EUROPEAN CENTRAL BANK

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THE NEW BASEL CAPITAL ACCORD
Comments of the European Central Bank

On 16 January 2001, the Basel Committee on Banking Supervision (BCBS) issued its *second consultative package* on the New Basel Capital Accord, asking for comments from all interested parties by 31 May 2001. The present note, which benefited from consultations with the Banking Supervision Committee, sets out the contribution of the European Central Bank (ECB) on the matter in view of the finalisation of the Accord by the BCBS. The present note is organised in two sections: the first contains remarks of a general nature, whereas the second addresses specific technical issues.

GENERAL REMARKS

In the context of its first contribution[1], the ECB welcomed the BCBS's initiative to revise the current capital adequacy regime. Whereas the first proposal of the BCBS represented a significant step towards achieving a more comprehensive and risk-sensitive approach, the second consultative package marks *further progress* in defining more precisely the technical aspects of the framework, though some issues still remain to be settled (e.g. the treatment of operational risk and the appropriate calibration of the overall level of regulatory capital).

In general, the ECB *remains very supportive* of the general thrust of the proposed new framework. The latter has many positive elements which contribute to strengthening financial stability. First, the enhanced risk sensitivity and the extended supervisory recognition of credit risk mitigation factors contribute to reducing the gap between the regulatory and economic capital. Second, the introduction of a spectrum of approaches, ranging from simple to advanced methodologies, provides banks with incentives to improve their internal control and risk management systems. Third, the interplay between the three pillars (minimum capital requirements, supervisory review process and market discipline) may in principle strengthen the overall effectiveness of the regulatory framework.

From a specific EU perspective, an additional positive aspect of the new proposed framework is the *wider use* of banks' internal ratings. The introduction of a simpler (foundation) methodology in the internal ratings-based (IRB) approach means in practice that many EU banks may be able to adopt it. Therefore, concerns that the EU banking system could be placed at disadvantage with regard to the

[1] The ECB provided comments on the first consultative package issued by the BCBS in June 1999.

standardised approach, owing to the low number of rated non-financial counterparties in the EU, have now diminished.

Against this background, there are some general aspects which are relevant from the perspective of the ECB and may deserve consideration either by the BCBS when finalising or further developing the New Accord, or by banking supervisors in the actual implementation of the framework.

First, the possible *pro-cyclical feature of the new regime*. Whereas a pro-cyclical pattern may characterise banks' activities irrespective of the capital adequacy requirements, capital regulation may accentuate pro-cyclicality. This may occur in the event of a downturn if capital requirements become a constraint, and the resulting capital shortage may induce banks to shrink lending in an excessive way, which could exacerbate the economic slowdown ("financial pro-cyclicality"). Arguably, the adoption of a significantly more risk-sensitive capital regulation may accentuate pro-cyclicality. However, the new regulatory framework should not accentuate pro-cyclical features inherent in banking activities in a manner that would potentially weaken financial and macroeconomic stability. The revision of the Capital Accord may significantly increase the risk of financial pro-cyclicality due to the fact that not only capital itself, but also the risk weights and, consequently, the capital requirements will become sensitive to cyclical conditions. Therefore, capital requirements would likely increase in a downturn and fall in upturns following movements in external ratings and, especially, in the internal ratings under the IRB approach. Accordingly, banks could need significantly higher capital buffers over and above the minimum requirement than before in order to absorb cyclical risks.[2]

The ECB – which already underlined at the time of the first consultation the possible pro-cyclical nature of the new Accord – acknowledges the progress made in the second consultative paper in addressing the issue and identifying some possible counter-measures. Such counter-measures include encouraging the setting of capital buffers in favourable economic times, support for developing banks' internal ratings with sufficiently long runs of data to assess the borrowers' ability to withstand normal business cycle fluctuations, as well as the conduct of stress tests. In addition, reference is made to the potential impact of provisioning practices and to the work on methods for addressing expected losses. It could also be argued that, owing to the enhanced sensitivity of the capital requirements, there may be stronger incentives for banks to hold capital buffers over and above the minimum requirements, without any external interference, and especially in periods of high economic growth. This trend, although potentially impacting on the long-term rate of economic growth, would further contribute to the smoothing of economic fluctuations.

The ECB *broadly supports* the following means to reduce the potential pro-cyclicality of the new Accord:

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2 The issue is analysed in more detail in the article entitled "*The new capital adequacy regime – the ECB perspective*" (ECB Monthly Bulletin, May 2001).

- within the scope of the Accord and under pillar one, recourse could be made to the *calibration exercise* which is currently under way for determining the overall level of capital under the new framework. In particular, a possible direction of the relevant work could be on reducing the amplitude of the risk weight ladder under the IRB approach. This would have the benefit of smoothing out movements in the risk weights resulting from swings in the economic cycle impacting on the assumed probabilities of default and hence on internal ratings. This could be the most effective means in the short term (i.e. before banks develop internal rating systems which appreciate more the time-varying risks) to reduce the risk of creating a too cyclically sensitive capital framework. The ECB is not in a position to make a concrete proposal as regards the calibration of risk weights and their appropriate risk sensitivity, given the lack of data on the distribution of losses, especially in the EU;
- within the Accord and under pillar two, banks deemed especially cyclically sensitive may be required by supervisors to develop *capital buffers over and above the minimum capital requirement* during periods of high economic growth. It should be acknowledged, though, that this option would require large discretion on the part of supervisors, and may not be easily implemented, particularly if there are national constraints to the implementation of pillar two. It could also be argued that this avenue may be resisted by banks, since the capital adequacy framework does not allow a corresponding reduction in the capital requirement when business cycle conditions deteriorate. However, two factors should be considered in this context. First, as mentioned above, banks themselves may have incentives to hold additional buffers and, second, during downturns, the capital requirements could be reduced at least up to the regulatory (or supervisory) minimum level;
- outside the scope of the Accord, the role of *provisioning practices* should also be recognised. Several empirical findings show that in many instances "static" loan loss provisions – set only when assets become impaired – tend to reinforce pro-cyclicality. If banks were required to assess expected losses with due consideration to the risk profile of a loan over the entire economic cycle and set aside provisions to cover these losses, buffers in form of provisions against cyclical variations would be available. This form of "dynamic" provisioning would then contribute to attenuating the possible pro-cyclical feature of the Accord by reducing the cyclicality of banks' profits. There are, however, some aspects that do not facilitate the pursuance of dynamic provisioning practices. First, the general lack of tax incentives for banks to make provisions for future losses. Second, in a more forward- looking perspective, ensuring the applicability of dynamic provisioning practices within the International Accounting Standards (IAS) framework remains a challenging issue for both regulators and accounting professionals.[3] The ECB recognises that the process of global harmonisation of accounting is under way, but is quite complex and cumbersome. At this stage, it may nevertheless be helpful to clarify the basic direction in which developments could go in this field. The principle could be established that in the longer term provisions would cover expected losses (including losses owing to the effect of the economic cycle), whereas capital would cover unexpected losses.

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3 By contrast, current accounting conventions in most of the EU countries do not represent, in principle, a major obstacle to the setting of provisions for future expected losses.

Second, *the structure of incentives.* The new framework provides banks with three approaches (standardised, IRB foundation and IRB advanced) to measure credit risk. Given their different degree of risk sensitivity, these approaches will generate different capital requirements, depending on the specific risk profile of banks' portfolio. This is an important aspect affecting the choice of banks. The IRB approach entails considerably higher capital requirements than the standardised approach for counterparties meriting unfavourable ratings. For counterparties meriting favourable ratings, the IRB approach yields lower requirements than the standardised approach.[4] Therefore, banks with a higher risk profile could have strong incentives to opt for the standardised approach, whereas banks with a lower risk profile may prefer the IRB approach. *Thus, banks whose soundness would benefit most from more advanced credit risk management techniques could have the weakest incentives to develop them.* This bias in the incentives may be further exacerbated. If, indeed, the IRB approach involves a more prompt and more sensitive reaction to cyclical downturns than the standardised approach, high-risk banks may refrain from adopting the IRB approach in particular in the expectation of a downturn. More generally, bank capital requirements under the IRB approach are expected to be more volatile than those related to the standardised approach, and the use of the IRB approach could entail high initial investment costs. The ECB suggests *two main ways* of addressing this issue, as follows:

- in the context of finalising the Accord, the *calibration exercise* could be used to identify adequate incentives for banks to move from less to more sophisticated approaches. The proposed capital alleviation for banks opting for the IRB approach does not seem sufficient to provide banks with the necessary incentives. The reduction of the amplitude of the risk weight ladder under the IRB approach proposed above to lower the risk of financial pro-cyclicality could help to improve the situation also from this perspective, since the capital charge for the higher-risk loans would be reduced. Therefore, a narrower amplitude of the risk weights could render the IRB approach more stable vis-à-vis business cycles. At the same time, it would address the incentive bias and may hence induce more banks to opt for the IRB approach, thus increasing the effective risk sensitivity of capital regulation;
- in the implementation of the Accord, *banking supervisors* could exert pressure on individual banks to develop adequate risk management systems in line with their risk profile. The Basel Committee may consider in this respect the pros and cons of allowing or requiring supervisors to impose the adoption by individual banks of the IRB approach.

Third, *the interplay among the three pillars.* A smooth interaction among the three pillars will represent a key issue for the successful implementation of the new Accord. The degree of effectiveness of this interplay will vary from country to country, depending on the extent to which the single components of the framework and, in particular, the supervisory review process and market disclosure are actually developed. The new Accord entails a major shift from a simple rule-based framework for setting the

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4 See the ECB article mentioned in footnote 2.

minimum capital requirements to a quite complex process. Supervisory authorities follow different approaches in evaluating the risk profile of banks and in promoting disclosure by banks. Therefore, it will be important to pursue some degree of convergence in the implementation of pillars two and three. This objective is relevant also in relation to the fact that the new regime provides supervisors with a larger degree of discretion, which can affect the level playing field. Early supervisory intervention, supervisors' assessments of banks' capital adequacy in relation to their risk profile and market disclosure practices represent specific areas in which convergence is a priority. Therefore, the ECB supports the intention of the BCBS to foster co-operation among banking supervisors in order to promote a higher degree of supervisory convergence. In the EU, work in this area is already under way within the relevant EU Committees. In this context, two additional aspects are worth mentioning:

- the transition from the current to the new Accord will have *distributional effects* across banks. Some will benefit, whereas others will have to face higher capital requirements. Therefore, supervisory authorities will have to step up their vigilance in order to promote a smooth transition at the level of individual institutions and for the banking sector as a whole. In this respect, it may be worthwhile for supervisory authorities also to monitor the level of capital requirements under the current regime in an initial phase of the implementation of the new Accord. Furthermore, there is a need to monitor the effects of the move towards the new regime across countries. In this context, it is noted that the new approach will introduce standard Loss Given Default (LGD) figures in the foundation IRB approach. Given the differences in recovery rates in insolvency procedures and more generally the difference between these procedures from country to country, the effects of the regime shift should be monitored systematically;[5]
- the implementation of the *current international standards for transparency* of supervisory policies in the context of the new Accord will have to be assessed at a certain stage. In this context, proposals for initiatives to require supervisory authorities to inform the public at large regularly about certain supervisory actions may be considered.

Fourth, the *regulatory capital*. Two aspects are worth mentioning under this heading:

- the *maintenance* of the overall level of capital is indicated as one of the primary objectives of the revision of the Accord. Whereas this objective will determine the calibration of the relevant parameters for the calculation of regulatory capital in general, the actual capital requirements will vary between banks, depending on their specific risk profile. In this context, it is important to ensure that smaller banks are not confronted with a disproportionate increase in their capital requirements in comparison with the current regime, possibly due to the new operational risk charges, in particular. This aspect is important in the EU, given the large presence of small and medium-sized banks;

[5] There are of course other factors that may affect the distributional effects across countries, such as the degree of concentration of banking systems or the non-synchronism of the economic cycle.

- although the current revision of the Accord is not intended to alter the current definition of regulatory capital, it seems that the pursuance of *further harmonisation* in this area will have to be considered at a certain stage. This stems also from the spreading in the market of innovative instruments (e.g. instruments with step-ups), which may be regarded as eligible for regulatory capital, whereas the current notion of regulatory capital limits the percentage of these instruments as part of tier one.

Finally, the *accounting rules*. The objective of harmonisation of accounting rules is set to become even more important in the context of the new regime. More harmonised accounting rules would also support competitive equality in the implementation of the new introduced pillars (supervisory review process and market disclosure). At the same time, the ECB acknowledges the complexity of the issue as well as the efforts of the BCBS to contribute to defining widely accepted international accounting principles for financial institutions. From a longer-term perspective, the macro-prudential effects of "full fair value accounting" should also be assessed, including the potential further amplification of the economic cycles.

SPECIFIC ISSUES

In this section a number of technical issues are addressed. In many cases, specific suggestions are put forward for consideration by the BCBS and banking supervisors.

1. Scope of application

First, the BCBS could consider expanding the proposed scope of consolidation to include financial holding companies that are parents of banking groups and securities companies. This would increase convergence with the EU framework on consolidation. *Second*, clarification seems to be needed on the notion of banking groups (currently defined as engaging predominantly in banking activities) and internationally active banks, owing to the increased importance of rules on consolidated supervision provided for in the proposed framework. The lack of any guidance on such definitions may harm the consistent application of the framework. The ECB notes the initiatives taken in the EU regulatory framework, whereby quantitative elements in the definition of financial holding company are being introduced. *Third*, the issue of the treatment of qualifying holdings in insurance companies is not mentioned in the relevant part dealing with the treatment of insurance subsidiaries.[6] The methods proposed for the majority-owned or controlled insurance companies (i.e. deduction from the capital or, alternatively, prudent approaches to supervision on a group-wide basis) could apply to the treatment of banks' qualifying holdings in insurance companies as well.

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6 There is only a reference to the surplus capital in significant minority-owned or controlled insurance subsidiaries not to be recognised.

2. Minimum capital requirements (pillar one)

Standardised approach to credit risk

First, according to the current drafting of the proposals on the preferential treatment of the claims on sovereigns, the lower risk weight proposed to be applied to banks' exposures to the sovereign of incorporation denominated in domestic currency and funded in that currency at the discretion of national authorities is not subject to any limitations. This leaves ample space for national discretion. The proposed revised treatment leaves unaffected the current broad-brush rules on the claims on sovereigns denominated in domestic currency and disregards the element of credit risk for this kind of exposures.

Second, with regard to the eligibility criteria of external credit assessment institutions (ECAIs), the ECB is interested in ensuring an overall high quality of ratings. The Eurosystem follows its own rules and procedures in terms of evaluating its counterparts and eligible collateral in the context of conducting monetary policy operations and for the management of its foreign reserves and own funds. However, the eligibility criteria that are introduced for regulatory purposes may influence the quality of ratings and have repercussions on the procedures followed by the Eurosystem. Although it is acknowledged that there are practical difficulties in striking the right balance between the need for prudent ratings to be extensively used for regulatory purposes and the need to avoid excessive regulatory interference, there is some scope for improvement. First, *comparability of rating scales* is a criterion missing from those listed in the proposal. The introduction of this criterion is important for the Eurosystem in order to ensure consistency between ratings of different ECAIs. The proposals could provide guidelines on how this comparability could be achieved (e.g. probabilities of default could be used as a key element to map different rating scales). Second, on the *track record* (as an element of the objectivity criterion), a minimum time period of one year for establishing assessment methodology may not be enough to show the ability of a system to adjust to the economic cycle. At the same time, a long track record may preclude new entrants. Thus, it would seem important to attain a trade-off between longer track records, which impinge on the number of eligible ECAIs, and shorter track records encouraging new entrants. It could, therefore, be preferable to focus on the rating methodology and rating processes as main factors in assessing objectivity than on the minimum time period of track records. Third, some practical guidance could be given on the implementation of the criteria related to the *adequate resources* that an ECAI should have. The prospect of the establishment of an excessive number of ECAIs having limited resources and narrow functionality will not be a desirable development for the Eurosystem. Fourth, it would be desirable to further emphasise the *credibility criterion* as a crucial element. Indeed other requested criteria may be regarded as a subset of credibility (e.g. if an ECAI lacks objectivity, independence or sufficient resources, it is unlikely to be credible).

Credit risk mitigation techniques

First, as a general comment, there seems to be ample space for banks' choices for credit risk mitigation techniques.[7] This is highly welcome in terms of incentives given to banks to develop adequate risk management systems. Supervisors could check, however, the consistency of the choices made by banks. The consistency could be low in some cases of banks opting for the standardised approach (thus refraining even from calculating or using their own estimates of probability of default for individual borrowers as required by the foundation IRB approach) and seeking eligibility for the more complex options for credit risk mitigation (i.e. providing their own estimates of market prices and currency volatility for each security in the context of calculating haircuts).[8]

Second, further specification seems to be needed in the case of recognising collateral by related group entities in the standardised approach. As a matter of principle, entities belonging to the same group are excluded. It needs to be clarified whether the proposed exemption also includes entities under indirect control of the group and companies in which the bank holds participating interests.

Third, the potential overlaps in the capital charges associated with the legal risks under the "w" factor and the legal risks as part of the operational risk charges should be examined and preferably eliminated.

Fourth, further clarification of the conditions for eligibility of collateral instruments seems to be needed. This applies in particular to the notions of "main index" and "recognised stock exchange" as preconditions for eligibility of equities and to the notion of "daily public price quotes" for UCITS/mutual funds to be eligible as collateral. In the latter case, at least in the EU, for most of these instruments only net asset values are published at which the sponsoring institution is willing to buy/sell shares or certificates; only in rare cases are such instruments really traded on an exchange.

Fifth, the range of eligible guarantors includes unlimited use of guarantees provided by corporates (including insurance companies) just on the condition of being rated "A" or higher. It could be argued that the introduction of the "w" factor of 0.15 may in practice limit the number of potential guarantors other than financial institutions. However, it should be noted that an undue proliferation of guarantees provided by non-banks and especially from non-regulated – and therefore not subject to capital requirements – entities may have adverse implications from the point of view of the level playing field and could give rise to reputational risks concerning the provision of guarantees in general. Therefore, some quantitative limitations on the use of guarantees issued by non-regulated entities may be considered.

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7 A simple and a comprehensive approach with the latter offering sub-options (as the banks could be allowed to provide their own estimates for "haircuts" or they could follow the supervisory approach with predefined formulas).

8 Banks that have received supervisory recognition for an internal market model are, possibly, eligible candidates for the more complex features of the credit risk mitigation techniques. Notwithstanding the fact that some banks may have different levels of expertise in market risk as opposed to credit risk, it is, in general, perceived that these banks are sophisticated enough to use the more risk-sensitive IRB approach.

Sixth, there is no explicit reference to the treatment of the securities firms and public enterprises as guarantors with regard to the application of the "w" factor for guarantees in the context of the standardised approach.

Finally, the acceptance of parental guarantees rated A (or higher) without any other limitations as credit risk mitigants for the standardised approach may need to be revisited. It does not seem consistent with the underlying principle for replacement of the risk inherent in the underlying asset with that of the guarantor, assuming that there is no strong positive correlation between the respective probabilities of default. It also seems inconsistent with the proposed treatment of collateral, whereby, inter alia, the low correlation between the collateral and the exposure is set forth as minimum condition for eligibility. The acceptance of parental guarantees could be considered, for instance, in the case of small companies within a group that are not rated, while the parent company is rated and its rating, according to supervisors' assessments, reflects the soundness of a group as a whole.

Asset securitisation

First, there is a need to ensure competitive equality and harmonised implementation of the minimum operational requirements for achieving a "clean break" between the bank originating the securitisation activity and the securitisation itself as a transaction. To that end, clarification is needed on the notion of "relatively small percentage" to be applied for the overall issuance of asset-backed securities representing clean-up calls. *Second*, the proposed treatment for revolving securitisations with early amortisation features seems to leave scope for divergent implementation. First, the capital requirement is quite patchy (i.e. the proposed minimum conversion factor of 10% to the notional amount of the balance sheet securitised pool could be increased to a higher percentage, such as 20%, depending on the insufficiency of operational requirements). Second, the treatment is basically left to national discretion on the basis of subjective estimates (the factors which are explicitly mentioned are the speed of amortisation and the permitted size of clean-up calls only).

The internal ratings-based approach

Whereas the main aspects of the proposed internal ratings-based (IRB) approach are shared, some specific issues deserve consideration. *First*, the use of the IRB approach for rating sovereigns. As to the standardised and the foundation IRB approaches, the issue of consistent application with respect to the risk weights and the respective capital charges seems of importance. In addition, divergent capital charges for sovereign credit risk stemming from the various proposed approaches should reflect real differences in measurement as, in practice, many banks use to a large extent the analysis and related ratings provided by international ECAIs. Moreover, a complementary element in the process of assessing sovereigns could stem from the utilisation of the country risk analysis conducted by supervisors. The BSC is currently undertaking some work in this field.

Second, a necessary precondition to ensure a prudent treatment of the ratings and capital requirements of the IRB approach is that delinquency and charge-off rates are commensurate with the quality of the loans and their distribution into different internal rating grades. As grades differ between banks, an ex-post supervisory review of the delinquency and charge-off rates is important in order to promote a prudent use of ratings produced in the IRB approach.

Third, with regard to the notion of default, banks are expected to use internal definitions of default consistent with the reference one proposed in the new Accord. Under a proposed option by the BCBS, banks could also be eligible for the IRB approach in case the reference and their internal definitions are not consistent, provided that the internal PDs are calibrated to take into account the differences in the definitions (mapping exercise). Two elements of this framework could give rise to practical implementation issues. First, no clear criteria are provided for the notion of consistency between the internal and the reference definition. Second, no precise guidance or other information is given on the design or even the broad characteristics of the complex mapping exercise envisaged by the BCBS, which would have to be carried out for a variety of internal definitions. The adoption of a stricter definition of default for prudential purposes seems to be a possible way forward to overcome these problems from a longer-term perspective.

Fourth, as to the calibration of credit risk weights, the choice of the distribution of losses and the confidence interval has a considerable impact on the level of risk weights. However, the distribution of corporate losses has been used for all types of exposures so far, including exposures to banks, sovereigns and retail portfolios. Given that such generalised use of the corporate losses may impair the degree of risk sensitivity of the IRB approach, a calibration on the basis of data collection on the distribution of losses for the aforementioned sectors could be pursued. This could also extend to sub-sectors of the corporate portfolio, with a finer distinction between e.g. small and large firms and, possibly, industrial sectors.

Fifth, the introduction of a maturity adjustment of risk weights in the IRB approach. This is in principle supported as a tool to address the time element in the calculation of credit risk. However, some possibly adverse incentives of the current proposals could be considered when calibrating the maturity adjustments. Since no maturity adjustment is applied to risk weights under the standardised approach, excessively high maturity adjustments would encourage banks with a high proportion of long-term exposures to opt for the standardised approach to the detriment of the IRB approach. Likewise, and if the option of a fixed maturity of three years is retained under the IRB foundation approach, banks would be inclined to choose the latter approach if the effective maturity is higher than three years rather than the advanced IRB approach. In order to overcome these problems, a possible way forward could be: (i) the introduction, under the advanced IRB approach, of a cap to the maturity adjustment or the restriction of

the choice of banks to the so-called "default-mode models", which imply lower maturity adjustments;[9] and (ii) the above could also be proposed under the foundation IRB approach, if the option of national discretion[10] were to be exercised..

Sixth, the recognition of physical collateral for the calculation of LGD under the foundation approach. An analysis of the impact of cyclical conditions on the market value of commercial and residential real estate could be useful due to the fact that historical evidence indeed suggests the existence of pronounced asset price cycles. In addition, two issues could be considered. First, the proposed formula for calculating LGD for values of collateral between the two thresholds (i.e. 30% and 140% of the value of collateral as percentage of the nominal value of exposure) might need to be reviewed with regard to its potential "cliff effects". A discontinuity can indeed be observed when collateral levels are slightly above the lower thresholds. Second, and more generally, the LGD level is not very sensitive to the level of the collateral, as it hovers between 40 and 50% whatever the level of the collateral.

Finally, with regard to the proposed treatment of equity, the BCBS proposes two options, namely: (i) the use of the PD-LGD-EAD framework; and (ii) a market-based approach, based on stress testing. Notwithstanding the tentative character of the proposed treatment, it seems that both options have their advantages and disadvantages. As there is no common industry practice concerning the treatment of equity in the banking book, a workable solution could be to include both options.

Operational risk

The proposals concerning the treatment of operational risk (OR) are broadly shared. However, a number of specific aspects deserve attention. *First,* the capital charge for OR should be prudent and fairly reflect the true risk profile of the bank. An unjustifiably high charge with particular regard to the simple indicator and standard approaches could be detrimental to small and medium-sized banks and, in the EU context, to investment firms that are subject to the same rules on capital adequacy as banks. The ECB acknowledges the reservations raised in the consultative paper and understands that the capital charge for OR will be subject to re-calibration on the basis of additional data stemming from the quantitative impact study currently under way.

Second, as the calculation of OR in the simple indicator and the standard approaches is based on relatively simple financial indicators mostly relating to gross income (aggregate or per business line), the capital treatment is not directly associated with improvements in banks' internal controls and risk management techniques. Consequently, these methods may not provide direct incentives for banks to

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9 The consultative paper presents two examples of the way to calculate maturity adjustments, namely the so-called mark-to-market (MTM) and default-mode (DM) models. The MTM models lead to particularly high maturity adjustments for longer-term exposures with lower default rates. For instance, the risk-weight adjustment factor relative to a maturity of 10 years and a probability of default of 0.02 % would be equal to 3.2, compared to 0.4 only for 1-year exposures with a similar probability of default. MTM models are sound from a theoretical perspective, but they should be considered with caution from the incentives point of view.

10 Instead of the fixed maturity of three years.

enhance their internal controls and risk management systems. From a financial stability point of view, it would be important to ensure that these banks, in conjunction with the fulfilment of the respective capital charges, are enhancing their risk management procedures. Therefore, it could be underlined in the new Accord, possibly under pillar two, that these banks should demonstrate to their supervisors that they are also enhancing their risk management in relation to OR.

Third, the ECB favours the introduction of a simple method, such as the proposed simple indicator, especially for small and medium-sized banks, and the suggested use of gross income has, in fact, the advantage of simplicity. However, the BCBS may wish to refine the simple indicator approach. In this context, the inclusion of the net profit and loss as part of gross income as currently proposed could be considered for refinement or exemption as it may unduly distort the level of capital charge for operational risk. The inclusion of the net profit and loss from financial operations implies in practice that a bank losing money in terms of proprietary trading reduces its capital charge on OR. This is not very sensible. In addition, the findings of the ECB Report on "The EU banks' income structure", prepared by the Banking Supervision Committee, show that the net profit on financial operations is the most volatile sub-category of non-interest income for the EU banks, that its relative importance varies between EU countries[11] and that it is the part of the banks' income most affected by accounting practices. A way forward in refining "gross income" in the context of a simple indicator approach for OR could be the introduction of a volume indicator for the trading activities of the bank or of an average figure (three-year average). This could partly alleviate the impact of fluctuations of trading activities.

Fourth, the regulatory treatment of outsourcing by banks deserves particular attention. A "clean break" of outsourced activities and the need for robust legal agreements mentioned in the text are a prerequisite in terms of ensuring that the costs will be incurred by the external service providers to which the activities are outsourced by the bank. In addition, the "ultimate" risk management responsibilities should remain with the bank. Moreover, the BCBS may wish to address the issue of outsourcing as deserving supervisory analysis with respect to the degree of dependence and of concentration of activities on a few service providers. The implementation of the new regulatory regime on OR may lead to shifts of banking-related activities to non-regulated service providers. Although this does not constitute a negative development per se, it may require greater attention to the possible implications for the stability of the banking system.

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[11] The net result on financial operations roughly accounted for 20%-22% of the non-interest income of the EU banks in the period 1995-98. Therefore, its inclusion as part of gross income could unduly affect the calibration of the operational risk.

3. Supervisory review process (pillar two)

The introduction of pillar two in the regulatory framework is a positive element. It not only introduces an ex-post review by supervisors but also encourages an ex-ante and ongoing vigilance by banks to demonstrate to their supervisors that they are adequately capitalised and have in place robust risk management systems. The implementation of pillar two raises some challenges for supervisors.

First, the broad content of the current proposals, the lack of specific guidance, the degree of complexity of the issues and the scarcity of supervisory resources could somewhat limit the role of pillar two in some countries. *Second*, the objectives of competitive equality and a level playing field call for extensive convergence of supervisory approaches between countries. The convergence embraces supervisory approaches in assessing banks' regulatory capital in relation to their overall risk profile, the setting of capital buffers and supervisory intervention at an early stage. The practical difficulties relating to the different legal regimes, powers and styles of supervision mentioned in the consultative paper are, of course, acknowledged. This enhances the role of the BCBS as a forum fostering co-operation among banking supervisors in order to promote a higher degree of supervisory convergence. The pursuit of this objective could draw on the EU experience as work in this area is already under way within the relevant EU Committees. *Third*, the envisaged need for enhanced supervisory disclosure and accountability would be a natural corollary to the greater degree of discretion and power, given the current lack of convergence in practices across countries. It should also be consistent with the implementation of the current international standards on the transparency of supervisory policies. At present, convergence in supervisory practices deserves priority as a requisite for achieving enhanced supervisory disclosure.

The establishment of specific capital categories under the second pillar for the banking system as a whole, in addition to a review of capital adequacy at individual banks, is an important aspect of the new Accord, especially for the non G-10 banks. A generally applicable higher capital ratio to domestic banks should properly reflect the macroeconomic conditions of the country concerned and the overall assessment of the efficiency of its financial system. In that context, the smooth co-operation between supervisory authorities and central banks represents an essential issue that needs to be properly covered in the new Accord.

4. Market disclosure (pillar three)

The overall proposed framework for banks' disclosure represents a useful tool in achieving enhanced market discipline. The distinction between core and supplementary elements provides the necessary flexibility for banks and public authorities for fine-tuning the disclosure requirements on the basis of the banks' risk profile and institutional factors. Also, the reasonable interest of the small and medium-sized banks in disclosure requirements adjusted to their role in the financial markets can be achieved by an adequate application of the materiality principle.

Two challenges to the effective implementation of the proposed disclosure framework should be borne in mind. *First*, the limited degree of international harmonisation of accounting rules. This aspect is relevant

even in homogeneous financial areas like the EU where core elements of disclosure, such as loan loss provisions, non-performing assets, valuation of trading portfolio and related recognition of operating result on financial operations, can markedly differ between countries. *Second,* the divergence in supervisory powers relating to banks' disclosure. Following the EU consultative document, the EU supervisors would be granted the necessary legal authority in this area. Level playing field concerns could arise if supervisors were provided with different powers in different jurisdictions.