared for regulatory purposes externally and thereby for a wider audience. The information for regulatory purposes is very detailed and technical and could potentially obscure/blur the financial standing of a bank for most users. We are of the opinion that the users of the financial statements would not benefit from the publication of this information. Furthermore, we recommend to make a distinction between interim reporting and inclusion in Annual Report taking into account that not all information is subject to change each quarter and that because of administrative burden in reporting departments, costs outweigh benefits.
The audit implications of including this information in the financial statements need to be further considered, including whether much of this information would be better included in the Report of the Managing Board instead of the Annual Report.
Given the move towards global recognition of International Accounting Standards, and adoption of IAS for all EU listed companies by 2005, we believe a better approach is to integrate the recommendations in Pillar 3 Market Discipline with that of the new International Accounting Standards Committee. IASC seems to be a better medium from the viewpoint of enabling disclosures to be evolved in light of market practice and other developments. The NVB is concerned about development of the proposed disclosures in isolation from the work of the Steering Group reviewing IAS 30 *Disclosures in the Financial Statements of Banks and Similar Financial Institutions.*
The New Accord will be applied to all *international* active banks. The NVB believes that the scope should be widened to include at least the significant *domestically* active banks. This would benefit both a world wide level playing field and the integrity of the financial markets in which also domestic active banks play an important role. This comment assumes that market disclosures will be applied (by banking regulators) similarly to all banks worldwide, to ensure that a level playing field results.
Standard & Poor's commented in March 2001 that if a bank lowered capital due to more favourable treatment under the new accord, but its underlying risk profile remained constant, a downgrade could result. Therefore the impact on financial institution ratings needs to be carefully weighed.

Structure of Capital
The NVB agrees with the basic principle that all simple capital structures require simple disclosure and more complex capital structures require more detailed disclosures. A short description on the quality of the different capital components seems relevant, especially with respect to innovative, complex or hybrid capital elements.

Accounting exposures and assessments

– Credit risk in banking book
– Disclosures applicable to all banks

The required disclosures are generally in line with the current accounting practices and therefore we have no major additional comments.
The NVB recommends to disclose balance sheet exposures on a net basis by taking credit risk mitigation techniques into account. However, for accounting purposes credit risk mitigation techniques may be treated differently, resulting in a different balance sheet value. Therefore, we support the Basel proposal and disclose credit exposures before and after recognising credit risk mitigation.

Disclosures applicable to banks using the standardised approach

Disclosure of the types of exposure for which each rating agency is used is not practicable as there might be different ratings of different rating agencies that should be specified each. The information is also likely to be applicable to only a part of the portfolio and is meaningless if not specified further. In summary the information is likely to be not available and can easily be subject to misinterpretation.

Disclosures applicable to banks using the IRB approaches

The proposed disclosures are very extensive both in volume as well as in technical detail. We have serious doubts whether a repetition of this regulatory data will benefit a user of a financial statement.
Furthermore, the IRB models used within a banking group will be assessed by a number of different supervisors. We would welcome a coherent assessment process in this matter.

Credit Risk Mitigation

Because of proprietary reasons disclosure of main guarantors/ protection providers is not desirable.

Market Risk

Disclosure of market risk started with the acceptation and implementation of internal models in 1996. The current disclosure is already perceived as detailed and difficult to understand (especially with respect to back testing results on theoretical Income Statements, and distribution of daily revenues per Line of business). A further elaboration goes in our opinion beyond the interest of users of the financial statements.

Operational Risk

In general we concur with the disclosure requirements for operational risk . However, for proprietary reasons we have objections to disclose the actual annual operational losses.

Interest rate risk in the banking book

For proprietary reasons banks have objections to the disclosure of the size of the portfolio with embedded optionality and the empirical or judgemental assumptions employed to model them and the use of hedging programs including characteristics, rationale and effectiveness. Modelling and managing these (embedded optionality) risks could be identified as a competitive strength/advantage of a bank.
Furthermore, we recommend to give more guidance with respect to the defintion of economic value. In our opinion this economic value should reflect the fair value of equity. The calculation of this contains a lot of subjective elements and assumtions.

Capital adequacy
It is recommended that banks provide information about contingency planning and its capital management strategy including future capital plans.

<u>NVB comment</u>
For confidentiality reasons banks should object to this disclosure requirement.

Economic capita
It is recommended to put emphasis on economic capital and compare this with reported capital amounts and regulatory requirements.

<u>NVB comment</u>
If economic capital is to be disclosed, the methods and for instance the confidence level should also be disclosed. However, we believe the level of detail is too much.

Appendices

Appendices on securitisation

APPENDIX A

Operational issues

In this annex we would like to give our view about the operational issues in the consultative document on asset securitisation. The operational issues dealt with in the consultative document are the operational requirements for achieving a clean break, the disclosure requirements and the treatment of implicit and residual risks.

'Clean break' requirements
When the 'clean break' requirements between the originating bank and the SPV are met, the originating bank is allowed to remove the securitised assets from the calculation of its risk-based capital ratio. The 'clean break' requirements that are summarised in the Consultative Document are directly derived from the US accounting standards (FAS 140). As such the requirements are drawn up from an accounting perspective (is all economic ownership sold?) instead of the perspective of a regulator (is there still downside risk?). Nevertheless, it is our expectation that the Dutch Central Bank will follow its current philosophy and that little will change in this respect. We are seeking a comment from the central bank sharing our view and confirming that the requirements in the consultative paper are comparable with the current requirements for 'true sale' of the Dutch Central Bank and the bankruptcy remote requirements by the rating agencies. So our expectation is that little will change in this respect. We hope and expect that the Dutch Central Bank supports our view.

Disclosure requirements
A difference between the current Basel accord and the proposals in the second consultative paper is the new pillar three on market discipline. For securitisation this has effect on the disclosure requirements by originators, sponsors / third parties and the SPV. Starting with the disclosure requirements for SPV's we have to conclude that little will change. The proposed items to disclose reflect the current practice in drafting offering circulars.

The disclosure requirements by originators are a different story. Currently, depending on which accounting standard is used, no disclosure on securitisation is required in the annual accounts. The proposal is to disclose detailed information on all securitisation transactions. The items to disclose are easily available for the originator, so this is not the burden. For frequent issuers the volume of the information will however be significant. Our idea is therefore to disclose the detailed information on securitisations only on an aggregated level and to mention the transactions. This, in our view, streamlines the information, and makes it better accessible.

If a bank has a material involvement in a transaction and is not the originator, this bank is also obliged to disclose, among others, the maximum credit exposure. Our idea is here the same as for the case where a bank is the originator. Thus, presenting exact information on an aggregate basis and to mention the individual transactions.

Implicit and residual risks
Originators might, in the eyes of the committee, give implicit support to 'their' transactions. In the consultative paper severe punishments are proposed to banks helping 'their' transactions beyond the contractual obligations. We can support this idea, as it is the regulator under pillar two who monitors the securitisation activities of the banks under their supervision. We see this as a useful tool for the regulators to threaten possible violators of the 'clean break criteria' with.

What in our opinion doesn't belong in pillar two or in the document on asset securitisation is the *ex ante* minimal capital charge for securitisation transactions to address implicit and residual risks. We agree with the committee that in complex structured finance products like securitisation there is always a risk that contractual obligations are not fully met. However in our view this is not specific for securitisation transactions. We think that these risks apply to all complex financing products and are an operational risk. We therefor propose to incorporate such capital charge in the operation risk measurement under pillar one.

APPENDIX B

Capital impact of credit risk transfer

The deduction of the full amount of credit enhancement from capital (paragraph 15) is in line with existing regulation. The proviso “Subject to national discretion, there may be additional requirements that a credit enhancement must meet to be accorded….” should be carefully utilised, in order to create/maintain a level playing field.

On the treatment of second loss credit enhancement (paragraph 16), the same comment with regard to national discretion and level playing fields applies. Especially, we note that under existing FED proposals, second loss enhancement (and in fact any enhancement) that receives a sufficient ECAI rating (in the FED proposal at least BB+, versus at least investment grade in the Basel proposal), would benefit from risk-weighting against the face amount, without the requirement for third party first loss coverage. We would very much support a similar treatment (no 100% deduction for sufficiently rated credit enhancement, with 'sufficient' being the same for all national regulators).

With regard to servicer advances (paragraph 17), the risk weighting of *generally* 100% requires clarification. We assume that the 100% refers to a situation where the underlying risk would be equivalent to a BBB rating, while for better rated risks lower weightings (and vice versa for higher risks) would apply. We would appreciate to receive confirmation.

In this context we note that comments on the proposed risk weighting for investment in securitisation tranches (paragraph 27), especially with regard to the lower/unrated tranches, that were widely voiced by the banking community, have not been reflected in the second draft. In this respect we could point (again) to the 150% risk weighting of BB-rated tranches (while comparable rated corporate risk is weighted 100%), and the full deduction of B+ and below rated tranches (corporate risk: 150%). We would like to continue the dialogue on these issues.

For unrated investments in mezzanine and subordinated tranches (paragraph 30) a risk weighting of 100% would apply. This will give rise to (undesired) arbitrage opportunities between rated and unrated transaction (see again our comments on paragraph 27).

On the IRB we share the feeling expressed in paragraph 63, that the assumption of 100% LGD is extremely conservative. As such, the two-legged approach could offer a way to better determine the real risk on first-loss positions, but as long as the 100% LGD applies for rated tranches, there is no incentive to switch from the standardised approach to an IRB approach.

APPENDIX C

Liquidity facilities and ABCP Conduits

Capital treatment of liquidity facilities for sponsoring banks
The capital charge of a liquidity facility provided by a sponsoring bank is determined by: a) its credit conversion factor times; b) its general risk weighting.

In the First Consultative Paper, the Basel Committee proposed converting all (liquidity) commitments, regardless of original maturity, at 20 % to on-balance sheet equivalent amounts. An exception would apply to commitments that are unconditionally cancellable, or that effectively provide for automatic cancellation, due to deterioration in a borrower's creditworthiness, at any time by the bank without prior notice. In such cases, a zero capital charge would apply. For instance, a liquidity facility that can only be drawn in the event of a general market disruption (i.e. commercial paper could not be issued at any price by any issues) could be considered unconditionally cancellable and, therefore, may qualify for a zero capital charge.

In the Draft Revised Accord, two main types of liquidity facilities can be identified:

- Liquidity facilities that satisfy the 'liquidity criteria' and which are eligible for a 20% credit conversion factor.
- Liquidity facilities that do not satisfy these criteria and which would fall under the 100% credit conversion factor.

(The minimum of 50% conversion factor for facilities with an original maturity in excess of 364 days remains)

Comments
It would make sense to make the general risk weighting dependent on the underlying assets. For example, a liquidity facility which complies to the 'liquidity criteria' written against a pool of 20% weighted assets, should have a capital charge of 20% (conversion factor) times 20% (risk weighting), instead of 20% (conversion factor) times 100% (risk weighting). Otherwise, banks have an inherent incentive to put relatively low quality assets (100% or higher weighted) in their conduits vs high quality assets (AAA rated ABS, weighted 20%). Furthermore, the rule for a liquidity facility to attain a 0% conversion factor is so restrictive that it becomes a 'theoretical' facility. The example of "i.e. commercial paper could not be issued at any price by any issuers" is too restrictive since it simply cannot be tested and therefore never sensibly be put in the conditions precedent to drawing liquidity. A well-defined borrowing base test should be sufficient to ensure the true liquidity nature of the facility and allow it to gain a zero percent conversion factor. Also, certain liquidity facilities which do not fully comply with the 'liquidity criteria' but do comply with a set of 'to be defined less restrictive liquidity criteria' should be allowed to have a 50% conversion factor. The banks are of course willing to come up with a proposal regarding these 50% criteria.

It should be possible to have different capital treatments for different liquidity facilities within one ABCP conduit. The idea is that if one facility has a conversion factor of 100%, this would not mean that all the other facilities will be treated the same way, since this not be the case in an on balance situation either.

Whether the liquidity facility backs assets coming from the sponsor's balance sheet or from a third party's balance sheet should have no effect on the capital treatment of the liquidity facility. Already, banks are deducting Euro for Euro from capital for the first loss credit enhancement they provide to their own assets. In our view the fact that an institution has more control over it's own assets is already sufficiently addressed in paragraph 90, where a punishment system is proposed for banks providing credit enhancement through the back-door to their own securitised assets. A different capital treatment of liquidity facilities provided by originating banks in addition to this 'proposed punishment system' is a double penalty. The idea is that the banks should not be penalised through the treatment of the liquidity facilities since other measures are in place to ensure no hidden credit enhancement is provided.

Capital charge of credit enhancement provided to conduits
The Basel Committee holds the view that:

> A first loss credit enhancement provided by a sponsor must be deducted from capital. Possible second loss enhancements should be risk weighted based on their external ratings. If they are not externally rated or if the assets are in multiple buckets, they should be risk weighted according to the highest weighting of the underlying assets for which they are providing loss protection.
> If the sponsoring bank sells its own assets to the conduit, then the bank must deduct the full amount of the loss protection from capital.

Comments
If the sponsoring bank provides credit enhancement to its conduit, and this credit enhancement has an external (shadow) rating, then the risk weighting should be based on the factors described in paragraph 27, since the bank is acting as an investor in this instance. Whether the sponsoring bank was the originator of the securitised assets should be irrelevant, since the commitment is rated. The idea is that since so much weight is assigned to external ratings, the idea of AAA is AAA and BB is BB should apply here as well, irrespective of the source of the underlying assets. Again, as is the case with the liquidity facilities, the banks should not be penalised twice through the 'punishment system' of paragraph 90 and a different treatment of a second loss enhancement.
Finally, we also wonder how the IRB will be applied to L/C's for ABCP conduits.

APPENDIX D

Synthetic Securitisation

General Comments

The Banks are disappointed with the lack of detail that has been provided on this topic. A key part of the European securitisation market utilises synthetic structures and this is likely to increase further in the next few years. With the lack of guidance given, there is a significant risk that a level playing field will not be achieved and that cross border arbitrage will exist.

Specific Comments

Risks related to mismatch - Whilst indeed certain risks relating to currency, term, asset mismatch can occur, these are not unique to synthetic products and can easily be controlled by a regulator within individual structures. Specific mention is made of materiality thresholds – it would be very simple to come up with a policy to ensure that this adequately covers risk. One of the key factors is that synthetic products highlight some of the risks inherent in securitisation, not necessarily create new ones.

Changes in benefit as a result of economic capital - The view that economic capital will remove the benefit of these structures may be slightly misleading – counterparties no longer enter these transactions solely for regulatory capital requirements but to achieve actual risk transfer as a part of their balance sheet and portfolio management processes. This development of Portfolio Management is likely to increase in the near future.

Expected v Unexpected Losses - This contradicts the fundamental approach contained in the standardised approach where ratings are used to determine capital requirements. The rating methodolgy models risk on the portfolio based on expected and unexpected losses. To suggest that just covering expected losses, which would be a prudent approach from a regulatory point of view, is insufficient and instead unexpected losses should also be covered raises a question about what the purpose of the regulators is. If the aim is to transfer risk on a portfolio, retaining both expected and unexpected losses defeats the object of the transaction.

Retained / Repurchased Senior / Mezzanine Risk - This is the fundamental element of synthetic structures. By selling notes from an SPV for say 10% of a structure with the most senior note then being AAA rated by an independent agency, it is clear that the risk on the portfolio has been transferred. To then question issues relating to market discipline is irrelevant as this risk also exists in traditional forms. That the Committee has failed to develop these ideas to a simple conclusion is disappointing.

The lack of progress relating to issues around retention of senior risk is somewhat confusing as one regulator has already developed comprehensive rules relating to this topic. The Committee raised many questions, some of which have already been addressed by regulators. The lack of progress is clear.

Retention of First Loss and Senior Risk - The lack of progress from the first draft is clear. Once again, merely a list of potential criteria is stated. There is a clear risk that this will lead to very different interpretation between different regulators leading to a non level playing field. We are already seeing this with the Fed developing rules for synthetic securitisation which go into far more detail than the new Accord.

Summary

The essence is that clarity is required both for regulators and participants. With a relatively small amount of work this area could be developed to a point where there is a clear environment for all banks to work within. We would strongly urge that representations are made to Basel in this respect otherwise the regulatory process will become extremely difficult in the short term which could lead to greater risks for banks.

APPENDIX E

Implementation issues

Although the new Capital Accord will not be implemented until 2004, we expect that a phased implementation will be envisaged as of 2002. Except for perhaps the risk weighting itself, the basic framework for the new rules on traditional securitisation could soon be ready for implementation. In principle the banks are in favour of an early and phased implementation.

Nevertheless, it is necessary that the time schedule for implementation is discussed between supervisors and the Banks beforehand. For the banks it is important that they can anticipate on any forthcoming regulatory changes.

Grandfathering of existing structures

Given the significant unwinding costs of securitisation structures, banks are concerned that if the new rules are applied to existing structures retroactively, that they could be faced with significant costs. There are two areas of concern. First is the eligibility of the structure. The second area of concern is the risk weighting of a structure.

Although we understand that the new Basel Accord will supersede all previous regulatory sign-offs, we would not agree if the new rules would result in a situation where the structure of an existing securitisation transaction would no longer be deemed acceptable. Such a situation could have as a consequence that the (securitised) assets would again have to be treated as being on-balance for the originating banks. For the remaining term of existing structures we therefore argue that the structure itself needs to be grandfathered. For ABCP conduits we argue that after the full implementation of the new Basel Accord after 2004 a minimal grandfathering of the structure of two years is reasonable.

It is logical that after implementation of the new Basel rules the risk weighting on existing structures will change. However banks stress that this should not be done unilaterally. Especially in case of a phased implementation, at all times a level playing field should be safeguarded.

Appendices on Market Discipline

Appendix 1: Scope of application (#642 - #643)

		Relevant[3]	Proprietary concerns	Alternatives
1	Core disclosure			
	The top corporate entity in the group to which regulatory capital requirements apply;	Y	-	-
	The entity(ies) to which regulatory capital requirements apply on a sub consolidated basis;	N	-	-
	The entities within the group, e.g. securities, insurance and other financial subsidiaries, that are not included within the consolidated approach (and the banking group™s percentage interest in the voting shares in those entities);	N or only major entities	-	-
	The particularities of how entities that are not included within the consolidated approach are captured within the capital adequacy calculations, e.g. deduction of the banking group™s equity and other regulatory capital investments in such entities;	N or only major entities	-	-
	In the event a method other than the deduction method is used, the impact of the application of such other method as compared to the deduction method;	N or only major entities	-	-
	In the event surplus capital, that is capital in excess of the regulatory capital required for entities that are excluded from the consolidated group, is recognised (i.e. given credit for), the impact on the group's capital adequacy position;	N or only major entities	-	-
	The entities within the group (and the banking group's percentage interest in the voting shares in those entities) that are (a) rata consolidated, or (b) given a pro deduction treatment;	N	-	-
	Deductions from each of Tier 1 and Tier 2 capital for unconsolidated entities;	N or only major entities	-	-
	The aggregate amount deducted from capital for commercial entities that exceed materiality limits;	Y	-	-
	Deductions from each of Tier 1 and Tier 2 capital for such commercial entities.	Y	-	-
2	Supplementary disclosures			
	Whether any subsidiaries that are not included in the consolidation, i.e. that are deducted, meet their regulatory capital requirements.	N	-	-

[3] Understandable/useful/compatible with type of other information provided in financial statements

Appendix 2: Capital structure (#644 - #646)

		Relevant[4]	Proprietary concerns	Alternatives
1	**Core disclosures (quantitative)**			
	The amount of Tier 1 capital, with separate disclosure of: 1. paid up share capital/common stock; 2. disclosed reserves; 3. minority interests in the equity of subsidiaries; 4. innovative Tier 1 capital instruments grandfathered (according to Press Release October 1998); 5. innovative Tier 1 capital instruments not grandfathered (according to Press Release October 1998); 6. goodwill and other amounts deducted from Tier 1.	Y	-	-
	The total amount of Tier 2 and 3 capital;	Y	-	-
	Deductions from Tier 1 and Tier 2 capital;	Y	-	-
	Overall eligible capital.	Y	-	-
2	**Core disclosures (qualitative)**			
	Their accounting policies for the valuation of assets and liabilities, provisioning and income recognition;	Y	-	-
	Information on consistency of accounting principles between years;	Y	-	-
	Whether unrealised gains are included in Tier 1 capital;	Y	-	-
	Whether unrealised losses have been deducted from the Tier 1 capital;	Y	-	-
	What influence deferred taxes have on Tier 1 capital;	Y	-	-
	The nature and features of innovative Tier 1 capital instruments.	Y	-	-
3	**SUPPLEMENTARY DISCLOSURES**			
	The amount of Tier 2 capital (split between Upper and Lower Tier 2), with separate disclosure of material components;	Y	-	-
	The amount of Tier 3 capital.	Y	-	-
4	**FOR BOTH CORE AND SUPPLEMENTARY DISCLOSURES**			
	Innovative capital instruments:			
	• Maturity (including call features);	Y	-	-
	• Level of seniority;	Y	-	-
	• Step up provisions	Y	-	-
	• Interest or dividend deferrals and any cumulative characteristics;	Y	-	-

[4] Understandable/useful/compatible with type of other information provided in financial statements

	• Use of Special Purpose Vehicles (SPVs);	Y	-	-
	• Discussion of key events (i.e. events which may cause the activation of significant clauses or penalties which may affect the nature or cost of capital instruments);	Y	-	-
	• Fair value and terms of derivatives embedded in hybrid capital instruments.	N	-	-

Appendix 3: Disclosures – Risk exposures and assessment (#647 - #658)
Appendix 3.1: Credit risk in the banking book

		Relevant [5]	Proprietary concerns	Alternatives
(i)	**Disclosures applicable to all banks**			
	Core disclosure (quantitative)			
	Total unweighted credit exposures, before and after recognised credit risk mitigation, plus total risk weighted assets, in current and previous period. Broken down by (i) loans, commitments, and other non derivative exposures, (ii) securities and (iii) OTC derivatives (this breakdown also applies to the following 2 bullets);	Y credit exposures only after	-	-
	The cross-border distribution of its credit exposures (using the same geographic breakdown that the bank uses to manage its cross-border exposures and/or for accounting purposes, e.g. by geographic region, by country, etc.) in current and previous period;	Y	-	-
	The industry sectors or counterpart types distribution of its credit exposures (using a breakdown consistent with its own internal classifications and/or accounting purposes, e.g. financial services firms, manufacturing, technology, etc.) in current and previous period;	Y	-	-
	The maturity distribution of its credit exposures, e.g. up to one year, over one year and up to five years, over five years and up to ten years and over ten years;	Y	-	-
	The amount of past due/impaired loans either gross or net of provisions, e.g. by counterparty type or industry sector in current and previous period;	Y	-	-
	The amount of the allowance for credit losses, including the amounts of provisions (specific distinguished from general), recoveries and charge-offs in current and previous period.	Y	-	-
	Core disclosures (qualitative)			
	The structure, management and organisation of its credit risk management function;	Y	-	-
	Its strategies, objectives and practices in managing and controlling its credit risk exposure;	Y	-	-
	Information on techniques and methods for managing past due and impaired assets;	Y	-	-
	Information on the definition of non performing, past due and impaired loans, and definitions of default;	Y	-	-

[5] Understandable/useful/compatible with type of other information provided in financial statements

	The definitions of specific and general provisions used, including, if applicable, trigger events, and statistical methods used in the estimation process.	Y	-	-
	Supplementary disclosures			
	An indication of average exposures over the period;	N	-	-
	A more detailed breakdown of exposures by type, e.g. loans, investments, contingent items, repos and types of derivative (in addition to the core breakdown);	Y	-	-
	Information about significant concentrations of credit risk, or any further information about the lumpiness of its portfolios;	Y	-	-
	More detailed breakdowns of the geographic, industry/counterparty distributions;	Y	-	-
	Quantitative information on the maturity breakdown for particular types of portfolios;	N	-	-
	More detail on the number of days overdue with respect to past due and/or impaired loans;	N	-	-
	Volumes of credit risk transferred into securitisation vehicles;	Y	-	-
	Credit protection purchased using credit derivatives;	Y	-	-
	Qualitative and quantitative information about its credit scoring or portfolio credit risk measurement models, including counterparty grading systems used by banks (or ECAI ratings if applicable).	N	-	-
(ii)	**Disclosures applicable to banks using the standardised approach**			
	Disclosure requirements(qualitative)			
	The names of all ECAIs or other sources of external assessments used for risk weighting purposes;	Y	-	-
	The types of exposure for which each rating agency is used (e.g. some rating agencies might be used only for certain geographic or sectoral exposures);	N refers to part of the portfolio and could lead to misinterpreation	-	-
	The alignment of different agencies alphanumerical scales with risk buckets;	N	-	-
	Disclosure requirements (quantitative)			
	The percentage of outstandings in each risk bucket covered by each agency's ratings.	N	-	-
	Disclosure recommendations			

	Any significant changes in the list of rating agencies used by the bank for portfolio outstanding (not otherwise disclosed) since the previous period's disclosures (and the reasons for such changes);	N	-	-
	The policy for translating public ratings on particular bond issues into borrower ratings on its loans;	N	-	-
	A comprehensive set of guidelines concerning the procedure to be used in transferring public issue ratings onto comparable assets in the banking book;	Y	-	-
	The average default rates experienced on rated credits in each rating category, together with the definition of default;	Y	-	-
	The default rates experienced on non-rated loans.	Y	-	-
(iii)	**Disclosures applicable to banks using IRB approaches**			
	Qualitative disclosures: general information on methodology and key inputs			
	Supervisor's acceptance of approach;	Y	-	-
	For each portfolio whether an own estimation or a supervisory vector for LGD and/or EAD are used;	Data for estimation of (rating) model not to be specified by rating model. There will be too many to specify. General description of most significant models should suffice.	-	
	For each portfolio, methods for estimation and validation of PD (as well as LGD and EAD);	N only for major portfolio's	-	-
	Required data for estimation of the model, internal use by bank of estimates besides for IRB capital purposes, responsibility for and independence of rating process;	N only for major portfolio's	-	-
	Relation between internal and external ratings;	N only for major portfolio's	-	-
	The process for managing and recognising credit risk mitigation;	Y	-	-
	For each portfolio, employed definitions of default (as well as EAD and LGD) used internally for each portfolio in the IRB framework, and mapping of internal and reference definitions of default (as well as EAD and LGD) including the methodology used by the bank, if the employed definition deviates from the reference definition; and	N only for major portfolio's	-	-

	Banks in supervisory approved transition between internal ratings based approaches must disclose: the specific minimum requirements to which the transition applies, the areas and the degree of missing compliance, and the progress made towards compliance with the full set of minimum requirements	N only for major portfolio 's	-	-
	Quantitative disclosures part (i): required information for risk assessment			
	The percentage of nominal exposure covered by IRB approach;	Y	-	-
	For each portfolio, PD (and LGD) assumptions related to each PD (and LGD) grade shown;	N only for major portfolio 's	-	-
	For each portfolio, for each PD (LGD) bucket, nominal exposure amount, before and after recognised credit risk mitigation, as well as weighted average maturity and the granularity adjustment for the whole portfolio;	N only for major portfolio 's	-	-
	For the retail portfolio (for which there is no foundation approach), as far as nominal amounts are concerned, values for PD and LGD or EL are shown for each risk segment	N only for major portfolio 's	-	-
	In the advanced approach, for credits with variable exposure, EAD assumptions, used for estimation, nominal exposure amounts and EAD estimates both before and after recognised credit risk mitigation;	N only for major portfolio 's	-	-
	For the retail portfolio, for credits with variable exposure, nominal exposure amounts and values for PD, LGD and EAD or EL for each risk segment; and	N only for major portfolio 's	-	-
	The distribution of external rated obligors over internal PD rating classes.	This may be different per rating agency, which to disclose? If bank choses not to align its ratings with that of a rating agency the information may be misleading.		
	Quantitative disclosures part (ii): *ex post* performance as an indication of quality and reliability			
	For each portfolio and each PD (LGD) grade, (i) the number of defaults, (and, in the advanced approach, (ii) the actual exposure amount at default and (iii) the actual average LGD and other summary statistics of distribution of LGD, such as standard deviation and 10th, 50th and 90th percentile) at 1,2 and 3 year intervals;	N only for major portfolio 's	-	-

	The percentage of losses in each PD/LGD cell which are fully worked out;	Cannot be determined as work outs generally can take a very long period. Recoveries are taking place gradually in time, but loss is only determinable at the end of the work out period.		
	The number of defaults for all PD (and LGD) grades exposures as slotted at a predetermined historical reference point, 1 year prior to default (instead of *at the time of default*);	N only for major portfolio's	-	-
	In the advanced approach, summary statistics and distribution of **actual** LGD, such as standard deviation and 10th, 50th and 90th percentile, also weighted with exposure. For the retail portfolio, values for PD, LGD and EAD or EL should be disclosed for each risk segment;	N only for major portfolio's	-	-
	For each portfolio, for each PD-LGD grade, (i) the number of facilities that defaulted and (ii) facilities and drawn amount at default must be disclosed. For the retail portfolio, values for number of facilities that defaulted and facilities and drawn amount at default for each risk segment. For each portfolio, as far as relevant, summary statistics of distribution of EAD, also weighted with exposure, along with the number of borrowers;	N only for major portfolio's	-	-
	For each portfolio, distribution of borrowers across rating grades for the last 1, 2 and 3 years;	No, 3 year of migration data should not be required for first year of transition period where only 2 years of data are required.		
	In the advanced approach, distribution of rating migrations weighted with nominal exposure and EAD, respectively, both after 1, 2 and 3 years;	N only for major portfolio's	-	-
	Where banks use their own LGD estimates, a comparison between economic capital, actual capital held and minimum capital requirements and summary indicators of economic capital attributed to major lines of business.	No disclosure of economic capital required as long as Basel does not want to recognize these calculations and where lack of uniform definitions and transparency makes information difficult to interpret.		
(iv)	**Credit Risk Mitigation Techniques**			
	Qualitative disclosures			
	Its overall strategy and process for managing collateral including, in particular, the monitoring of collateral value over time;	Y	-	-

	Key internal policies for the recognition of collateral, for example, the ratio of underlying exposure to collateral (i.e. LTV ratio) and maturity mismatches; and	Y	-	-
	Its strategy and process for monitoring the continuing credit worthiness of protection providers and administering the guarantees and credit derivatives as required for collateralised transactions.	Y	-	-
	Quantitative disclosures			
	It's total exposures, the amount of exposure secured by collateral and on-balance sheet netting contracts, and risk weighted assets excluding and including the effects for collateral/on-balance sheet netting. These values must be disclosed by risk weight bucket/internal risk grade;	Y	-	-
	The type of regulatory calculation methodologies it has selected (i.e. simple/comprehensive, standard supervisory/own estimate haircuts).	Y	-	-
	Recommendations			
	Qualitative disclosures			
	Its overall strategy and process for managing on-balance sheet netting contracts, if effects of on-balance sheet netting are material.	Y	-	-
	Quantitative disclosures			
	Net exposure amounts (after effects for collateral/on-balance sheet netting) used for internal risk management purposes by risk weight bucket/internal risk grade;	Y	-	-
	Total annual recovery amounts from collateralised transactions;	N	-	-
	Exposure amounts (total, risk weighted assets excluding/including collateral) by types of eligible collateral, by geographical grouping used by the bank for internal management purposes;	N	-	-
	Total and net exposures, and risk weighted assets excluding/including on-balance sheet netting of loans and deposits should be disclosed separately along risk weight buckets/internal risk grade. The types of counterparty should also be disclosed;	N	Y, type of counterparty	-
	Total exposures covered by guarantees/credit derivatives, risk weighted assets excluding and including the effects for guarantees/credit derivatives by geographical and industrial sector; and	Y, only including effects	-	-
	Its main guarantors/protection providers.	N	Y	-

Appendix 3.2: Asset securitisation (#659-#661)

		Relevant[6]	Proprietary concerns	Alternatives
(i)	**Disclosures by originators**			
1	Quantitative data on the *(All data should be disclosed by deal if material)*: 1. Aggregate amount of loans and commitments securitised (nominal, notional and outstanding balance) broken down into synthetic and traditional securitisation categories; 2. If appropriate, this should be broken down; 3. Further into term and revolving assets; 4. Where revolving, the amount of seller interest should be disclosed; Amount of funding provided by securitisation activity.	Y	-	-
2	Asset types securitised. By deal if material.	Y	-	-
3	Roles played by the originator in relation to its securitisation activities (e.g. servicer, provider of credit enhancement, liquidity provider, swap provider etc.).	Y	-	-
4	Aggregate data regarding the maximum amount of credit exposure arising from recourse/credit enhancement provided to the transactions coupled with a declaration that support is limited to these contractual obligations only. Disclose data on credit enhancement by deal if material.	Y	-	-
5	Aggregate date regarding the size and nature of liquidity facilities provided. Disclose by deal if material.	Y	-	-
(ii)	**Disclosures by sponsors/ third parties**			
1	Data regarding the maximum amount of credit exposure arising from recourse/credit enhancement provided to the transactions coupled with a declaration that enhancement is limited to the contractual amounts specified. Disclose by deal if material.	Y	-	-
2	Size and nature of liquidity facilities. By deal if appropriate.	Y	-	-
(iii)	**Disclosures in offering circulars by issuers (i. e. SPVs)**			
1	The names of all rating agencies or other sources of external assessment used for risk weighting purposes.	Y	-	-
2	A summary of the legal structure of the transaction.	Y	-	-
3	The form of transfer used, in particular any residual links to or rights held by the originator.	Y	-	-

[6] Understandable/useful/compatible with type of other information provided in financial statements

4	Asset types securitised, selection criteria and substitution criteria.	Y	-	-
5	The names of all parties participating in the structure of the transaction and their associated role: originator, servicing agent, provider of credit enhancement, provider of liquidity, swap counterparties, provider of GICs, security trustee, underwriter & marketmaker.	Y	-	-
6	The amount and form, rating (where obtained) of the credit support within the transaction. With declaration that credit support is only as outlined Œ no further support is possible.	Y	-	-
7	The amount, form, rating (where obtained) and position in payment ranking of the liquidity facility (if any) supporting the transaction.	Y	-	-
8	The early amortisation triggers on the pool.	Y	-	-

Appendix 3.3: Market risk (#662-#664)

		Relevant [7]	**Proprietary concerns**	**Alternatives**
(i)	**Disclosures applicable to banks under the standardised measurement method**			
	Core disclosures			
	Which portfolios are covered by the standardised approach;	N	-	-
	For each portfolio, the measurement methodologies used. For instance, whether the bank has applied the maturity or the duration method for the measurement of interest rate risk in the trading book;	N	-	-
	The capital requirements for each of interest rate risk, equity position risk, foreign exchange risk and commodity risk;	Y	-	-
	The capital charge for option positions.	N	-	-
	Supplementary disclosure			
	The movement of portfolios between the standardised and internal models approach;	-	Y	-
	The capital charges specified for different risk categories or portfolios. For instance, for interest rate risk in the trading book, the risk categories are the distinction between general and specific market risk and the different points on the yield curve.	N	-	-
	For equity positions the standardised approach gives risk weights for general and specific market risk and makes a further distinction between index and arbitrage positions. In a similar way, positions in foreign exchange and commodities can be disaggregated;	N	-	-
	The daily variability of profits and losses on the trading positions concerned.	Y only at aggregate level and not for separate risks	-	-
(ii)	**Disclosures applicable to banks under the Internal Models Approach (IMA)**			
	Core disclosures			
	Which portfolios are covered by the IMA;	N	-	-
	For each portfolio covered by the IMA, the characteristics of the models used and the stress test program;	N	-	-
	The scope of acceptance granted by the supervisor;	N	-	-

[7] Understandable/useful/compatible with type of other information provided in financial statements

	In aggregate, the level and variability of market risk for IMA portfolios in terms of value-at-risk data and the backtesting results.	N	-	-
	Supplementary disclosures			
	The movement of portfolios between the IMA and the standardised approach;	N	-	-
	The treatment of non-linear risks, specific risk and event risk;	Y	-	-
	The application of stress test results;	Y	-	-
	The daily variability of profits and losses on IMA positions;	Y only at aggregat e level and not for separate risks	-	-
	If applicable, the value-at-risk and the back test results for different regions and/or portfolios;	N	-	-
	A description and quantification of important outliers in the backtest.	Y	-	-

Appendix 3.4: Operational risk (#665-#666)

		Relevant [8]	**Proprietary concerns**	**Alternatives**
1	Core disclosures			
	The approach(es) a bank qualifies for;			-
	Key elements of the operational risk management framework. This should include information about: risk policies; • the organisational structure; • risk reporting system; • the documentation of risk management procedures; • effective use of an information system; • the organisation (reporting framework) and responsibilities of an independent risk control unit; • independent reviews of the risk management systems at least annually; • active involvement of board of directors and senior management in taking responsibility for operational risk; • any operational risk mitigation techniques used;	Y	-	-
	Its operational risk exposure (by business line). A proxy for the risk exposure is the capital charge;	Y	-	-
	The operational risk regulatory capital charge as a percentage of total minimum regulatory capital.	Y	-	-
2	**Supplementary disclosures**			
	Actual annual operational losses (per business line).	N	Y	-

[8] Understandable/useful/compatible with type of other information provided in financial statements

Appendix 3.5: Interest Rate Risk (IRR) in the banking book (#667-#669)

		Relevant [9]	Proprietary concerns	Alternatives
(i)	**Qualitative disclosures: general information on methodology and key inputs**			
	Core disclosure			-
	The risk management structure for overseeing IRR in the banking book including lines of responsibility, risk measurement systems utilised, policies and strategies for managing IRR, including limits and frequency of IRR measurement;	Y	Y, for limits	-
	The nature of IRR in the banking book and key assumptions employed in its measurement. In particular, identifying the size of portfolios with embedded optionality and the empirical or judgmental assumptions employed to model them, such as assumptions regarding loan prepayments and behaviour of non-maturity deposits;	N	Y	-
	The use of hedging programs including their characteristics, rationale and effectiveness;	N	Y	-
	A general overview of the characteristics of the internal measurement systems used. Discussion of how the measurement systems are used to establish the risk measure;	Y	-	-
	A description of methodology chosen to incorporate the supervisory rate scenario: the standardised parallel rate shock or actual rate moves over the past 6 years. Also, identify the number of separate rate scenarios that were incorporated to account for material currency exposures.	N	-	-
	Supplementary disclosure			
	Any sensitivity analysis employed with regard to key assumptions and their effect on results;	Y	-	-
	The use of other stress test scenarios including twists in the yield curve, larger rate moves, etc.	N	-	-
(ii)	**Quantitative disclosures part (i): required information for risk assessment**			
	Core disclosure			
	The size of the standardised interest rate shock by currency;	Y only for main currencies	-	-
	The absolute increase (decrease) in economic value for the upward and downward rate shocks;	N	-	-
	The absolute increase (decrease) in earnings for the upward and downward rate shocks;	Y	-	-

[9] Understandable/useful/compatible with type of other information provided in financial statements

	Increase (decrease) in economic value as a percent of both economic value and actual regulatory capital;	N	-	-
	Increase (decrease) in earnings as a percent of earnings;	Y	-	-
	The bank's internal limits on IRR exposure in terms of both economic value and earnings;	N	-	-
	Notional value of derivatives used for hedging banking book assets or liabilities.	Y	-	-
	Supplementary disclosure			
	If applicable, these same metrics for alternative stress test scenarios with regard to the rate scenario and behavioural assumptions.	N	-	-
(iii)	**Quantitative disclosures part (ii): *ex post* performance as an indication of quality and reliability**			
	Core disclosure			
	If applicable, goodness of fit of the models and/or validation of assumptions used.	N	-	-
	Supplementary disclosure			
	The core disclosure, but specified for different currencies and/or portfolios.	N	-	-

Appendix 4: Disclosures; capital adequacy (#670-#674)

		Relevant [10]	Proprietary concerns	Alternatives
1	**DISCLOSURES: CAPITAL ADEQUACY**			
	CORE DISCLOSURE (QUANTITATIVE)			
	Capital requirements for credit risk for balance sheet assets;	Y	-	-
	Capital requirements for credit risk for off-balance-sheet instruments;	Y	-	-
	Capital requirements for market risk, including disclosure of capital charges for component risk elements;	Y	-	-
	Capital requirements for operational risk;	Y	-	-
	Total capital requirements;	Y	-	-
	Total eligible capital;	Y	-	-
	Percentage of total capital to total capital requirements.	Y	-	-
	Capital requirements for component elements of market risk	N	-	-
2	**SUPPLEMENTARY DISCLOSURES**			
	Changes in capital structure and the impact on key ratios and overall capital position;	Y	-	-
	Information about its contingency planning;	N	Y	-
	Its capital management strategy including future capital plans (where appropriate);	N	Y	-
	The amount of economic capital allocated to different transactions, products, customers, business lines, or organisational units (depending on the bank's methodology).	N only for major SBU's	-	

[10] Understandable/useful/compatible with type of other information provided in financial statements