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Basel Committee on Banking Supervision
Bank of International Settlements
CH-4002 Basel
Switzerland

Brussels, 31 May 2001

Subject: The New Basel Capital Accord – Euroclear Bank comments

Dear Sirs,

Euroclear Bank is pleased to provide comments and suggestions on the Consultative Document on the New Basel Capital Accord (hereafter “the Accord”), issued by the Basel Committee on Banking Supervision in January 2001.

We believe the Accord may have a significant impact on the banking industry in general, and on the repo and securities lending markets, securities settlement as well as collateral management services in particular. We would like to highlight our areas of concern and to suggest modifications to the Accord. Also, as the Accord will have an impact on the capital required by Euroclear Bank, we include comments and recommendations with specific reference to this effect.

We welcome the open approach taken by the regulators and, in particular, the decision to involve the banking industry in the discussion. We believe it represents an excellent approach in establishing a capital charge that is truly risk sensitive and correctly reflects the risk profile of each individual bank. Moreover, it will encourage banks to improve their risk management practices.

In general, we share and support the comments made by the European Banking Federation and the Belgian Banking Association.

Sincerely,

Theo Van Engeland
Chief Financial Officer & Member of Management Committee of the Board of Directors

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Content

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I. Credit Risk

New CAD and Euroclear Bank services

We share the concerns expressed publicly by active participants in the financial markets as to the relevance of the floor factor "w" in the calculation of collateral value. The "w" factor is intended to cover risks which are targeted in the operational risk charge. We would propose to drop the "w" factor or, at least, to extend the carve-out conditions to low-risk and well-documented transactions.

Carve-out conditions for government repo-style transactions (§102/103/104/105 and 160/162 – Standardized Approach)

We applaud the favourable treatment for government-style repo transactions. However, we strongly believe that the carve-out is too limited and does not recognise the established and well-controlled practices in the repo and securities lending markets. The currently proposed criteria for the carve-out focus on repo and securities lending activities involving government bonds where the cash and securities legs are denominated in the same currency and are settled in a settlement system "proven for that type of transaction in the jurisdiction or currency area in which the securities are issued".

Very substantial amounts of repo and securities lending activities are transacted on an international basis, reflecting the increasing globalisation and integration of the financial markets. Settlement of such transactions takes place either on the books of the international securities settlement systems, such as Euroclear, or through domestic settlement systems that may be located in a jurisdiction other than that in which the referenced securities were issued.

The well-controlled, vital and growing international repo and securities lending markets should be explicitely considered in the carve-out. Moreover, the enormous task of obtaining regulatory approval in each jurisdiction, that each securities settlement system would need to undertake, must be avoided.

⇨ *We therefore recommend that the Basel Committee amends the conditions for the carve-out as follows: "the transaction should be settled across a settlement system which has been regulated and approved by its own national*

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regulatory authorities for conducting such business"[1]. In addition, the condition that "both the exposure and the collateral must be denominated in the same currency" (§102-104) is only relevant for a zero haircut and not for a zero "w".

Carve-out limited to government securities
This carve-out (zero "w" and zero haircut) would, according to the Accord, only apply to domestic transactions in government securities: "both the exposure and the collateral are cash and a sovereign or PSE security qualifying for a 0% risk weight in the Standardized Approach".

The unfortunate effect of this carve-out is that it would penalise many other funding transactions employing equally robust credit risk management practices and involving other types of liquid securities collateral. For example, a lot of repo and securities lending is done through an independent triparty collateral agent, responsible for the valuation and mark-to-market duties. This agent executes (automatically or upon request) the daily transfers of securities and collateral between the parties' accounts at the bank, thereby minimising external transfers of cash and securities, and systemic risk.

Specifically, the following practices are standard in these transactions: use of master agreements (such as the PSA/IPMA Global Master Repurchase Agreement), daily marking-to-market of contracts to determine net exposures, daily re-margining to eliminate any net exposure, and substitution of collateral pursuant to pre-defined eligibility criteria for the collateral giver to gain more flexibility.

⇨ *We therefore request that the carve-out in §102/103/104/105 be extended to all types of eligible collateral as defined in §76 and, thus, not only to government securities.*

[1] Such regulatory approval could be based on the recommendations outlined in the Consultative Report of the CPSS-IOSCO Task Force on Securities Settlement Systems

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Custody risk (§93 Standardized Approach and §344 New Basel Accord)

§93: "where the collateral is held by a custodian, the bank must seek to ensure that the custodian ensures adequate segregation of the collateral instruments and the custodian's own assets"

§344 (Advanced IRB): in addition, "the bank must consider its ability to liquidate the collateral expeditiously where the collateral remains in the possession or under control of the borrower".

⇨ *We propose that the condition stated in §344 and applicable to Advanced IRB also be included in the conditions for the Standardized and Foundation IRB. Indeed, custody risk is a concern in any collateralised transactions and should not be treated differently in the various credit risk calculation methods.*

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Euroclear Bank capital requirements

Standardized Approach

- In option 1 (i.e. bank weighting determined by its country rating)
  - ⇨ *We propose to extend the possibility (currently available under option 2) of having a preferential risk weighting for short-term claims to option 1 as the same logic applies, i.e. short-term exposures carry less risk.*

- If the weighting for banks is determined by the country rating instead of the individual counterparty rating (option 1), there is a disincentive to use internal ratings as proposed under option 1; unrated banks are rare.

Internal ratings-based Approach

- Maturity adjustments should be possible in the IRB Foundation Approach. As Euroclear Bank's credit exposure is almost always overnight, it is very short-term in nature. Considering that the IRB takes a three-year maturity as its basis, we believe an adjustment for claims up to one year should also be foreseen (as in the IRB Advanced Approach).
  - ⇨ *We thus recommend that the one-year maturity basis be extended to the IRB Foundation Approach.*

- The requirement that no more than 30% of the gross exposure should fall within one borrower grade is meaningless: the Probability of Default (PD) does not change because there is more exposure in a particular rating class. Euroclear Bank's clients and their counterparties are high-quality, highly rated financial institutions, central banks and supranational organisations that may only be assigned a limited number of internal rating classes, without affecting the PD.
  - ⇨ *We propose that this condition be dropped*.

- The results of the Quantitative Impact Study show a disincentive in the use of internal ratings: specifically for BBB-ratings and below. This method compares unfavourably to the Standardized Approach.
  - ⇨ *To preserve the continuum principle within the various approaches for credit risk, we request a more adequate calibration of the IRB distribution, specifically for entities with higher PDs.*

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- Both the granularity adjustment and the EU directive on Large Exposures cover risk concentration:
  - ⇨ *Granularity and Large Exposure should be integrated to ensure that risk concentration is covered only once in the regulations.*

- The granularity adjustment is based only on large single-name exposures and does not take into account geographic or sector diversification within the credit portfolio. Considering the fact that Euroclear Bank has a limited number of client families, <u>the granularity adjustment has an excessive impact, not in line with Euroclear Bank's geographically diversified, low-risk profile.</u> This is yet another disincentive to use the IRB Approach.
  - ⇨ *We propose that the granularity adjustment be calibrated to specifically take into account portfolios for which the mapping to a homogenous portfolio results in a small number of exposures (less than 200). It should also take into account other risk-diversifying factors such as geographic and sector diversification.*

<u>Collateral</u>

- For Euroclear Bank, there is no incentive (under the form of a reduced capital charge) to apply a more advanced collateral calculation based on its own haircuts. Indeed, as end-of-day exposures are highly over-collateralised, a more advanced collateral calculation, resulting in higher collateral value, will have no impact on the capital required.

- Floor factor "w" (§154 – Standardized Approach): "There are two reasons for introducing the factor w: the first relates to the type of collateral and the second to the process on which the transaction is based, particularly the documentation and controls provided such as remargining. In both cases, there is a risk that the collateral may turn out worthless, so that an exposure that is apparently secured turns out to be unsecured".
  The minimum conditions for using collateral as a credit risk mitigation tool already include strict requirements with regard to "Legal Certainty", sound collateral management policies and processes, and so forth, which are designed to reduce the risks targeted by the "w" factor. Moreover, the risks targeted by the "w" factor are included in the Operational Risk Charge (e.g. Loss of Recourse), resulting in double counting.

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⇨ *As stated above, we recommend that the "w" factor be dropped or, at least, to extend the conditions for carve-out to well-documented, collateralised transactions.*

- Treatment of guarantees as risk mitigation: The proposal to use the weighted average of the weights assigned to the obligor and to the guarantor is not in line with, and in fact overstates the inherent risk.
  ⇨ *We propose to use a methodology that encompasses joint probabilities of default of both the obligor and the guarantor or, at least, to use the lowest probability of default of both.*

- We find that some definitions of eligible collateral may lead to prohibitive investment and maintenance efforts in database management, e.g. acceptance of investment funds as collateral requires information on the funds' investment policies.

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II. Operational Risk

Operational risk definition

We welcome the fact that regulators and financial market participants have reached a consensus on the definition of operational risk. This definition correctly encompasses the various factors giving rise to operational risk, while excluding reputation and strategic risk.

Since the definition includes legal risk, regulators should exclude legal risk from credit risk and market risk capital requirements. Otherwise, when applied to a particular institution, legal risk would be double counted. Accordingly, the definition and categorisation of credit events should be clarified to enable banks to more easily allocate the corresponding losses under credit risk or operational risk, depending on their cause. This would avoid confusion and eliminate the need for the “w” factor.

Pillar I: Capital Requirements

Scope of application

International Central Securities Depositories (ICSDs) are banks, and therefore fall under the scope of the Accord, whereas most national Central Securities Depositories (CSDs) are not banks. However, in their roles as settlement and custody agents, national and international CSDs incur similar risks. They can be categorised under the “Payment and Settlement” and “Agency Services” business lines.

⇨ *We therefore recommend that regulators extend the Accord’s scope of application to all Central Securities Depositories, or at least impose similar capital requirements for operational risk on CSDs that are not banks. This will improve operational risk controls within the sector and establish a level playing field among ICSDs and CSDs.*

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Calibration

It is important that the risk factors under the three approaches to calculate capital requirements are correctly calibrated in order to guarantee the continuum principle. Since the regulators' purpose is to motivate banks to improve their operational risk management practices, regulators should make sure that stepping up the continuum results in decreased capital charges for the banks. The investments made by banks to attain a better operational risk management framework should be properly rewarded through a significantly decreased capital charge.

It is also the area where the most work still needs to be done. At this stage, it is impossible for banks to assess the impact that the Accord will have on their capital, using the more advanced approaches.

In relation to calibration of the risk factors, the regulators should pay particular attention to the following issues, as further explained below:

- the operational risk charge compared to the overall capital charge;
- relevance of the data used as the basis for the calibration;
- avoidance of double-counting;
- linearity of capital charge in terms of size; and
- risk mitigating aspects, such as pricing, insurance and outsourcing.

⇨ *Given the current status of the calibration, and the resulting uncertainty about the impact of the various computation models, we recommend that regulators confirm the overall framework by the end of the year 2001, as intended. However, regulators should allow sufficient flexibility to perfect these computation models before implementation.*

⇨ *In addition, regulators should allow those banks that are ready for the most advanced approaches to use them and, as a result, benefit from a reduced capital charge, even if only two years of data are available (due to the delay in setting the framework).*

We hope that the Quantitative Impact Study currently under way (and any future studies) will help regulators properly calibrate the risk factors in order to define capital requirements that are not too drastic.

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Historic figures

The operational risk framework defines how to compute the capital charge, but it is not yet clear which figures to take into account (last term, last year, average of last three years, three or five-year data?).

One can debate the value of historic figures. One can hope that a bank properly managing its operational risk will learn from the past and improve its operational risk management practices, thereby reducing the risk of re-occurring errors. If the capital charge is based on average historic data, it will result in an over-estimation of the capital charge.

⇨ *Together with the European Banking Federation, we recommend a sliding scale weighting of data over the collection period, with more weight being given to more recent data.*

Basic indicator approach

We understand the need for a basic approach, but have serious doubts about the risk sensitivity of using gross income as the basic indicator. There is no proven link between operational risk/losses and gross income.

It is also important to establish common accounting standards when defining gross income before deduction of operational losses. This will ensure full compliance and fair treatment within the banking industry.

The actual calibration of the risk factor is also an issue. The 30% risk factor was based on preliminary studies with a very limited set of banks; it showed that the capital reserved by these banks included a 20% buffer for risks other than credit risk and market risk, i.e. operational risk, but also reputation and strategic risks. Operational risk, therefore, represents only part of the 20% buffer. The operational risk charge itself should, therefore, correspond to less than 20% of the current overall capital charge.

In addition, the limited set of research data, as well as the large variance at individual bank level, raises questions in terms of the statistical value of this calibration.

<u>Standardized Approach</u>

At this stage, it is difficult for banks to assess the impact of this approach on their capital requirements, since all of the risk factors are not available.

Business lines

- The qualitative criteria for the Standardized Approach include the fact that "banks will have to develop specific, documented criteria for mapping current business lines and activities into the Standardized framework." For banks to do that, regulators should provide clearer definitions of the different business lines.

- Although some of the operations run by custodians and asset managers are similar, their respective responsibilities are very different, implying lower risks for custodians. Under "Agency Services" we would include CSDs, custodians and banks offering agency services to issuers.

⇨ *We recommend that an "Agency Services" business line also be recognised under the Standardized Approach, as it is under the Internal Measurement Approach.*

This "Agency Services" business line is already recognised in the European Commission Consultative Paper.

Linearity

Although activity seems to serve as a better risk indicator than income, there is no proven direct link between size and operational risk. The linearity of the Standardized Approach is clearly a problem and will, with no good reason, put large firms at a competitive disadvantage. An increase in activity and size will often occur in parallel with more effective management, automation (including contingency measures) and economies of scale (allowing more investment in overall management, risk management, etc.). Overall, this usually results in a marginal decrease of risk per operation, both in terms of severity and frequency. For example, manual transaction processing results in very different levels of risk compared to straight-through processing. This should be reflected and allow banks to differentiate themselves from the industry average based on their true risk profile.

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If calibration is based on simple industry averages, then large entities with extremely high turnover values (value of securities settled) and assets under custody will be at a disadvantage. Because of that, the continuum principle may be broken for low-fee, high-volume businesses (i.e. the capital charge under the Standardized Approach would be higher than under the Basic Indicator Approach). As a result, some banks may be tempted to stay with the Basic Indicator Approach since that will result in the lowest charge, which seems to contradict the regulators' intent.

Cap

⇨ *In order to maintain the continuum principle, it would be a good idea to impose a cap on the capital charge based on the Basic Indicator Approach.*

<u>Internal Measurement Approach</u>

This approach is definitely one step ahead of the others in terms of risk sensitivity, as it is based on actual losses.

Loss event

While the definition of operational risk is now clear and corresponds to widely used categorisations, the definition of a loss event is still unclear. The incorporation of "near misses" or "latent losses" would raise issues such as trace-ability, and therefore, comparability between different institutions.

⇨ *We strongly recommend the use of booked P/L losses only. This will ensure easier trace-ability and comparability of data.*

In this respect, it is important to harmonise accounting standards so that losses are defined the same way for all banks (which will ensure fair treatment throughout the industry).

It is not clear at this stage whether such losses should be considered as gross or net of any recovery from, for example, insurance and/or service providers, nor how to take into account the timing of such recovery.

It is also important to clarify whether all losses, i.e. from the bottom up or from the first euro up, will be taken into account or whether a floor will apply.

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Recording all losses from the first euro up would result in excessive collection work and costs.

⇨ *We recommend the use of a minimum loss amount (e.g. EUR 10,000).*

Unexpected versus expected loss

The consultative paper rightly mentions that "conceptually, a capital charge for operational risk should cover unexpected losses due to operational risk". Banks will usually include expected losses in their financial planning and/or factor them in their pricing, especially in low-fee, high-volume businesses. These expected losses should, therefore, not be included in the computation of the capital charge.

Loss categorisation

First, the definition of each loss category needs to be made clearer. Similarly, activity indicators should be better defined to make sure they are really risk sensitive (e.g. value of transactions under Agency Services: what is it?).
Second, the loss categorisation is effect-based, although the definition of operational risk is cause-based. To reduce operational risk, banks will have to act on the causes rather than the effect. Therefore, is it advantageous for banks to develop a model/infrastructure that is effect-based and does not correspond to what banks will be monitoring to act on the causes?

Floor - Cap

The introduction of a floor is definitely a concern. Why should a firm operating on a large scale, but with a history of small losses, suffer a charge based on a percentage of the Standardized Approach? The fact that regulators are considering the use of a floor raises questions about the value of the calibration and the risk factors.

If the Standardized Approach is not properly calibrated for large firms, this floor, set as a percentage of the Standardized Approach, could result in a very high capital charge for large firms.

Calibration

Calibration is particularly important in this case, although it appears the most difficult to achieve, given the current lack of data. Correct calibration is key to motivate banks to move to this most advanced approach.

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Industry loss data

The use of external data and calibration of risk factors seem difficult at this stage, given the lack of an industry loss database. It is true that there are several private initiatives underway, although none seems to have emerged as the leader thus far. It would be a good idea for the regulators to take the lead in this area by setting clear standards, guaranteeing confidentiality and attaining critical mass.

RPI – Qualitative factors

We welcome the introduction of the RPI factor, as it will counter the fact that the risk indicators will be calibrated based on industry averages. However, we do not understand why the RPI should be set by the regulators, nor do we understand its basis. The regulators should, at least, define what criteria they will use to set the RPI.

In addition, there is a gap between the qualitative criteria proposed for the Standardized Approach and the Internal Measurement Approach and the corresponding capital charge formulas. The result would be that, qualitatively, banks will be at a more advanced stage in operational risk management, but will use a simpler computation method for the capital charge.

⇨ *We recommend that the RPI be based on the qualitative criteria, and, for example, on the control self-assessments or scorecards performed by the banks themselves.*

The RPI is only mentioned under the Internal Measurement Approach. If the risk factors are calibrated based on industry averages, a firm should always be able to reflect its better-than-average risk management practices through the RPI in the Standardized Approach as well.

Risk mitigation

Insurance

Insurance typically covers low-frequency, high-severity events rather than capital. Historically, banks have relied on insurance to cover such events. Why should banks pay insurance premiums if they cannot benefit from this investment through a reduced capital charge? We recognise that insurance raises issues such as standardisation of insurance policies, payment periods, and credit risk taken on

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insurers. But regulators should, at least, define minimum qualifying criteria. This would help financial market participants to define the preferred coverage of future insurance policies with insurers.

Outsourcing

Banks will usually outsource their non-core activities, for which they lack the specialised knowledge, the staff and the systems necessary to maintain an adequate risk control environment. To the contrary, the institutions offering outsourcing services will have these specialised resources and risk control. Moreover, when outsourcing their non-core activities to specialised institutions, banks will have more time and resources available to improve the control environment of their core activities. This should result in a decrease of their operational risk profile, and hence be encouraged by the regulators.

The Consultative Paper only stipulates that to benefit from a reduction in capital requirements, banks that outsource should demonstrate that an effective risk transfer has occurred.

The regulators should provide a clearer view on the scope of the activities eligible for outsourcing. In addition, we recommend that capital relief is granted not only to outsourcing of complete business lines, but also to outsourcing of certain activities. This would avoid double, or even multiple, counting of operational risk for the same activity by different institutions.

The criteria applicable in order to qualify for a capital reduction should also be better defined. In our opinion, it would be necessary, for instance, for the institution offering outsourcing services to be regulated for this kind of activity.

<u>Loss Distribution Approach</u>

It is true that there is currently no industry-recognised, tested and approved operational risk model. The possibility for such a model(s) to be developed in the future should be clearly recognised. Regulators should incorporate in the Accord the flexibility to use such a model(s) in the not-too-distant future.

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Pillar II: Supervisory review

The supervisory review will facilitate analysis of the qualitative aspects of operational risk management practised by banks. Why should this analysis only result in a potential charge increase, and not a potential charge decrease?

Some banks have developed comprehensive qualitative frameworks to manage operational risk, and continue to substantially improve their risk environment. This should be taken into account and be factored in to their advantage.