European Association of Co-operative Banks
Groupement Européen des Banques Coopératives
Europäische Vereinigung der Genossenschaftsbanken

POSITION PAPER ON THE 2ND CONSULTATIVE DOCUMENT OF THE BASEL COMMITTEE ON BANKING SUPERVISION ON THE NEW BASLE CAPITAL ACCORD

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PREFACE

The European Association of Co-operative Banks (EACB) is one of the main associations of the European credit industry. Its core objective lies in defending the professional interests of its members. The EACB is officially recognised as the representative body of the European co-operative banking sector by the European Union institutions and by the European Central Bank.

The European Association of Co-operative Banks represents one of the leading banking groups in Europe. Its membership base of more than 30 organisations comprises co-operative banking groups from the 15 European Union Member States, but also from Central and Eastern European countries. These represent 38 million Members, 104 million customers, 527,000 employees in more than 50,000 business points and deposits of about EUR 1,317,000 million.

The majority of the EACB's members focuses on their respective national or regional markets and do not operate across national frontiers. Even where they are identified as having an international dimension, they are nonetheless groups of medium-sized or small-scale institutions. Their second salient feature is that they are universal banks, but within which the retail banking arm, geared to promoting the personal segment and SMEs, definitely takes precedence. Indeed, co-operative banks are among the leading providers of capital to small businesses and private customers right across Europe.

The Association welcomes the fact that the Basle Committee published its second consultation document on a new capital adequacy framework in January 2001 and requested the banking industry to return its comments on this extremely important subject, even if the time span was short.

GLOBAL COMMENTS

The EACB's members, who have been inquiring extensively into the Basel Committee's second paper, collectively pledge their support for its concern to enhance financial stability and control risks more discriminatingly. They are genuinely pleased to discern that this second consultative paper accords infinitely more relevance to the internal ratings-based approach. However, before outlining details, they unanimously think it essential to return a number of global comments.

A. Time-Scale for Consultation and Further Dialogue

The first concerns the unduly short time-scale set for consultations, which must be completed by 31 May. This will not allow sufficient time for an in-depth and detailed investigation into the consequences of the measures advocated nor for adequate light to be shed on the respective advantages of the various methods proposed so that the right choice can ultimately be made. This stems from the vagueness of the language in which some of the concepts are couched, e.g. operational risk (and which will rebound to produce numerous instances of double counting), several parameters not yet definitively established or lending themselves to discussion, i.e. betas or the W factors allied to the sophistication of new risk assessment methods. In pride of place in this respect is also the final calibration of the banks' internal rating systems and hence the final level of the future capital charge. Only on the basis of a "Quantitative Impact Study II" to be drawn up during 2001 will the precise risk weights and crediting rates be determined. The evaluation and presentation of the results of this study will only occur long after the expiry of the consultation deadline.

Therefore, our Members consider it to be very important for the consultation process to be extended beyond 31 May 2001 in the form of an open, constructive dialogue on these issues. Interim papers on the most important topics, which are open to comment from the banking industry, would seem to be the most appropriate way to conduct such a dialogue before editing the new Basel Capital Accord. The EACB will be prepared to respond to such interim documents at short notice.

B. Maintaining the minimum global capital ratio of 8%

There is a general feeling among members of the EACB that risks are being overcalibrated as are the constraints involved. Arguably, such sentiments are at variance with the assertion that the reform is intended to be financially neutral and that the minimum global requirement of 8% should be retained. Our experts argue that such assertion can unquestionably be challenged in as much as

- It conflicts completely with the fact that firstly the denominator in the ratio is to be revised upwards and that secondly the numerator will be revised downwards:
- Without altering the equity capital requirement pursuant to risks already taken into account in the Cooke ratio's denominator, i.e. 8% for counterpart and market risks only, new risks categories are being added to which consideration must be given, i.e. setting the operational risk at least 1.6 points of the ratio and which must be aggregated with the preceding ones: the conglomerate effect arising from the impact of deducting equity capital stake holdings in insurance companies.
- Moreover, henceforth deducting stake holdings in nonconsolidated entities by 50% from Tier 1 and 50% from Tier 2, whereas previously deducted from Tier 2 as a matter of priority will reduce equity capital in the numerator very significantly and thus generate serious repercussions on gearing. Such a measure will also render equity capital volatile and run counter to the object of the exercise, which is to create greater stability.
- Compatibility between retaining a global requirement of 8% combined with the inclusion of new risks and a reduction in equity must be seen as the outcome of a simulation undertaken among an excessively small sample of exclusively American banks. This will lead to overestimating the positive impact arising from the inclusion of external ratings for wholesale banking and allow recognition be accorded to new risks within the framework of an unchanged requirement. The upshot will be detrimental to retail banking which, by its very nature, is less risk prone owing to it being characterized by wide risk-spreading.

This is the frame of reference within which the Association's members request:

- That, taken as a whole, the requirement for market and counterpart risks be effectively and explicitly lowered from 8% to 6% so that account can be taken of new risks incorporated into the minimum requirement which is being maintained at 8% (4.1);

- That, on the other hand, equity capital requirements for retail banking, also within the standardized approach, be set at least half as low as those for wholesale banking, particularly when plans are not being made to allow it qualify for granularity, one of its hallmarks (2.1.1.).

C. Making the IRB Approach a realistic option for co-operative banks

Conceptually, the IRB approach is designed as an approach to regulatory capital that reflects a bank's individual risk profile more accurately and provides capital reductions for various forms of transactions. However, we consider that the capital cover rules in the IRB approach are incorrectly calibrated (3.5.). The multiplicity of security buffers, haircuts, add-ons, floors and caps presupposes that all potential crisis scenarios, errors and disasters occur simultaneously and to the full extent. Maturity, weighting and inappropriate granularity rules compound the problem, so that capital cover which is higher than the entire volume of credit can only be avoided through a cap regulation.

On the other hand, some of the technical requirements laid down as a prerequisite for applying the IRB approach seem too strict and should therefore be more realistic. This is particularly true of

- The minimum requirements for estimation of PD - Estimation using reference definition of default (3.6.2.3.)
- The building up of data histories (3.2.; 3.4.)
- The possibility of partial use (3.2.)

Also, the EACB recommends replacing the quantitative thresholds for retail portfolios within the IRB by tighter qualitative criteria. This option would consider the risk framework within which the bank operates and which moreover would reflect the risk-sensitivity of the portfolio (3.1).

D. Developing appropriate calibration and reliable methods for operational risk

The members of the EACB suspect that a ratio of 20% for operational risk would definitely be too high and should be lowered considerably (4.1.). Only on the basis of a wide basis of collected loss data and the results of Quantitative Impact Studies will it be possible to identify operational risk precisely and to develop reliable methods for calculating and calibrating appropriately (4.2.).

E. Guarantees/Collateral

In addition to the instruments mentioned in the draft paper, any collateral accepted by banks in the course of ordinary business should be validated for the purposes of risk mitigation (2.2.3.1., 3.6.1.) Moreover, co-operative banks argue that it would be highly desirable to extend the scope of the risk mitigation techniques to all guarantees/collateral used up to and including their own internal solidarity schemes. In fact, the IRB approach will lead to canceling out risks internal to the network (or at least reducing them very considerably) be it by determining the PD factor if the solidarity system is preventive or else by the LGD factor if the system is not preventive.

Consequently, it would be advisable to provide for zero weightings for these risks under the standardised approach so as to ensure that the two approaches are treated consistently.

This notwithstanding, the large exposures directive allows these categories of risk to be excluded.

F. Avoiding Competitive Distortions

Another comment relates to competitive distortions likely to arise from applying an enlarged surveillance perimeter to financial systems reposing on very different structures. The new Basel Accord is intended to create a level playing field internationally. Thus it must not create any distortions to the detriment of specific banking groups or certain financial instruments.

One major cause for concern is that, due to risks being overcalibrated in the draft proposal, medium and lower solvencies would be systematically disadvantaged. This would be particularly detrimental to small and medium-sized borrowers, in other words: to private

customers and small and medium-sized enterprises (SMEs). A situation of this nature would not only affect the competitiveness of SMEs as the backbone of the European economy very seriously, but would also put retail banks themselves at a disadvantage. Thus, fixing appropriate risk weightings for retail portfolios, and likewise, fixing the necessary capital cover for retail banking in general, means setting the stage for the competitive environment of the future.

In the sense of a comprehensive harmonisation of the scope of banking supervision regulations, we propose adapting the scope of application of the Accord regarding the group of undertakings to be consolidated to the regulations applicable in the EU. Taking over the EU provisions would have the advantage, in addition to their proven efficiency, that the standards in the majority of the States represented on the Basle Committee are already applicable (1.1.).

Although the principle of extending consolidation to insurance subsidiaries may be widely advocated, we still wonder whether cross-sector activity automatically implies double gearing and risk accumulation (1.6.). By contrast, international research underlines the benefits and positive impact of cross-sector diversification. One way or the other, the Association's members maintain that this broader-based supervision should not translate into new quantitative requirements being imposed on the equity capital ratio by applying methods such as deduction. Rather, national competent authorities must be permitted to exercise qualitative supervision, if appropriate, on the basis of observation ratios, the regulations for which should be established at their discretion.

G. Pillar 2 – Supervisory Review

Under Pillar 2, interpretation of the discretionary power vested in supervisory authorities should be clearly demarcated to obviate the emergence of competitive distortions and also be capable of upward or downward revision depending on requirements. "Quantitative" consequences in the form of individual capital charges for specific banks should only be used as a last resort in the event of banks persistently failing to remove shortcomings in their risk management (5.1.).

H. Pillar 3 - Market Discipline

Finally, the requirements in pillar 3 must be strictly confined to tightening market discipline. Information should remain confidential in the interests of competition and everything done to prevent investors lodging complaints (6.1., 6.2.).

TECHNICAL COMMENTS

1. Part 1 -Scope of application

1.1 Definition of “banking groups“

The proposed definition of “banking groups” (No. 2) as “groups that engage predominantly in banking activities” seems unclear and is open to substantial national discretion. Greater precision is therefore required to standardise the sphere of consolidation. We therefore propose referring to the definition of the “financial holding company” given in Article 1, point 21 of EU Directive 2000/12/EC relating to the taking up and pursuit of the business of credit institutions, which contains a precise and hence neutral definition from the competition point of view for subordinated holding companies in banking groups.[1]

1.2. Decisive provisions for the consolidation (No. 5)

In internationally active financial groups, the various member undertakings are periodically subject to the supervision of different States. It is then possible that, within a banking group, not only is the banking supervision law of different States applicable for subsidiaries and parent, but also divergent supervisory law in terms of content. In view of the particular sensitivity to competition of the consolidation provisions, it is precisely in this area that conflicts of laws could prove to be particularly problematic. Such a case would arise, for instance, if the respective supervisory law governing parent and subsidiary provided for different scopes for the consolidation or if the supervisory arrangements governing the parent provides for sub-consolidation and those governing the subsidiary do not.

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[1] Pursuant to Article 1, point 21 of EU Directive 2000/12/EC relating to the taking up and pursuit of the business of credit institutions, “financial holding company (FHC) shall mean a financial institution, the subsidiary undertakings of which are either *exclusively* or *mainly* credit institutions or financial institutions, one at least of such subsidiaries being a credit institution.” In the context of the current reform efforts at EU level, the concept “mainly” is to be made more precise - possible approach: share of the assets of a financial entity accruing to the financial sector > 50% = FHC.

In the view of the EACB Members, it is absolutely vital to prevent the most restrictive supervisory law prevailing in the end. Rather, it should be established, in accordance with the principles of Directive 2000/12/EC relating to the taking up and pursuit of the business of credit institutions, that in this respect it is always the supervisory law of the home State of the parent undertaking of the group which is decisive.

1.3. Securities firms

According to the draft new Capital Accord, majority-owned or controlled securities entities, where subject to "broadly similar" supervision as banks *or* where their activities are deemed banking activities under the national supervisory arrangements, "**should**" generally be fully consolidated (No. 5).

In the view of the EACB Members, this represents a convergence with the scope of consolidation under EU Directive 2000/12/EC relating to the taking up and pursuit of the business of credit institutions, which is in principle to be welcomed. However, it is possible to derive a far-reaching **right to choose for States** from the vague formulation ("should"). The new Capital Accord should therefore only authorise renunciation of inclusion exceptionally and confine it to clearly defined cases. The provisions of Article 52(3) of EU Directive 2000/12/EC should be included in the Accord.

1.4. Level of consolidation

To guarantee adequate capital resources and distribution within a "banking group", the Basle Committee considers it necessary for subordinated internationally active banks for their part to consolidate investments in financial institutions (**"sub-consolidation"**). Sub-consolidation could be waived providing the Capital Accord is applied at the level of the individual institution (subordinated internationally active bank) and the book value of the investment is deducted from the capital.

In the view of the European co-operative banks, there would be little point in such an obligation to undertake sub-consolidation and it should therefore be rejected. Sub-consolidation entails considerable expense, but with no adequate recognition or use in terms of banking supervision in exchange. For precisely these considerations, in the European

harmonisation of banking legislation, no obligation was imposed to undertake sub-consolidation (Art 52(7) of Directive 2000/12/EC relating to the taking up and pursuit of the business of credit institutions, Article 7(7) of Directive 93/6/EEC on the capital adequacy of investment firms and credit institutions).

We consider the alternative to sub-consolidation provided for of **deduction of investments at the level of the subordinated parent institution** to be inappropriate for the same reasons. Through the consolidation, groups of institutions or financial holding companies are simulated as *one* undertaking, so that only the group is considered for supervisory purposes. Through the consolidation of *all* undertakings of a group to be undertaken by the parent of the group, the risks actually existing in the group are covered <u>in full</u> and compared to the capital existing in the group. The exemption of a subordinated parent institution is appropriate in this respect and should continue to exist.

<u>1.5. Minority interests owned by third parties</u>

The draft consultation paper provides that the supervisors have the discretion to decide whether, and if so to what extent, minority interests owned by third parties can be included in the regulatory capital of the group on consolidation (No. 14).

In fact, as a result of the control relationship between parent and subsidiary undertakings, the share of the capital owned by third parties can also be used without restriction in the interests and to the benefit of the entire group (e.g. for investments in other undertakings of the group). The capital of the subsidiaries is available without restriction as liable funds in the event of losses.

For this reason, the minority interests owned by third parties should also be included in full in the capital through full consolidation. To assess capital adequacy, the decisive factor must be that the fully comprehensive risks assumed are also set against the fully comprehensive capital of the group accordingly. It would not be appropriate to reduce capital available to cover these risks.

On account of the control relationship between parent and subsidiary undertakings, the share of the capital owned by third parties can also be used without restriction in the interests and to

the benefit of the entire group (e.g. for investments in other undertakings of the group). The capital of the subsidiaries is available without restriction as liable funds in the event of losses. The deduction of shares owned by third parties would also not correspond to the aim of consolidation, which is to consider the group as a single undertaking.

In any case, however, national rights to choose with regard to the recognition of minority interests owned by third parties should in any case be avoided. For it would jeopardise the level playing field at international level if such a right to choose were exercised in different ways. [If the new Basle Capital Accord were nevertheless to maintain such rights to choose, these should also be incorporated in a EU Regulation, so that the option of the national supervisors can be exercised under a common view.]

1.6. Insurance subsidiaries

The Basle Committee believes that “at this stage it is, in principle, appropriate” to deduct banks’ investments in insurance subsidiaries from their capital (No. 9).

In the opinion of the EACB Members, in principle there should not be a unilateral obligation for banks to deduct their investments in insurance entities. Insurance entities are not required conversely to deduct majority interests in banks.

Moreover, the approach adopted by the draft New Capital Accord seems inappropriate in this respect from the risk point of view. Insurance risks display totally different characteristics from banks’ credit and market risks. They are outside the scope of banking supervision. A correlation or even identity of risks has so far not been documented. The contemplated deduction from capital of investments in insurance entities would as a result correspond to a risk weighting of 1.250%. Technically, with the complete deduction of an investment in an insurance entity it is assumed that an insurance entity uses the capital made available through the investment in such a way that a transaction with banking risks is mounted which corresponds to 12.5 times this investment capital. This assumption is unrealistic and signifies a serious exaggeration of the risk deriving from an investment in an insurance entity. In fact, the volume of transactions subject to credit or market risks affected by insurance entities continues to be small compared to the actual insurance risks. If need be, insurance entities

should be required to comply with the banking supervisory provisions for their “banking transactions”.

All told, activities on the treatment for banking supervisory purposes of shares in insurance subsidiaries should be postponed until corresponding specifications for worldwide supervision of financial conglomerates have been adopted.

1.7. Significant minority-owned equity investments in non-insurance financial entities

With regard to “significant minority-owned equity investments” in non-insurance financial entities, the draft provides for either a pro rata consolidation or the deduction of the book value of the equity. Establishing the threshold, i.e. the definition of the “significance“ of a significant minority-owned equity investment is to remain at the discretion of the national supervisors.

The Members of the EACB are of the view that here too a “level-playing-field“ must be created. They therefore recommend the adoption of the corresponding EU regulations. On account of the higher risk for the parent undertaking, joint ventures should be included in the compulsory pro rata consolidation.

1.8. Significant investments in commercial entities

The draft new Capital Accord proposes deducting from capital, investments in non-financial entities, which exceed “certain materiality levels” of liable capital. Establishing the decisive threshold, i.e. the “materiality level” is to come under the discretion of the national supervisors. As “standard values” the Basle Committee refers to the thresholds to be applied in the EU of 15% for an individual investment and 60% for the aggregate of all significant investments in non-financial entities.

In our opinion, it should be made clear that in cases of exceeding the thresholds mentioned, the deduction of the entire investment is not intended, but merely the part exceeding this threshold. Under the threshold values mentioned, investments should only be assigned an “appropriate” risk weight. It is therefore right, as provided for in the draft, for such investments in non-financial entities to be assigned a risk weight of 100% under the standard

approach. Under the IRB, no special weights should be created for investments. Possibly higher capital requirements could be taken into account through the awaited rating-dependent regulation on the handling of equity.

Part 2: The First Pillar – Minimum Capital Requirements

2. The Standardised Approach –

2.1. General Rules

2.1.1.Individual Claims

In general, to the members of the EACB it is quite surprising to find that weightings assigned in the standardised method do not take account of the statistical mutualisation of risks inherent in retail banks' credit business. Hence, logic suggests applying a 50% reduction systematically to current weightings in so far as this would be consistent with the reference weighting factors used for the internal rating system.

This particular reduction coefficient is essential due to the fact that a retail bank's portfolio has enough credit lines to wipe out all forms of statistical risk and retain only the global risk portfolio (sensitivity to exogenous parameters: macro-economic environment, regulatory framework,…).

Therefore, owing to extensive risk-spreading, it is proposed to set:

- 25% on residential mortgage credit, real estate leasing and listed companies 3, i.e. collateral eligible for the ESCB ;
- 50% on all other categories of mortgage credit on commercial premises, consumer credit and credit to very small SMEs (immediately after corporates 3, i.e. corporates 4).

2.1.2. Claims on Banks

In the opinion if the members of the EACB the concept of short term exposures should be extended from 3 months to 1 year.

2.2. Credit Risk Mitigation in the Standardised Approach

2.2.1. Collateral

Securities repurchase agreements or similar transactions (Repo/Reverse Repo transactions or securities lending transactions should also fall under „collateralised transaction“. No. 65 refers only to those securities repurchase agreements or similar transactions that are almost equal to proprietary trading activities. Therefore proprietary trading activities should be included in the definition.

2.2.2. Minimum conditions

The standards that have to be met before capital relief will be granted to any form of collateral (No. 67), should be serviceable and go along with business practice.

Banks must obtain legal opinions confirming the enforceability of the collateral arrangements in all relevant jurisdictions (No. 68-71).

- Legal opinions should be updated at appropriate intervals only, if a change in the law or the facts makes it necessary
- A legal opinion may be issued by a lawyer of the bank itself or of an association
- The use of framework contracts or skeleton contracts should require a legal opinion once only. Generally accepted forms of collateral agreements should not require a legal opinion for every single transaction.
- Confirmation of the enforceability of the collateral arrangement should be required for the country of residence of the garantor only.

There are no criteria for establishing a positive correlation between the credit quality of the obligor and the value of the collateral. Considering the fact that the double risk of default shall not be considered, we suggest deleting this paragraph (No. 72).

2.2.3. The methodologies (No. 75)

Generally it should be considered that in many countries collateral is issued not on the basis of individual transactions but –within certain limits- on the basis of the bank-customer business-relationship in general. This makes collateral in easier to handle and reduce cost, i.e. cost involved when collateral agreements must be updated.

2.2.3.1. Eligible collateral

In addition to the instruments mentioned (No. 76), any collateral accepted by banks in the course of ordinary business should be validated for the purposes of risk mitigation. Thus, particularly the following collateral instruments should be eligible for recognition:

- Gold and other precious metal (a haircut of 50% of the value could be considered for the volatility of the market price
- Any transferred debt, where the borrower has a rating of at least AA-, if the transfer has been formalized and the borrower could be obliged to pay directly to the bank to which the transfer was made. (a haircut of 50% could be considered.
- Cash deposits by third banks
- Lien upon real property
- Uncovered Bonds and banks' promissory notes
- Lien upon ships and airplanes
- Leasing and similar titles to moveables

In addition, *non-subordinated* bank securities that are not rated should be accepted, where the rating of the issuer is sufficient (No. 77-79). For those securities the rating of the security can never be better than the rating of the issuer. The condition that no other issue by the issuing bank is rated below BBB should only refer to an issue of the same kind (No. 78).

Also, the conditions imposed for bonds issued by banks which are not assessed by a recognised external credit assessment institution to be treated equivalently to those assessed A/BBB are far to narrow (No. 78). We suggest to include all kind of securities listed on an exchange or traded on market.

It seems inappropriate to accept rated securities BB- and above issued by sovereigns and public-sector entities (PSEs) whereas BBB- is required for securities by banks, securities firms and corporate securities(No. 76, 78). Here also BB- should be sufficient.

The requirement that no other issue by the issuing bank is rated below BBB as a condition for non-assessed bonds to be treated equivalently to those assessed A/BBB implies considerable disclosure obligations for banks (No. 78). Problems will occur, if ABS-securities are also to be considered. Very often, some tranches of ABS-securities are assessed below BBB.

2.2.3.2. The comprehensive approach

There should be no haircut *(HE)* appropriate to the exposure *(*E). The adjusted value of the collateral should only depend on factors corresponding to the type of collateral involved (No. 86). It seem inappropriate to consider an “add-on“ for the market risk of the credit exposure by means of a deduction from the value of the collateral.

The general use of a a haircut for currency mismatch *(HFX)*(No. 86) seems inappropriate, where collateral is considered within the currrency position of the annual accounts.

A simple addition of haircuts implies the proposition that all uncertainties and market fluctuations might occur at the same time (No. 80-91). However, first impact studies have shown that this may cause an overstatement of the risks involved. Thus, the probabilities of such events arising and the correlations between certain market fluctuations should be considered. The mere addition of haircuts may cause an overcollateralisation.

2.2.3.4. Own estimates for haircuts (No. 92)

The members of the EACB support the view that own estimates of market price volatility for haircuts could also be based on data pooled by associations, central institutions of cooperative banks and savings banks or third parties, only if these data are sufficiently reliable.

The permission to do so should be conditional on the satisfaction of minimum qualitative and quantitative standards but not be limited to those banks that have received supervisory

recognition for an internal market risk model. The conditions which must be satisfied for the recognition of such models far exceed the standards to be met for the estimation of haircuts. For the adjustment of the holding periods it should be considered that lower-quality assets are not necessarily less liquid.

2.2.3.5. W: remaining risks

The members of the EACB reject the idea of implementing a „w“ factor as suggested under No. 101. The factor is designed as a buffer for the risk of loss when trying to realise the collateral, in particular due to legal errors when preparing contracts. Thus, such risk is legal risk and is defined as part of the operational risk. A further consideration of such risk would mean a double-count of risk and therefore a double charge of own funds.

2.2.3.6. Special treatment for government repo-style transactions

The limitation of the permission to apply a zero w to certain government securities repo-style transactions, (i.e. repo/reverse repo and securities lending/securities borrowing transactions) (No. 102) seems inappropriate. Considering that the quality of transactions and securities is very similar, if not almost identical, application of a zero w should be extended to all government securities and cash deposits.

2.2.3.7. Carve-out from the comprehensive approach

For transactions where conditions for a zero *w* set out in the previous paragraph are satisfied, and in addition the counterparty is a *core market participan*t, the EACB members disagree with the proposal that supervisors may, for transactions where conditions for a zero *w* are satisfied, choose not to apply the haircuts specified in the comprehensive approach and may instead apply a zero H, if the counterparty is a *core market participan*t (No. 103). In order to avoid competitive distortion, there should be no such far-reaching discretion by national supervisors. The “may in paragraph 103 should therefore be replaced by a “must.

2.2.3.8. The simple approach - Minimum conditions

In contrast to paragraph 106, the collateral should not be revalued with a minimum frequency of six months. Such collateral should also be accepted when is to be revalued after one year. All in all, for collateral that is subject only to minor market fluctuations, revaluation periods of less than a year should only apply where special incidents require it.

The requirement that the collateral must be pledged for the life of the exposure excludes incongruous durations of collateral and debt within the simple approach, a fact that in our opinon can not be justified. The risk-reducing effect of collateral does not depend on the supervisory approach taken with respect to it.

2.2.3.9.Risk Weights

The introduction of a floor of 20% for the risk weight on the collateralised portion would cause a deterioration vis-à-vis the current situation and is therefore to be refused (No. 108-111). Any provision of collateral that has a risk weight of 0% should imply the same risk weight for the collateralised portion of the exposure (notwithstanding the fact whether "***transactions subject to daily mark-to-market and daily remargining" or "other transactions" are involved.*** It should also be noted that the legislations of some EU-member states oppose the requirements set up in paragraph 108, according to which a bank, notwithstanding the counterparty's insolvency or bankruptcy, must have the unfettered, legally enforceable right to immediately seize and liquidate the collateral for its benefit. Therefore, the scope of this requirement should be enlarged.

2.2.4. On-balance-sheet netting

All in all the EACB welcome the proposal to increase the possibilities of on-balance sheet netting agreements of loans and deposits of banks to or from any other counterparty (No. 112-116). With reference to the "enforceability of the agreement in each relevant jurisdiction including in insolvency proceedings" it should be sufficient to provide a well-founded legal basis for the country of residence of the counterparty. The country of residence of the bank

should be excluded from this condition. The Ability of the bank to determine those assets and liabilities with the same counterparty that are subject to the netting agreement should imply the ability to specify these transactions in due time.

Furthermore, we do not see any reason for the requirement to decompose and net on an individual basis (paragraph 114), where banks have a number of loans and deposits with the same counterparty. Any netting agreement is referring to a number of loans of deposits and reducing the supervisory risk to the net exposure. We see no reason for the establishment of pairs.

We furthermore reject the limitation to netting with one counterparty. If only the enforceability is given, all nettable transactions, whether onto or off the balance sheet should be admitted to risk mitigation.

We also reject the idea of a haircut for currency risk in this context. Currency risk is already considered within the total currency position of a credit institution.

The proposals for the treatment of a maturity mismatch when the residual maturity of a hedge is less than that of the underlying exposure (paragraph 146-148) seem inappropriate and hardly serviceable. Netting-Agreements include changing positions. There is no decomposition of a portfolio or attribution of exposures.

3. The Internal ratings-based approach (IRB approach)

3.1. Definition of retail exposures

The draft Capital Accord (No. 156) defines retail exposures as claims with fulfilment guaranteed by individual persons. This approach already causes considerable problems in banking practice, since categorisation is not undertaken according to the collateral. The categorisation of an exposure under the various definitions should therefore not be made compulsorily dependent upon by whom or how this exposure is secured.

The product criteria stated in the definition should also be deleted. The segmentation according to product criteria as a condition for the categorisation of an exposure under the retail sector is neither required from the risk point of view nor does it serve a purpose in terms of business management. The products in the draft are, on the one hand, generally offered to all borrowers and so do not characterise the retail sector. On the other hand, categorisation according to product groups would result in one and the same borrower having to be allocated different product-specific risk weightings despite the same probability of default. The default conduct in this customer segment is however precisely independent of the products used.

Likewise, the establishment of a maximum amount for the treatment as “retail exposure” and the requirement that the exposure should be part of a large pool of loans is disproportionate. These criteria too in themselves give no guarantee of an appropriate risk weighting.

In contrast, the members of the EACB endorse the idea of not restricting retail banking to personal borrowing but allowing it to include loans to the liberal professions and very small businesses too. In fact, on a par with personal sector borrowing, the latter implies an ongoing timeless relationship and a multiplicity of commitments in exchange. Moreover, common statistical decision-making tools are often used in the credit-granting function (scores, expert systems,…) or else the same collection procedures are applied.

This notwithstanding, the banking industry is concerned to call the regulator’s attention to problems which the establishment of quantitative criteria will pose (upper limit per loan, minimum number of loans) on the grounds that threshold effects will inevitably ensue from

operational difficulties inherent in the increased volume of data required.

Consequently, the EACB recommends replacing the quantitative thresholds by tighter qualitative criteria. For instance, providing loan capital for small businesses could be brought within the scope of retail banking if it necessitates bulk processing for both granting and collection and if the underlying portfolios offer an adequate level of statistical mutualisation, application of these criteria being incumbent on each national regulator.

This would leave the definition of the retail portfolio to the individual banks to choose their own application of 'retail'. This option would consider the risk framework the bank is working in and additionally would reflect the risk-sensitivity of the portfolio. Therefore, such an approach would allow the most appropriate results.

For clarification and to avoid misunderstandings, it could however be helpful if a few typical components of a retail portfolio were listed in the new Accord. Such a list should however be indicative and in no way binding for the banks.

3.2. Adoption of the IRB approach across all exposures

The regulations for partial application of the IRB approach are on the whole too strict and make it more difficult for the groups of institutions organised on a decentralised basis, such as the co-operative banks, to qualify early for an IRB approach in terms of banking supervision.

This is especially true of the requirement to implement and use the IRB approach across all exposures and across all significant business units within a short period of time. Hence it must be admissible to exclude definable business units, such as subsidiaries or branches, for example, for which constructing the necessary data history is not possible or is inappropriate, entirely from the IRB approach.

The significant criterion provided for in the context of extending the “internal ratings-based” approach to all portfolios in any one group must be applied in the context of the group’s extension.

Furthermore, it should also be left to the discretion of the credit institutions to use the IRB approach only for certain portfolios and to exclude other, for example smaller, business units entirely from the IRB approach for cost-benefit reasons. Against this background, the regulation, as proposed by the EU Commission in its consultation document (paragraph 55), should also be adopted in Basle. According to this, financial institutions, which possibly only have one or more categories of liabilities for which they have developed rating methods and procedures, may use essentially less complicated methods and procedures for the other liabilities. Accordingly, it should also be possible to use the -standardised approach on a lasting basis for specific part portfolios, for example claims on governments or banks, for which it is not appropriate to develop an own internal rating procedure.

In as far as banks use different methods for different portfolios and the majority of the portfolios (about 80%) is on the same method, it should be allowed to keep these different methods permanently in place. The national supervisor can check whether there is a clear distinction between portfolios in place (separate management, administration) and no cherry picking is exercised. If these conditions are met also the solvency-penalty for internal deals (these being normally weighted) should be omitted.

In addition, the requirement to present a (self-)committing schedule, within which implementation and application of the internal rating to all exposures and to all relevant business units must be completed, should be refrained from. The Basle Committee intends anyhow to calibrate the internal rating approach more favourably in relation to the standardised approach so that with appropriate calibration of the different approaches, a sufficient incentive should exist for the banks to switch as early as possible to the next more developed approach. As regards the timing, each institution should be allowed to take its own decision freely without additional coordination with the supervisor.

3.3. Adoption of elements of the advanced approach for IRB

On the transition from the foundation approach to the advanced approach (No. 161-163), the decision should remain with the institution for each portfolio as to whether the foundation approach or the advanced approach should be used (permanent coexistence of the basic approach and advanced approach).

3.4. Transitional regulations for data requirements

The consultative paper provides for transitional regulations, but makes them into exceptions subject to discretion of the national supervisor (paragraph 163). Such far-reaching discretion for the national supervisor must be rejected. Different handling at national level may to a large extent lead to distortions of competition, which it is vital to avoid. Since in these cases no reliable data are available, the idea is open to abuse (cf. paragraph 159 ff.).

The transitional regulations and implementation deadlines (paragraph 163 ff.) should also be designed to enable a flexible changeover from one system to the other.

For by successively raising the data requirements in parallel to the entry into force of the new Basle Accord, rating systems may only de facto be recognised under supervisory law in either 2004 or 2008. If a bank does not meet the requirements imposed on internal rating systems at the end of 2001 or has not rated and entered the entire credit stock into the system, the necessary historical series can no longer be adhered to by 2004. A supplementary entry, i.e. a backwards extension of the time series and hence the data would be disproportionately expensive for the institutions. The decisive factor is far more that the requirements in many fields are unclear until at least the end of the year, i.e. up to the planned adoption of the Basle regulations. The supervisor therefore here too lays down a de facto impossible condition of implementing rules by the end of 2001, which are established at the end of 2001 at the earliest. We therefore propose prescribing only a two-year data history of internal ratings up to at least the end of 2006 without the requirements being raised already during this transitional period.

After the expiry of the transitional period, i.e. from the beginning of 2007, the original requirements then apply (five-year data history, three-year use test). Once a bank has achieved recognition for the IRB procedure it should not be lost when after the transitional period higher requirements are imposed on data quality and the use test (“grandfathering”).

All requirements designed to build up data histories, particularly transitional periods of at least five years, should also be extended to LGD and EAD. In terms of business management it is not clear why a data history for LGD and EAD should at 7 years be longer than for PD. In particular in the case of EAD, it is a secondary credit risk parameter.

3.5. Calibration of risk weights for corporate, retail and bank exposures

The benchmark risk weights (BRWC) calibrated in No. 173-177 and 424-430 are far too high. In our opinion, this is also attributable to the intention of the Basle Committee to cover not only unexpected losses but also the expected losses with banking supervision capital. In the banks, it is normally only the volatility of the expected loss, the so-called unexpected loss, which is covered by economic capital, since the expected loss is usually already considered in pricing and also in the risk provisions. According to the consultative paper, the components of the expected loss are considered twice, for which there is no justification.

However, if the expected losses are also to be covered by capital, the entire risk provision set aside by credit institutions for expected losses would consequently have to be recognised as capital for supervisory purposes. This would give rise to considerable practical problems - especially with regard to quantification - which in our opinion it would be very hard to solve. In addition, the various national tax law provisions would lead to insoluble distortions of competition.

The Basle Committee rightly calls on the institutions to consider their own PD estimates as well when forming the risk provision. However, we consider it to be decisive that here accounting considerations are to be focused on and not purely economic assessments (paragraph 274). Since credit institutions hold economic capital only to cover unexpected losses, the planned capital cover of expected losses on the basis of economic assessments would lead to a divergence between economic and supervisory capital. Corresponding errors in control would be the consequence in the institutions.

Establishing the individual parameters in the formula to determine the benchmark risk weight (BRWC) is also problematic. Here a standard normal distribution is assumed which in our view would not correspond to the realistic risk distributions in a typical reference portfolio. The assumption of BRWC = 100 with a PD of 0.7% seems to be too strict. It would lead to own funds requirements being 30% higher compared to the current method. This makes it necessary to align the 100% weighting with a higher PD level of, at a minimum, 1% instead of a PD of 0.70%. That reduction should be applied in due proportion to the retail banking segment.

Finally, it also seems essential to us that the correlations between BRWC and PD are not made in the context of graduated tables, as presented in paragraphs 176, 428, but in the flexible context of curves, as shown in paragraphs 175, 427.

3.6. Rules for Corporate Exposures

3.6.1. Eligible collateral

As already stated under 2.2.3.1. on eligible collateral under the Standardised Approach, the EACB members hold firmly to the view that any collateral banks accept in the course of ordinary business must also be validated under the IRB approach for risk mitigation purposes (No. 197). Our comments mentioned above, shall apply here too.

3.6.2. Minimum requirements for corporate exposures

3.6.2.1 Rating grade structure

The minimum number of rating grades should rather be six for performing loans and two for non-performing loans. This number is sufficient to express risk differentiation authoritatively (No. 240).

Furthermore, the possibility must exist for institutions to be able to undertake the segmentation into various risk categories individually when different rating methods with sometimes differing numbers of risk categories are applied for specific part portfolios (e.g. special ratings for housing construction firms, insurance companies).

In principle, a meaningful distribution of loans into risk categories to avoid excessive concentrations is to be welcomed. However, the requirement of a strict upper limit could lead to above all small and medium-sized institutions, which concentrate their business on specific segments of borrowers, being unable to adhere to such an upper limit. This may also cause problems if institutions pool their data - for example at association level - in order to obtain statistically reliable estimates of the probability of default. Especially in the small and medium scale financing field, this could lead to an institution being excluded from the IRB approach

on account of such upper limits alone. Hence the requirement proposed in the draft Accord that no more than 30% of the net exposures should fall in a single risk category (No. 242), is rejected.

3.6.2.2.Oversight by the board of directors and senior management

Since all aspects of the rating process also have to be approved by the top administrative body, internal ratings - as proposed - should be an essential part of the reporting to these bodies. However, we are of the opinion that a quarterly report suffices for reporting to the top administrative bodies rather than reporting at monthly intervals (No. 249).

3.6.2.3. Minimum requirements for estimation of PD - Estimation using reference definition of default

According to No. 272, a default is considered to have occurred when one *or more* of the events listed have taken place. The main problem is that this means that the credit institution must retain all the events of default referred to in the definition. In practice this is impossible, or only possible at disproportionately high expense. As a result, this requirement would make almost all existing data files unusable as in the past not all four events of default were entered. Therefore it should suffice if in each case one of the criteria listed is met. Greater accuracy is not to be expected from a cumulated approach.

3.7. Rules for Retail Exposures

3.7.1. Minimum requirements for retail exposures

In principle, the consideration of over 70 criteria (No. 438-478) in the same way as for a corporate exposure is not appropriate for the retail sector. A smaller number of criteria would also be sufficient.

3.7.1.1. Independent review

In particular, the requirement to subject the status of individual borrowers to an annual independent review (No. 456) is not appropriate. Naturally, it is out of the question that reliable internal scoring methodologies and risk assessment criteria are established. On the

other hand, the conditions in the retail sector are not comparable with those in the field of corporate exposures. Here the review must take place because there have been special reasons and effects on the scoring criteria are suspected. Such a cause-related review can take place several times a year. In view of the expense entailed, it appears however that a systematic annual scrutiny by an independent unit is excessive if there are no circumstances to be observed which could constitute a reason for a review.

3.7.1.2. Requirements for estimation of EAD and either PD/LGD or (EL)

As we see things, the economic definition of the EL factor for the retail-banking segment seems unrealistic. The accounting loss written off should be enough given the significant number of accounts and their low value (No. 462). In fact, the economic loss would include discount effects, funding costs and direct and indirect costs not administered by operational category. As a result, in the case of focusing on economic losses, over-compensation of the losses would in turn occur.

4. Operational Risk

4.1. General Comments

The members of the EACB find it difficult to understand why regulators have selected a ratio of 20% of regulatory capital despite their acknowledging that it is "…..based on a small sample of banks….." (No. 21 in document "Operational Risk"). Apparently, only four banks seem to have provided this type of information. Moreover, they have set it against economic and not regulatory capital, although economic capital is known to be infinitely lower than regulatory capital. Therefore, the members of the EACB suspect that a ratio of 20% for operational risk would definitely be too high. It should be lowered considerably.

Our major concern is that risks are overcalibrated. The assertion that the reform is financially neutral is questionable. Our estimations concerning counterpart and market risk have shown that there will be no reduction of 20% to the current 8% ratio. Thus, calibrating operational risk at 20% of the Cooke ratio would imply a considerable increase of capital requirements.

Furthermore, since competition between banks and non-banks is seen to be increasing steadily, and particularly in the field of retail-products, levying an inappropriate capital charge for operational risk would affect banks' competitiveness quite seriously. If banks are the only financial service providers to take precautions for operational risk, this might turn out to be detrimental to their market position and thus cause competitive distortions.

The members of the EACB suggest reducing the capital charge for operational risk, where satisfactory insurance policies are available. In this connection, they think it highly desirable to take any reduction of operational risk into consideration. Their typical division-of–labor-structures, the centralization of competences at their central banks and their solidarity schemes contribute to improving the qualitative aspects of operational risk

Management policies generally referred to as "quality management" and implemented in various forms, are qualitative elements, which cannot be overlooked in that they contribute to managing operational risk more discerningly and hence should be taken into account as reductive techniques.

4.2. Definition of Operational Risk

The members of the EACB reason that an adequate definition of "operational risk" is a central issue. It is very much appreciated that strategic and reputational risk are not included (No. 547), since they merely are an outflow of normal business risk and thus strongly related, if not only a reflex of it. However, in day-to-day business, it would be very difficult to decide, whether a risk or indirect loss *"results from inadequate or failed internal processes, people and systems or from external events"* or whether it results from business as such. Particularly in the case of legal risks it will be very difficult to draw the line.

Since there is a strong potential for double-counting capital charges, the EACB wishes that clear rules be set up in a pragmatic manner regarding operational risk events for regulatory purposes. Because whenever losses materialize, assurances must be given that they can easily be allocated to the appropriate risk categories and that no double counting will occur in practice.

In this context, we point out that the "value at risk" coefficient 3 multiplier used to calculate the regulatory capital charge on market risks also covers the operational risk.

Finally, a clear definition of operational risk would certainly help to avoid any overlapping with the "w" factor recommended to attenuate the reductive impact of collateralization on the capital charge (No. 84) and thus any double-counting of a risk already identified as an integral part of the operational risk.

4.3. The Measurement Methologies:

The members of the EACB agree that work on operational risk is at a stage of development. Among other things, it will be of central importance to collect loss data and gain experience in this complex before there are any realistic measurement methods. So it is not surprising, that discussion among the members of the EACB of the three measurement methologies proposed has shown that none of them is sufficiently developed to ensure satisfactory results and competitive neutrality:

- The Basic Indicator Approach (No. 552; No. 22, 23 of the “Operational Risk” document) will lead to high and inappropriate capital charges owing to the fact that a value of 30% is assigned as a multiplier coefficient. Linked to gross income, the calculation of the capital charge for operational risk is not risk-sensitive at all. Creating a link between gross income and risk charge would even be prejudicial to highly profitable banks.
- The Standardised Approach (No. 553, No. 24-30 of the “Operational Risk” document), the β–multiplier coefficients used to calculate the capital charge on the operational risk attaching to various “business lines” will, in all likelihood, be high and the indicators chosen do not appear to be the most suitable.
  The business line approach provides for a beta factor, which will apply to the amount of the gross product or asset volume managed. Now, operational risk charges, beyond a certain threshold, do not increase linearly in terms of these criteria. On the contrary, institutions are aware of the risks they are incurring and hence will draw on the techniques required (human, legal) as a mechanism for capping them. So, an upper limit should be set on the repercussions these calculations are likely to generate.
- The Application of the Internal Measurement Approach (No. 556, No. 31-39 of the “Operational Risk” document) would create a number of problems. On the one hand, the relevant data collected will be defined differently depending on the banks involved and will certainly vary in terms of quality. On the other hand, regrouping data by third-party entities will inevitably give rise to serious legal risks. Lastly, this method will take “expected loss” into account whereas operational losses are essentially of the “unexpected” kind. This might conflict with the concept of capital requirements.

Thus, only on the basis of a wide basis of collected loss data and the results of Quantitative Impact Studies (such as the current QIS 2) will it be possible to identify operational risk precisely and to develop reliable methods for calculating precisely and calibrating appropriately.

5. Part 3: The Second Pillar – Supervisory Review Process

5.1. General Remarks

The members of the EACB welcome the greater emphasis to be placed on qualitative banking supervision, which the introduction of the Supervisory Review Process is intended to achieve. The supervisory authorities must, however, take care to avoid making excessively detailed demands on banks when assessing their risk management and risk control. This would not only constitute considerable interference in banks' business policy, but it would also hamper the development of new methods of risk management and risk control. On no account must supervisory authorities be allowed to intervene directly in banks' individual business processes.

In our view, qualitative supervision basically requires the implementation of qualitative measures. If supervisors find risk management to be inadequate, they should first of all endeavor to remedy the situation in consultation with the management of the bank. We feel that hard "quantitative" consequences in the form of individual capital charges for specific banks should only be used as a last resort in the event of banks persistently failing to remove shortcomings in their risk management.

On the other hand, it could be argued that the scope of the supervisory review process seems to lack equilibrium in certain respects. In that, supervisors have no options available to reduce capital charges. Thus, supervisors will be unable to equalize extra charges on one side by reductions of charges on the other side, although this would be appropriate for an overall view.

With greater sensitivity on business risk, with the implementation of new factors such as operational risk, the new Basel Capital Accord will be, within pillar 1, a tool suitable for adaptation to an enormous spectrum of situations and correlations. In our opinion, a wide-ranging use of additional capital charges under pillar 2 would completely run counter to the development of an overall set of rules under pillar 1. Serious competitive distortions could occur and question any “level-playing-field”.

5.2. Specific Issues

Furthermore, apart from principles 3 and 4 of the supervisory review process, the vagueness of definitions laid down or certain discretionary powers concerning the scope of application either explicitly or implicitly increase the scope of supervisory authorities' powers. Together, these powers seem too extensive and should be curtailed. As an indication, attention would need to be called to the following issues:

- The Definitions of a "banking group" (No. 2) or of an "internationally active bank" (No. 3) arrow unclear and allow room for national discretion.
- The treatment of minority interests is open to wide discretion (No. 6)
- Within the field of consolidation the discretionary powers of supervisors go very far (No. 5-8)
- Supervisors may permit the recognition of such surplus capital in calculating a bank's capital adequacy, under "limited circumstances" (No. 12).
- The level of materiality levels for significant minority-owned equity investment in commercial entities is discretionary (No. 16).
- At national discretion, a lower risk weight may be applied to banks' exposures to the sovereign (No. 24)
- National supervisors are responsible for determining whether an external credit assessment institution (ECAI) meets the criteria listed (No. 45).

Considering such far-reaching discretionary powers on one side, reference should be made to a lack of flexibility on other issues. In the first place, such flexibility would be necessary for meeting the requisite minimum requirements for the IRB approach (No. 153-158) and for relaxing minimum requirements during the transition period (No. 163). Such flexibility is a very important issue for European cooperative banks and their decentralized networks of retail banks.

6. Part 4: The Third Pillar – Market Discipline

6.1. General comments

The members of the EACB agree with the Basle Committee on the introduction of a link between the new capital ratio and the disclosure of financial information on the risks borne by the banks. However, a clear distinction should be made between regulatory reporting for supervisory purposes and the disclosure of information, which contributes to financial analysis and therefore is relevant to investors and business partners.

In the opinion of the EACB, the pillar three disclosure requirements are much too detailed and generally inappropriate as they focus on the inputs to models instead of outputs. Thus, a significant proportion of the disclosure requirements proposed will not really serve to establish market discipline since they are too complex for the vast number of market participants to understand and are only useful to the regulator and supervisor. Also, a case could be made as to whether a system for disclosing prudential information over and above accounting information is needed, since prudential information is validated by the authorities. Disclosing two sets of information will be very expensive for credit institutions.

Furthermore, the disclosure of information implies the aspect of proprietary information (No. 21 of “Pillar 3 (Market Risk)”). The EACB welcomes the fact that the quality of such information has been recognized and, by implication, the need to protect it. In fact, the disclosure of some of the information to be provided according to the draft proposal could, under certain circumstances, lead to disastrous results: Particularly when smaller banks and regional banks are involved, the structure of the data disclosed or even the data themselves could allow direct conclusions be drawn on individual customers as well as conclusions on details of a bank’s business policy.

In other words, inappropriate disclosure of information may lead to distorting competition between market participants and damage the privacy of customer information, and yet not serve the needs of either investors or business partners.

6.2. Recommendations

Therefore, the financial information to be disclosed by banks should be limited to that required for market discipline. Furthermore, clear rules on the protection of proprietary or confidential information should be established, as well as rules on appropriate ways of disclosure should establish guarantees for anonymity and privacy of the data published. Therefore, the members of the EACB suggest:

- To restrict information on structure of capital to the core disclosures (decomposing Tier 1 and Tier 2 by major category);
- To limit disclosure on portfolios, cover policies, scorings and internal ratings to synthetic information on an aggregate basis in order to comply with the confidentiality deemed essential for commercial data;
- Not to establish any link between disclosure and any supervisory authorization concerning any internal processes, e.g. concerning IRB.
- To exclude information on collateralization policies, the suppliers of collateral and credit derivatives from disclosure requirements. This information is confidential;
- To leave it up to the "group head" company to chose whether the information is to be disclosed on an individual or consolidated basis;
- To base information on market risks on the VaR (by leading risk group, e.g. rate, exchange and others) and not on "stress-tests" which cannot be compared between one institution and another;
- To limit disclosure on the risk rate to qualitative information supplied in aggregated form, which will respect the confidentiality of reporters and not create the potential for unfounded comparisons;
- To defer reporting requirements on operational risks until such time as a precise classification system can be disseminated defining the functions and regulations for calculating their attendant losses.
- To exclude disclosure on economic own funds risks. Such disclosure comes under the internal choices of each institution and is not the goal of market discipline.

6.3. Detailed observations

Our aforementioned proposals are mainly based on the following conclusions:

6.3.1. Scope of Application (No. 643, Annex 1 of "Pillar 3 (Market Discipline)")

Some obligatory information on the scope of application seems inappropriate for the maintenance of market discipline since it is only relevant for supervision purposes:

- The prudential treatment of entities not consolidated for prudential purposes, and connected matters (differential impact of methods used other than deduction, surplus capital coming from such companies, and impact on group's capital adequacy),

6.3.2. Capital (No. 644-646; Annex 2 of "Pillar 3 (Market Discipline)")

There is no problem in disclosing obligatory information on own funds (however, the use of the disclosure of innovative Tier 1 capital instruments grandfathered / not grandfathered may be questioned). On the other hand, disclosure of many of the supplementary elements may be misleading. Either they are subject to interpretation (discussion of trigger events) or by definition incomplete (contractual terms) and may, by contrast, generate the operational risk of being contested by investors. Therefore, limitation to the core disclosures seems more adequate.

6.3.3. Credit risk (No. 648-661; Annex 3 of "Pillar 3 (Market Discipline)")

Problems arise here on account of the information to be disclosed, regardless of the methods used:

- Core disclosure: the substitution of "bad debt" by the concept of "non-performing loan"

- Supplementary disclosures: indication of average exposures over the period; volumes of credit risk transferred into securitisation vehicles; credit protection purchased using credit derivatives; 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).

Disclosures applicable to banks using the standard approach:

- For retail banks, the use of rating agencies is of limited interest. This feature is

increased, for co-operative banks, by their decentralized structure, which makes the setting-up of an IRB-based information system more difficult.

Disclosures applicable to banks using IRB approaches:

- With respect to IRB and credit risk mitigation techniques, specific information is considered confidential and will not really contribute to market discipline. Being too complex, it will not improve understanding and weaken supervisory authorities' role

<u>6.3.4. Market risks (No. 662-664; Annex 4 of "Pillar 3 (Market Discipline)")</u>

Due to difficulties in making stress-test comparisons, it appears preferable to emphasize the use of VAR. Disclosure on VaR should only be based on the approved VaR at aggregate level.

<u>6.3.5. Operational risk (No 665-666; Annex 5 of "Pillar 3 (Market Discipline)")</u>

The fact that supervisors at present have no typology and no method for information gathering is highly unsatisfactory. Furthermore, the information to be disclosed should be only qualitative in nature, because intensive attention to the quantitative angle would certainly be penalized by the market.

<u>6.3.6. Interest rate risk in the banking book (No. 667-669; Annex 6 of "Pillar 3 (Market Discipline)")</u>

It seems inconsistent to treat this on one hand under pillar 2 due to there being no harmonized analytical methods common to all countries, and on the other hand include it under pillar 3 for standardized reporting. Generally, the proposed method seems unsatisfactory: The information might be misleading since risk profiles differ depending on the banks' assumptions. There is also a potential for generating an operational risk through the disclosure of assumptions or calculations of an interpretative character, which could lead to litigation between banks and investors. Some assumptions, conventions, or methods used are proprietary. Their disclosure could damage the competitive position of the disclosing institutions. Therefore the members of the EACB suggest confining disclosure of the requested quantitative data and the results of back-testing to supervisory authorities.

6.3.7. Capital Adequacy (No. 670-674; Annex 7 of “Pillar 3 (Market Discipline)”)

The Disclosure of economic capital has to be considered a confidential matter in so far as it reflects internal policies on how each institution allocates its own funds and their strategic priorities. The Proposals for disclosing market risk seem too detailed. The market risk disclosed should therefore be grouped together into three broad categories: interest rate, foreign exchange, and other.

6.3.8. Influence of IAS

IAS, particularly IAS 39, will impose new constraints on financial information: ‘Fair value’ accounting will result in own funds losing their stability and altering as much macro-cover as micro-cover when there are elements to be covered.

6.3.9. Disclosure in USA

A comparison with the annual reports of American banks makes it clear that they tend to draw on economic concepts more (VAR, Stress-test, fair value), but the general nature of the assumptions and the extent to which they are aggregated rebound to limit their scope very considerably.