EUROPEAN SAVINGS BANKS GROUP
GROUPEMENT EUROPEEN DES CAISSES D'EPARGNE
EUROPÄISCHE SPARKASSENVEREINIGUNG

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Position Paper

on the Second Consultative Paper

THE NEW CAPITAL ACCORD

issued by the Basel Committee on Banking Supervision

on 16 January 2001

Profile European Savings Banks Group

The European Savings Banks Group (ESBG) represents 25 bank members from 25 countries (all EU countries, Norway, Iceland, Czech Republic, Hungary, Latvia, Lithuania, Malta, Romania, Slovak Republic) with total assets of 2,964 billion euro, total deposits of 1,700 billion euro, total loans of 1,561 billion euro, 1,000 savings banks, 74,000 branches and more than 700,000 employees. Its members are retail banks that generally have a significant share in their national domestic banking markets and enjoy a common customer oriented savings banks tradition, acting in a socially responsible manner. Their market focus includes amongst others individuals, households, SMEs and local authorities.

Founded in 1963, the ESBG has established a reputation as the advocate of savings banks interests and an active promoter of business cooperation in Europe. Since 1994, the ESBG operates together with the World Savings Banks Institute (WSBI, with 106 member banks from 86 countries) under a common structure in Brussels.

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1. EXECUTIVE SUMMARY

Improvements of the second consultative paper of the Basel Committee on Banking Supervision

The European Savings Banks Group (ESBG) welcomes the fact that, in contrast to the first consultative document published in June 1999, the current New Capital Accord contains several improvements. In particular, the ESBG welcomes the following proposed provisions:

- the Basel Committee's considerations that risk weightings should be carried out on a more differentiated basis than under the present framework;

- the consideration of a special treatment for mortgages and commercial real estate by applying a 50% risk weighting;

- the recognition of the Internal ratings-based approach (IRB approach) on the same footing as the External ratings-based approach;

- the Committee's intention to extend the Capital Accord to include "bank holding companies" on a fully consolidated basis.

Time Schedule for the Completion of the New Basel Capital Accord

The proposed Capital Accord leaves, however, important questions still open. The credit risk model on which calibration is based is unclear. This goes particularly for the ultimate size of future capital requirements. The 'Quantitative Impact Study II' is currently undertaken. But results of this survey will only be presented after expiry of the proposed consultation period. For this reason, it is difficult to properly assess the impact of the proposed rules. The ESBG is prepared to continuously contribute to the ongoing process and would appreciate an open exchange of views on the future regulation of those issues which so far have not been fully disclosed. In this respect, we request the Basel Committee:

- to disclose every single calculation step and models and methods used;
- to issue interim papers in the next three months about areas still being worked on (such as treatment of retail exposure, treatment of equity within the IRB Approach, project finance, operational risk, market discipline, etc.);
- to publish the results of the Quantitative Impact Study II and to explain in detail to the credit sector industry the conclusions for calibration of internal rating drawn from this study.

Given the complexity of the new Consultative Document, the 31 May 2001 deadline set by the Basel Committee for comments should, in our view, not terminate the consultation. On the contrary, the ESBG calls for the consultation process to be continued in the form of an open dialogue on these points even after the official deadline for comment has expired and – where necessary – even after adoption of the New Capital Accord. We feel that the credit sector industry should be given ample opportunity to provide its opinions during an ongoing and interactive consultative process. At the same time, the transitional period

between the publication and the entry into force of the new Basel Capital Accord should not be extended.

Internal Ratings-Based Approach (IRB Approach)

A. *Too High Risk Weights:*

One key point of criticism of the Basel Committee's internal rating requirements is that the risk weights in the IRB approach are much too high. These high risk weights are in our opinion mainly due to the fact that the Committee requires banks to cover not only their actual credit risk (unexpected loss) with capital but also the risk which banks have already covered via the risk premiums included in interest rates (expected loss). Moreover, the numerous safety cushions and haircuts imply that all potential crisis scenarios, errors and catastrophes will occur simultaneously with full force, which is, however, unlikely. It is therefore to be feared that capital requirements for corporate exposures will increase on average, resulting in poorer loan terms. This would impose an unreasonable burden on small and medium-sized enterprises in particular.

B. *Exposure Maturity:*

The percentage of long-term loans in continental Europe is much higher than, for example in the USA. The Basel Committee's Consultative Document foresees capital add-ons for long-term loans. This would seriously affect the international competitiveness of the European credit sector industry. Higher interest rates for borrowers would be the consequence which are not justified by the risk exposure.

C. *Partial Use:*

The rules on partial use of the IRB approach are, overall, too strict. They make it more difficult to qualify early for an IRB approach for supervisory purposes. Credit institutions should be allowed to exclude clearly definable business units, for which establishment of the required data history is unreasonable, from the IRB approach in general.

D. *Requirements Concerning Data History:*

The ESBG would like that until at least the end of 2006, a two-year data history should be stipulated for internal ratings. Moreover, there should not be any increase in requirements during the transition period.

Operational risk

The ESBG is concerned about the levels of capital that would have to be carried by credit institutions to cover operational risk. The Basel Committee's intention to gear the size of the capital charge for operational risk to a pre-determined result of 20% of the regulatory capital required appears arbitrary. This makes it more difficult to achieve the aim of establishing a risk-sensitive capital regime.

Market discipline

The amount of required individual data would lead to “information overkill” at the expense of transparency. It would no longer be ensured that information is clear and relevant. The principle holding that only significant information should be disclosed is cancelled out by the requirement to disclose roughly 1.000 individual items of data.

2. COMMENTS ON THE CONSULTATIVE DOCUMENT

PART 1: SCOPE OF APPLICATION

The ESBG generally welcomes the efforts of the Basel Committee to further standardise the scope of application of the Basel Capital Accord at an international level. However, besides the general comments regarding consolidation, the national authorities are endowed with far-reaching discretionary powers (e.g. the possibility to circumscribe the definition of a holding company or banking group, of securities firms, requirements for taking into account minority interests, the recognition of the surplus capital of an insurance subsidiary, the significance of minority-owned equity investments, significant investments held in important equity interests). This undermines the scope of application of the Basel equity capital provisions for consolidated supervision.

The ESBG cannot accept a mandatory sub-consolidation at every level, nor can the European Savings Banks agree to the deduction of third-party capital investments, especially in the proposed form, which is on the one hand undifferentiated and on the other hand imposes no limit on the discretionary powers at a national level.

The ESBG at this stage also rejects the deduction of investments in insurance subsidiaries for a variety of reasons (too undifferentiated, gives authorities at a national level sufficient room to employ other alternatives, prejudicial treatment puts banks at a disadvantage).

I. COMMENTS ON INDIVIDUAL ISSUES

A. Introduction

Para. 2. The ESBG welcomes the decision to extend the scope of application of the Accord to include holding companies. However, the definition of "banking group" as a group that engages predominantly in banking activities is not sufficiently clear and gives authorities at a national level greater possibility to act at their own discretion. A precise definition of a banking group would be required to obtain a uniform standard for the companies to be consolidated, such as is for example contained in Article 1, Para. 21, of the EU Directive 2000/12.

Para. 3. In order to ensure a reasonable level of capital resources the Basel Committee considers it necessary for full consolidation to apply at every tier within the group (sub-consolidation). Furthermore, according to the proposed Capital Accord, the requirement for sub-consolidation is waived only if the subsidiary company (which itself constitutes a lead company) deducts the book value of any investments in subsidiaries, which are financial, or credit institutions not included in the consolidation from its capital.

The requirement for sub-consolidation is not acceptable because sub-consolidation does not serve any additional purpose in regard to banking supervision. The alternative proposal made by the Basel Committee, which is to deduct the equity investments at the level of the subordinated institution, would imply a significant tightening of the current regulations (EU). One reason why such a procedure is inappropriate is because the consolidation of all group entities by the parent company would involve the complete inclusion of all risks that

exist in this group. It would therefore be proper to exempt a subordinated parent bank from deduction of equity investments.

Para. 4. The question of whether individual banks of a banking group should also be required to have a reasonable level of capital resources on a stand-alone basis should, as a competitive factor, not be left to the discretion of the supervisory authorities at a national level.

B. Securities and other Financial Subsidiaries

Para. 5. In order to establish an international level playing field it is essential that not only banks but also securities firms and other financial institutions are captured through the consolidation of financial holding groups. In this regard Item 5 is welcomed. Item 5 however also contains an exemption clause, since securities firms are only to be included in consolidation "where subject to broadly similar regulation or where securities activities are deemed banking activities". This soft wording makes it possible for the national authorities to take securities firms out of the group of companies designated for consolidation. From the perspective of Europe's financial industry such a procedure is unacceptable as it is not commensurate with EU regulations.

It should at least be ascertained in which countries the conditions referred to above – mainly the supervision of banking activities on similar lines – have been fulfilled.

Para. 6. Basel wants to leave it to the national supervisors to recognise "in consolidated capital the minority interests that arise from the consolidation of less than wholly owned banking, securities or other financial entities".

Generally, consolidation also involves the inclusion of all assets with contingent claims. This means that minority interests held by third parties also need to be taken into account in the consolidating company's regulatory capital. As, furthermore, the Basel Capital Accord requires the consolidation or deduction of interests whilst also recommending consolidation at every tier within a group and capital adequacy compliance by individual banks, an uneven distribution of the capital within a group is hardly possible and there is no double counting of capital, insofar as the owner of the minority interest is himself subject to the regulations pertaining to capital and deduction.

In addition, such a case (deduction of minority interests held by third parties) calls for the creation of a special provision for Special Purpose Vehicles (SPV) for the issue of hybrid capital, which, given a specific volume, is recognised by the Basel Committee under certain conditions.

Finally, the formulation by Basel Consultative Document, which leaves the inclusion or non-inclusion of third-party interests in the capital of the group at the discretion of the national supervisory authorities, is not acceptable because such discretionary powers at a national level will result in an uneven international level playing field.

Para. 7. The Basel Committee concedes that under certain conditions the consolidation of securities firms or other financial entities subject to supervision is not possible or desirable. This is also a very vague formulation and results in a broad variety of options,

which is not desirable. Any decision not to include companies in consolidation should be limited to ex ante precisely defined cases. (cf. also Article 52 of the Directive 2000/12).

C. Insurance Subsidiaries

Para. 9. and 10.

The Basel Committee believes it to be "in principle, appropriate" for banks' investments in insurance companies to be deducted.

The wording "in principle, appropriate" is not concrete enough and is, therefore, not acceptable.

The deduction of investments in insurance companies from the capital held by banks is generally to be rejected, as insurance risks are in principle different to the credit and market risks of financial entities. Furthermore, such an asymmetric regulation would result in "supervisory arbitrage" between insurance companies as parent companies and banks as parent companies, since banks are required to deduct the investments, while insurance companies are not required to deduct their investments in banks. The totally different nature of insurance risks and bank risks means that the risk of an investment in an insurance company is, in a worst-case scenario, limited with the loss of the actual investment. However, pursuant to current legislation, the risk of an investment is already covered by the eight percent underpinning requirement. According to the higher underpinning rate for risky investments that is proposed in the Accord, this risk would thus have to be underpinned with a maximum twelve percent (150% weighting) and not 1250% as in the case of the deduction.

The danger of competitive distortions is even greater because these alternative approaches and risk aggregation are not more closely defined.

Overall, it is clear that a single bank supervisory regulation cannot cover all the specific and cross-sectoral issues in connection with financial conglomerates.

Para. 11. and 12.

The ESBG assumes that the EU in the Financial Conglomerate Directive will consider both investments in insurance entities and the recognition of capital in entities that are consolidated. As neither the Basel nor the EU capital requirements make it possible at this stage to foresee what impact these new requirements will have on the capital of banks, the European Savings Banks propose that the entire issue "regulatory capital of a financial conglomerate" be postponed to a time after the new capital provisions have come into force so that it can then be regulated at an international level.

For the purposes of the current discussion the ESBG is therefore opposed to the proposals for the reasons mentioned at the outset.

Para. 13. When ensuring that insurance subsidiaries are themselves adequately capitalised, it is important to address the question of which capital adequacy criteria should actually apply.

D. *Significant Minority-Owned Equity Investments in Financial Entities*

Para. 14. Pursuant to the proposals of the Basel Committee, the threshold above which a minority-owned investment will be deemed significant is left at the discretion of the national supervisor. Here too, it is essential that a general uniform regulation is established to ensure a level playing field. The ESBG recommends that the regulations, which already exist in the EU, are also used here. The same applies to the pro rata consolidation of joint ventures, which is mandatory in the EU.

E. *Significant Investments in Commercial Entities*

Para. 16. Please refer to Para. 14. regarding a definition of the term "significant".

With regard to significant minority and majority investments in commercial entities that exceed materiality levels of 15% and 60%, this item should also make it quite clear that deductions can only relate to the portion, which exceed these levels.

Para. 17. It is not understandable why significant investments, which are below the materiality levels, have to be weighted at **no lower** than 100%.

The ESBG request that these investments be weighted commensurate with the rating, like those which are not significant (in the IRB approach equity interests will be treated separately in a category of their own. Further details are not yet available).

F. *Deduction of Investments in Deconsolidated Entities*

Para. 18. Investments which are deducted at an equal rate from Tier 1 and Tier 2 means that the deduction of minority investments will be subject to "stricter" provisions, on both a consolidated and a deconsolidated basis.

PART II: THE FIRST PILLAR – MINIMUM CAPITAL REQUIREMENTS

II CREDIT RISK – THE STANDARDISED APPROACH

A. The Standardised Approach – General Rules

The ESBG generally welcomes the refinement of capital allocation for regulatory purposes. Therefore the ESBG welcomes a more differentiated risk-weighting system.

1. Individual Claims

(i) Claims on Sovereigns

At national discretion, a lower risk weight may be applied to banks' exposures to the sovereign (or central bank) of incorporation denominated in domestic currency and funded in that currency. The ESBG advocates this provision under the precondition, that such national decisions will be disclosed and published worldwide. Furthermore, the ESBG demands for the allowance to credit institutions, which are located in another country to apply this lower risk weight as well for their claims to this sovereign without the need of any additional decision of their national supervisory authority (automatic mutual recognition of national discretions).

The ESBG also welcomes the possibility for supervisors to recognise the country risk scores assigned to sovereigns by Export Credit Agencies (ECAs). However, it must be assured, that these risk score schemes are not influenced by any political consideration.

(ii) Claims on Non-Central Government Public Sector Entities (PSEs)

The possibility to treat claims on domestic PSEs as claims on the sovereigns in whose jurisdictions the PSEs are established, subject to national discretion, must also be granted for credit institutions, that are located in another country (mutual recognition of national discretion).

(iii) Claims on Multilateral Development banks (MDBs)

No comments.

(iv) Claims on Banks

The ESBG advocates the unique application of Option 1 for claims on banks. At the same time, the ESBG demands for the extension of the preferential treatment of short-term-claims also to Option 1. This would be more risk sensitive and would lead to an alignment to the provision in Para. 33.

(v) Claims on Securities Firms

Claims on securities firms should be treated as claims on banks, and not only may be treated as such claims, if these firms are subject to supervisory and regulatory arrangements comparable to those under the New Basel Capital Accord.

(vi) Claims on Corporates

With respect to the first consultative paper of the Basel Committee, the ESBG demands to maintain the risk classification for claims on corporates within the 150 %-category. There is no reason to extend this category to credit assessments below BB-. The first proposals of the committee provided a 150 % risk weighting for credit assessments below B-.

(vii)- (viii)

No comments.

(ix) Higher Risk Categories

The risk weighting at 150 % for the unsecured portion of any asset that is past due for more than 90 days, net of specific provisions, is not generally adequate. Specific provisions have to be taken due to the principles of commercial prudence and must include that part of a claim which is exposed to default. For this reason, such specific provisions do not justify, in principle, the assumption, that the remaining unsecured portion of that asset is more risky than other performing loans.

In addition, a supplementary extension of the 150 % category is to be objected, because a risk classification should only be taken due to the individual quality of the borrower, not to the type of investment (except project finance).

(x) – (xi)

No comments.

2. External Credit Assessments

(i) The Recognition Process

No comments.

(ii) Eligibility Criteria

It is obvious, that the criterion “disclosure” imposes less severe requirements to external credit assessment institutions to disclose its methodologies, time horizon, meaning of each rating, etc. These requirements are much less detailed as those for the use of credit institutions’ internal ratings as they are described in pillar 3 (Market Discipline). This would lead to a massive disadvantage for the use of internal ratings which is not justified.

3. Implementation Considerations

(i) – (v)

No comments.

(vi) Unsolicited ratings

The ESBG has some considerable concerns about the use and the quality of unsolicited ratings for the same reasons, the Basel Committee has outlined in Para. 60. Furthermore, the general allowance to use unsolicited ratings would be in contradiction with the eligibility criteria of “Resources”, due to that an ECAI should have substantial ongoing contact with senior and operational levels within the entities assessed.

B. Credit Risk Mitigation in the Standardised Approach

The general impact of haircuts on collateral is regarded as excessive, as the proposed procedure makes the haircuts work on an accumulative level, leading to low collateral values in total. As, on one hand, any positive correlation between risk asset and collateral is not considered, on the other hand specific risks are considered twice:

- legal and administration risk using the "w" within collateral revaluation is considered within operational risks as well.
- volatility of the risk asset using HE within collateral revaluation and being considered within the capital to be allocated for credit facilities, which is necessary to cover the entire possible value of the risk asset.

As the general approach of the new regulations should be encouraging institutions to make use of collateral to improve their risk positions, the ESBG does not consider this very strict attitude of the proposal as motivation.

The following points are of special importance:

Para. 70. - 75.

Para. 70. requires that banks should obtain legal opinions, which should be updated e.g. annually, to confirm enforceability of collateral. To avoid unnecessary costs and administration, it has to be ensured, that the legal opinion can be issued by the banks' internal lawyer or an association (ISDA, etc.).

Although the paper does not accept the consideration of correlation effects between risk asset and collateral in favour of the institution, on the other hand it requires to avoid correlation between collateral provider and obligor without being very precise. The definition of "material" positive correlation needs further interpretation, the example given in Para. 72. of the draft is not sufficient. For example, a collateralised and highly rated bond issued by the obligor of a loan may of course be considered as collateral for the loan.

The strict requirement to operate under only one of the two approaches to the treatment of collateral enforces banks, to implement one procedure in all types of business areas, branches and subsidiaries without considering peculiarities of special business or foreign law, so that the economical impact and background of the business / collateral is completely neglected. A period of five years, starting with the introduction of the new capital accord should be accepted for partial use. This period would enable banks to implement a sound procedure, considering the important business areas first and adapt proceedings at a later stage, where necessary.

Para. 76. – 148.

With regard to collateral instruments listed in the paper, security firms should be treated as banks (76., etc.). In addition, commodities and life insurance contracts (capital insurance only) should be accepted as collateral.

The criteria requested for the acceptance of non-rated bonds should be modified in that way, that bonds **eligible** for trading on a recognised exchange, but not necessarily listed are accepted. Instead of senior debt only any debt not subordinated should be acceptable. Additionally, conditions described under c) and e) should be eliminated, as otherwise any subordinated issue of a bank with a lower rating than BBB would prohibit the acceptance of this bank in general. The confirmation of the supervisor for each issue on an individual basis is not a practicable procedure.

The factor "w" included in the formula proposed for calculating the collateral value should be eliminated. As already explained, the "w"-factor has been included to cover any risk resulting from imperfect contracts, legal problems, etc.. These risks are on the other hand included in Part V "Operational Risk" of the paper. To avoid double calculation and coverage of the same risk type, the "w" itself as well as any relating calculations (floor factor, etc.) should be eliminated (compare e.g. Para. 80., 100., 103., 132., 143., etc).

In addition, credit derivatives should be treated in the same way as guarantees. There is no need for a stricter treatment as proposed in Para. 145, requesting a "w" of 0,15 for credit derivatives with banks. The credit derivative business is realised within a transparent market and is usually based on standardised agreements (e.g. ISDA), so that remaining risks resulting from these transactions are not higher as those ones of guarantees.

As the requested consideration of liquidity of lower-quality assets is hardly precise, Para. 94. of the draft should be eliminated.

In general any specific national rule (e.g. Para. 105. of the paper) should be made transparent to the market and become valid in other jurisdictions as well. Otherwise no level playing field would be achieved.

Para. 111. refers to the simple collateral approach. The exceptions described for not considering the 20% floor should include the net exposure resulting from derivatives as well. The currency match required in condition a) can be eliminated, as this is requested as a main condition already. For the consideration of securities issued by sovereigns / PSE, a haircut of 10% is considered as sufficient, as these securities are of high quality and do not bear major market risks.

The haircut FX is proposed to be 8% as a minimum. This is considered to be a very strict rule, which in addition does not reflect correlation effects between two currencies.

The reference made in Para. 115. regarding maturity mismatches should exclude the rules requesting a minimum maturity of one year.

The ESBG would like to state that guarantees and credit derivatives must not increase other risks in any case, although this may happen in individual cases. Para. 116. should be modified respectively.

To avoid interpretation problems, Para. 121. should include a clear reference, when a direct claim on the protection provider is requested: ".., in the event that the original obligor fails to make the payment(s) due."

This is valid for Para. 125. as well, where condition a) should include the reference ".....outstanding under the loan *and guaranteed / collateralised,...."* Condition c) should be eliminated, as this condition would not allow partial guarantees.

Para. 127. should be eliminated as booking procedures are depending on national accounting standards. As far as these standards are not identical, there will be no basis for this requirement.

As the restriction to certain types of credit derivatives does not consider further market development, the ESBG proposes the elimination of Para. 128. Otherwise new products would not be accepted as collateral until the official sign-off of the Basel Committee is achieved.

The refusal of materiality thresholds (Para. 131.) resulting from collateral agreements is not in line with existing market standards. Smaller thresholds are necessary to cover errors and misunderstandings within the payment procedure. The ESBG proposes to modify this rule in a way, that instead of capital deduction the materiality thresholds are treated as uncollateralised position.

The regulations proposed for the consideration of collateralised tranches of assets (Para. 136. – 140.), which are differentiating between junior and senior tranches, should include a cap in that form, that the total capital requirement (including capital deduction) will not exceed that on an otherwise identical loan for which there is no credit protection.

The ESBG understands the proposed treatment of option rights explained in Para. 147. in that way, that it refers only to option rights in favour of the guarantor / protection seller, except step-up features, which are usually structured in favour of the protection buyer. Any plain vanilla option which enables the protection buyer to terminate the collateral agreement, should not be considered as maturity mismatch, as otherwise advanced repayments of the underlying cannot be covered as necessary.

Para. 148. concerns the proposal not to accept a maturity mismatch for hedges of less than one year. This rule would discriminate short-term transactions as well as long-term transactions with a remaining maturity of less than one year. To avoid this, the ESBG proposes to modify the requirement in that way, that the maturity mismatch for transactions of less than one year is restricted to a maximum period of three months.

The requirement that regulatory capital recognition should depend on the fulfilment of disclosure requirements (Para. 149.) is not acceptable. The publication of information on quantitative disclosures according to Para. 654.-656. should be voluntary for institutions.

III INTERNAL RATINGS BASED-APPROACH (IRB)

A. Mechanics of the IRB Approach

1. Categorisation of the Exposures

(i) – (iii)

No comments.

(iv) Definition of Retail Exposures

Para. 156.

The definition of exposures to individual persons should be based on the following criteria:

- Recipient of the exposure
- Product criteria
- Low-value of an exposure
- Large number of exposures.

The ESBG would like to comment on this proposed definition as follows:

The inclusion of small businesses/trades/the professions, in addition to natural persons, in the category "Retail Exposures" should be regulated directly by the Basel Accord and the EU Directive; their inclusion should not be exclusively subject to national discretion.

The definition of a small business should be based on turnover. Product criteria would not be feasible for this purpose because when customers in this segment default on a loan this is not related to the products used by the customer.

The second criterion should be the size of the exposure. In this regard it would make sense to set a maximum loan amount for each individual product. A minimum requirement would be to differentiate between mortgage loans and other loans. The focus should however be on the borrower's overall exposure, which should not exceed a certain amount, which still has to be defined.

Nor is it expedient to use the "number of exposures" as a criterion for the categorisation of retail exposures. One reason why it is not appropriate is because the criterion "large" cannot be applied from the outset when a new product is introduced, which results in a break in the method used.

(v) Definition of Project Finance Exposures

Para. 157.

It is necessary to clarify whether this definition should also cover exposures for property development (e.g. construction of subsidised housing).

2. Adoption of the IRB Approach across all Exposures

Para. 159. and 160.

Banks which make partial use of the IRB approach are required to coordinate a challenging and detailed plan with the regulatory authorities to the effect that they will apply the IRB approach across a) all exposure classes, and b) across all relevant business units "within a reasonably short period of time".

In this connection the possibility of making "partial use of partial models" should already be included in the Basel document and the EU Directive. In other words, it should be possible for banks to apply the standardised approach and the IRB approach simultaneously for individual portfolios and units, with equal recognition being given to the two approaches (no cherry picking!). This is considered necessary because certain activities like acquisitions and the penetration of new business segments involve a period of preparation (historical time series for at least five years?) for the development and implementation of internal systems and procedures. Furthermore, the application of the IRB approach to non-significant business segments is for instance not always expedient (whilst this is at present proposed by the Accord, it is "subject to national discretion").

Additionally, the transition periods for segments, which are treated in the beginning of the standardised approach and which should be calculated with the Foundation IRB approach within a reasonably short period of time, should be adapted, e.g. the same periods should be defined as for segments which are included from the beginning into the Foundation IRB approach.

3. Adoption of Elements of the Advanced Approach for IRB

Para. 161. and 162.

Here too, the ESBG advocates a "partial use" approach by banks for the reasons stated above (again with the proviso that there is no cherry picking). For banks using the advanced IRB approach any duplication of the calculation of capital requirements should at any rate be avoided.

4. Transition Period for Data Requirements under the IRB Approach for Corporate, Sovereign, Bank and Retail Exposures

Para. 163. – 166.

During a transition period of 3 years after the new agreement on capital requirements has taken effect, the historical observation period used for estimating the probability of default (5 years) can be shortened (subject to the discretion of the national supervisor). Banks would thus embark on their transition period with a historical observation period of 2 years and reach the required 5 years only at the end of the transition period. This should apply to corporate exposures, bank exposures, government exposures and, as appropriate, retail exposures.

The passage, which states that the aforementioned, more relaxed standards can be applied at the discretion of the national supervisor, should be unconditionally deleted.

In our opinion, the transition period is too short. In order for banks to comply with the proposed requirements, the implementation of the internal rating systems would have to be concluded by the end of 2001. The data for estimating the probability of default would have to be collected and recorded as from 2002 in order to fulfil the minimum requirements for a two-year historical observation period when the new Accord takes effect in 2004. One reason why the implementation of the internal rating systems cannot be concluded by the end of 2001 is because it is only then, at the end of 2001, when all the requirements will probably be known through the publication of the new paper. The regulatory authorities will still be working on many issues contained in the paper throughout 2001 in order to put in concrete terms the requirements which are in some cases still very loosely formulated. This for instance applies to retail customers and project finance, where the paper points out that a more detailed formulation can be expected only in the course of the year after the banks have provided their feedback on the proposal.

The consultative paper furthermore requires that banks, from 2004 onwards, already use rating systems, which for the most part meet the minimum requirements outlined in the draft, for at least three years. This is on the one hand inconsistent with the requirement for a two-year historical observation period, and on the other hand some of these minimum requirements are not yet known, as stated above.

An historical observation period of at least five years is mandatory for all banks which do not use the foundation IRB approach from 1st January 2004 onwards. This period is deemed to be too long, and an historical observation period of three years is considered to be sufficient.

5. Derivation of Risk Weighted Assets under IRB Approach

No comments.

B. Rules for Corporate Exposures

1. Risk Weighted Assets for Corporate Exposures

(i) Formula for Derivation of Risk Weights

Para. 171. – 177.

Risk weights are derived with the help of a continual, constant function which is dependent on the probability of default (PD), the loss given default (LGD) and the maturity (M). The maturity is explicitly only taken into account in the advanced approach, while the foundation approach assumes an average maturity of three years for all exposures.

The risk-weighted assets are the product of the weighting of risks and the exposure at default that is calculated pursuant to the Accord.

Please note: the benchmark risk weights (BRW) and the risk weights were calibrated by taking into account the expected loss. Banks normally only underpin the volatility of the

expected loss, the so-called unexpected loss, with economic capital because the expected loss is usually already taken into account in the pricing via the standard risk costs and also in the loan loss provisions. The expected loss component is thus taken into account twice over, which cannot be justified.

This calibration method is moreover also inconsistent with the regulatory requirement outlined in Para. 291., which states that the creditworthiness should also be reflected in the terms and conditions of the loan.

In this regard it is necessary to discuss and clarify which types of losses should be underpinned by capital, and with what amount.

Nor is the use of credit risk models for calibration by the regulatory authorities (Para. 164. Supp Doc) consistent. An adequate calibration assumes the employment of *valid credit risk models*. The regulatory authorities do however not assume this because appropriate models could otherwise also be used to calculate the funds required to underpin equity capital.

Here the banks require that all methods, parameters and models used for calibration by the supervisors are disclosed, so that banks know and understand how risk weightings are calculated by the regulators.

An important requirement is thus that credit risk models are recognised:
If these models are used for calibration by the regulatory authorities, they should also be recognised by the regulatory authorities.

It is emerging, that the values assumed by the Basel Committee for the internal rating, for example for the risk weighting resulting from the individual functional relationships, are to be set far higher than those resulting from the calculations of savings banks for their economically necessary capital. The reason is, that the Committee now also wishes to include in the consideration of capital the expected losses, which are normally absorbed exclusively by setting aside provisions, i.e. the structure of the conditions and the provision for the risks in the context of the accounting, for example through specific provisions. This represents an extremely surprising turn in the consideration of the basic understanding and the real function of capital as a “risk buffer” for unexpected losses.

Therefore, the ESBG calls for an adjustment of the present calibration of the internal rating on the basis of unexpected losses.

This correction would lead in addition to a much more “plain level playing field” between the EU and the US, because for reasons of national accounting rules, specific provisions are not taken in every member state of the G10 countries in the same extend.

It is also the fact, that the inclusion of expected losses into regulatory capital requirements leads to competitive distortions to the debit of especially small and medium sized enterprises, because the negative effects of this inclusion are leveraged in higher risk categories.

In general, the provisions of the capital accord for credit risk management and accounting standards should be brought much more in line in order to have an integral coherent system of rules and requirements.

(ii) Inputs to the Risk-Weight Function

Para. 178. – 234.

(a) Probability of Default:

The following is a definition of PD:

"The PD of an exposure is the greater of the one-year PD associated with the internal borrower grade to which that exposure is assigned, or 0.03%".

In this regard the Supporting Document gives preference to the average PD per grade over the individual PD of the borrower for regulatory purposes.

The ESBG questions the reason for the floor of 0.03%. In some cases, a borrower's PD is actually lower; this should also be taken into account by the regulatory authorities.

Furthermore, by giving preference to the average PD per grade, borrowers in the same grade all have the same PD. For internal bank use this can result in a classification that is too rough, especially for borrowers with large exposures. In the banks' own models these are often presented as individual clusters with their own PD. This alternative approach should therefore also be permitted for internal use.

If a transaction is backed by a guarantee or credit derivative, the principle of substitution will continue to apply for all approaches as before.

Pursuant to the foundation approach this involves linking the recognised collateral to a borrower rated not lower than "A" or to a comparable internal rating. In this connection the ESBG requests that the rating of the borrower be at least "BBB" or a comparable internal rating.

Furthermore, the ESBG believes also that $w = 0.15$ is unacceptable for the reasons which have already often been stated (e.g. double counting of operational risk).

(b) Loss Given Default (LGD):

The loss given default – this is in principle the size of the loss – is determined by the regulatory authority in the case of the IRB foundation approach. Under the advanced approach the LGD is calculated by the respective bank.

The following applies pursuant to the foundation IRB approach:
- 50% LGD for unsecured claims and claims supported by non-recognised collateral;

- 75% LGD for subordinated claims.

The national regulatory authorities can decide whether they should create a "further" definition for the concept of "subordinated". At this point it is important to establish *uniform* regulatory criteria in order to eliminate, as far as possible, any differences between the relevant countries.

Generally, a more differentiated approach, based on the type of transaction, should be adopted for determining the LGDs.

Commercial real estate, residential real estate:
Under the present procedure - subject to compliance with certain minimum requirements which are very strictly formulated - the size of the LGD for these mortgage loans is fixed at between 40% and 50%, depending on the ratio of collateral value to nominal exposure.

The effective LGDs are determined on the basis of the threshold levels of the ratio C (collateral) to E (exposure):

Case	Condition	Effective LGD	Treatment
Case 1	C/E ≤ 30%	50%	as unsecured
Case 2	C/E>140% ⇔ E/C < 100/140=71%	40%	Floor-LGD
Case 3	30%<C/E ≤ 140%	{1-[0.2 x (C/E) /140%]} x 50%	Weighted average based on on secured a unsecured LGD

This type of collateral is thus treated in a very disadvantageous manner. This is because only the portion of the exposure which does not exceed 60% of the collateral value or 50% of the market value of the real estate is assigned an LGD of 40%. The remaining portion of the loan is assigned an LGD of 50%. In view of the strict and detailed minimum regulatory requirements, the ESBG believes that the LGD should be further reduced here.

(c) Maturity (M):

225. – 228.

The Foundation IRB Approach

The IRB foundation approach assumes an average maturity of three years for exposures. While this approach benefits some of the products (such as mortgage loans), it puts banks at a significant disadvantage in regard to the short-term overdrafts extended by them. If the remaining period to maturity is taken into account, it would be necessary to undertake a further segmentation along product lines and maturities to ensure that the risk is adequately represented. In general, it is here again not quite clear why the maturity of the transaction needs to be taken into account to measure the risk, given a one-year observation period.

The Advanced IRB Approach

Within the consideration for an explicit maturity dimension in the advanced approach, the maturity adjustment factors proposed by the Basel Committee cause a over proportional leverage effect on long-term investments. Such a treatment of long-term exposures would lead to a considerable danger for long-term investments, which are an essential part of the continental Europe culture of financial markets and, in general, for the stability of financial systems.

The mark-to-market approach for maturity adjustment proposed by the Basel Committee, could only be acceptable, if the expected losses will be excluded out of the spread. But, the ESBG prefers – with the same restriction in use – a maturity adjustment on the basis of the default mode.

(d) Measurement of the Exposure at Default (EAD):

In the case of on-balance and off-balance sheet transactions the exposure is measured after deducting EWBs.

The process of breaking the borrower's business down into three components (on-balance sheet transactions, off-balance sheet transactions, OTC derivatives) to measure his exposure at default remains unaffected.

1. On-balance sheet:

   EAD = nominal amount of the exposure after this is netted with the deposits of the company in question (requirements pursuant to the standardised approach, mismatched currencies or maturities are treated pursuant to the standardised approach)

2. Off-balance sheet (traditional transactions involving exposures which have been committed but are undrawn):

   EAD = exposures which have been committed but are undrawn * credit conversion factor (CCF)
   EAD is in this case the credit equivalent amount.

   Foundation approach:

   A credit conversion factor of 75% is applied, regardless of the maturity bands, to all credit lines apart from those which are uncommitted, the facilities which are unconditionally cancellable or that provide for automatic cancellation, for example on account of a deterioration in the borrower's creditworthiness, at any time by the bank without prior notice.

Advanced approach:

The CCF and thus the EAD can be estimated by the bank provided that it is in a position to reasonably monitor historical and anticipated average drawings of facilities.

3. Off-balance sheet (OTC derivatives):

EAD = replacement costs + add-ons according to maturity bands/transaction type (potential future exposure, PFE)

Foundation approach:

Identical to the existing approach, also in regard to the percentage rates in the matrix.
Exception: the 50 % cap is no longer applicable.

Advanced approach:

Banks may estimate the PFE on the basis of their own models insofar as it is possible to set adequate additional requirements for the estimates within the consultation period.

Comments to off-balance sheet transactions:

It is proposed to raise the CCF for loan commitments from 20% (original maturity up to one year) or 50% (original term of more than one year) in the standardised approach to 75% in the IRB foundation approach, irrespective of the original maturity. All CCF's are independent of the borrower's creditworthiness.

It needs to be stated here why the CCF was raised for the IRB approach – because this signifies a weaker position relative to the standardised approach. The requirements for the standardised approach should also be applied here: 20% irrespective of the maturity; the basis should be the remaining period to maturity and not the original maturity.

2. Minimum Requirements for Corporate Exposures

These requirements to ensure high standards of quality should focus on the ability to establish forecasts and on the accuracy of the statistical procedures that are employed. The evaluation of the quality of the forecast should therefore explicitly be given top priority.

(i) Composition of Minimum Requirements

Para. 235. and 236.

The regulatory authorities define minimum requirements which the banks are required to meet if they want to use the IRB approach.

(ii) Criteria to ensure a meaningful Differentiation of Risk

Para. 237. - 243.

A rating system must differentiate between the risk of borrower default and transaction specific factors. In addition, it must provide for a meaningful differentiation of risk.

The term "rating system" embraces all methods, processes, controls, data (collection) and IT systems that support the assessment of credit risk, the assignment of internal ratings, and the quantification of loss estimates. The rating system must have two components:

- The first component must be oriented to the risk of borrower default (same borrower rating for all exposures).
- The second component takes into account transaction specific factors.

The rating grade structure proposed by the regulatory authorities:
- 6-9 borrower grades for performing loans;
- at least 2 borrower grades for non-performing loans
- resulting in not less than 8 borrower grades.

The supervisor determines whether the number of grades is appropriate, but the minimum number of grades may not be undercut. The exposures should be "meaningfully" distributed across the grades (no more than 30% of the gross exposures in one grade).

It needs to be clarified here why a pre-determined number of grades is still proposed despite the application of a constant function for risk weights. Moreover, the problem of mapping internal borrower grades in line with regulatory borrower grades no longer exists.

In a rating system, the quality of the forecast of a borrower's creditworthiness cannot be guaranteed by the requirement for a certain minimum number of grades.

It is not expedient to limit gross exposures per grade to 30%, and is a proposal which banks wanting to service specific customer segments cannot implement. See comments below on the granularity factor.

(iii) Completeness and Integrity of Rating Assignments

Para. 244. - 247.

A rating must take place before a loan is granted. The rating is to be undertaken or reviewed by an *independent* unit (applies to the initial assignment of a rating and to the ongoing review of the rating during the term of a loan). The rating is to be updated at least once a year during the term of a loan, but more frequently in the case of certain other loans such as problems loans or loans granted to higher risk borrowers. Loans should be reviewed if important new information becomes available. Banks must establish suitable processes to obtain relevant up-to-date information.

The term "independent unit", in particular, needs to be more accurately defined. A person's or unit's remuneration may not depend on the rating assigned by it, nor may it derive any other benefits from ratings assigned by it. If this is interpreted in a narrower sense, this means that ratings are reviewed by a unit which is not associated with sales and operative risk management. It is currently in part not universal practice to place such requirements on organisational structures in the area of credit risk. The implementation of these requirements would involve substantial organisational changes.

(iv) Oversight over the Rating Systems and Processes

Para. 248. - 257.

(a) Oversight by the Board of Directors and Senior Management

The requirements placed on the management are in part excessive (e.g. an *ongoing* dialogue between management and credit risk control and internal audit).

The European Savings Banks propose the following procedure: the rating procedure and possibly changes to these procedures are to be approved by the management. The management must ensure that the models are properly implemented, applied and recorded. Furthermore, that the management is informed of developments, of the ability of the models to present accurate forecasts, and of the limitations of the models at *regular* intervals.

It would make more sense to include the details to the items "Documentation, Assumptions of Models" under one single point.

(b) Internal and External Audit

The internal auditors must review the rating system (in quantitative and qualitative terms) at least once a year. The supervisors can request an audit to be performed by external auditors.

(c) Credit Review Function

The function of the credit risk control unit is to be independent of the unit which is responsible for a bank's operative business (e.g. the unit which takes decisions regarding the granting of loans). The credit risk control unit is to be responsible for the following areas: the design, implementation and performance of the rating system, assigning and/or reviewing and monitoring internal ratings, production and analysis of credit risk reports, ensuring that procedures are in place which reveal any failure to comply with internal guidelines and any inconsistencies in the rating system, documentation of changes to the rating process, accompanied by the reasons for such changes.

(d) Quality of Staff

The employees who are responsible for the rating process should be adequately qualified and trained. Management must allocate sufficient skilled and competent resources to these functions.

The requirements of the supervisors are here based on the guidelines for securities trading. The same applies here to what has been stated above, namely that it is currently in part *not* universal practice to place such requirements on organisational structures in the area of credit risk. The implementation of these requirements would involve substantial organisational changes.

The proposal which states that national supervisors may, at their own discretion, request (without prior notice) an external audit of the bank's rating assignment process and estimation of loss characteristics is not acceptable in this form.

An audit of the rating systems by external auditors (it is not clear who – still needs to be defined) has only to be performed when:
- the IRB approach is introduced
- the rating systems are modified to any significant degree.

(v) Criteria and Orientation of the Rating System

Para. 258. - 269.

Specific rating criteria: A bank must have a specific rating system, specific processes and criteria for assigning an exposure to a borrower grade. A bank should document carefully the source and critical decision points that led to the choice of its internal rating criteria.

General rules on risk assessment process: A bank's assessment of risk should be conservative. The rating decision should consider the quality of financial and other information, and move beyond accounting information as needed.

Assessment horizon: A bank must assess risk factors for the future ("conservative view of projected information"). For risk quantification (the process of assigning PDs to grades), a one-year horizon is used. The assignment of ratings to a borrower should ideally involve a longer horizon (term).

Criteria on risk assessment of a borrower: The bank must demonstrate that its criteria cover all factors that are relevant to the analysis of borrower risk.

Specific criteria for the use of models within the rating process: The variables used in a model must have statistical power and the model should capture all key variables. The variables not considered in the model should be focussed on in the risk assessment conducted by expert personnel. Model-based rating assignments must be subject to review and approval by staff in the credit risk control unit.

Exceptions to rating criteria: Clear guidelines and processes are required for cases where human judgement has overridden an output of the model. Where ratings have been assigned to a borrower on the basis of expertise, banks must clearly articulate the

situations in which employees may modify the result of the rating process, and they must state how and to what extent such changes may be done, and by whom.

Here it is not clear when it is possible to move beyond accounting information ("as needed").

Besides quantitative elements based on data from annual financial statements, rating systems also incorporate qualitative elements (e.g. market position or management quality).

The requirement that *all* relevant indicators/factors (a list is provided) be taken into account, should be dropped. The inclusion of additional risk factors does not necessarily improve the statistical quality of a forecast. Furthermore, models with only 3-4 variables can have a high forecast quality without taking into account all "relevant risk factors".

(vi) Minimum Requirements for Estimation of PD

Paras 270. - 283.

Estimation using reference definition of default:

The regulatory authorities require the establishment of a reference definition in order to ensure a consistent approach. The definition reads as follows (Para. 272):

Proposed Reference Definition of a Default Event for the IRB Framework:

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

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

Banks must prove that their definition of default is consistent with that of Basel. The definition is to take account of the fact that most banks link their definition of default to specific instances where default has taken place.

Comments: The main problem of this wording is that banks are required to identify and store *all* default events listed above. From our perspective, a default event is when a bank sustains a probable financial loss.

For regulatory purposes, a default event could be defined as above with the following restrictions:

- Every credit institution should be required to establish within the institution *one* of the points mentioned above as a method of measuring the probability of a financial loss.

- The above-mentioned reference points differ only in regard to timing. This difference can be offset either by taking into account the recovery rate or via the amount of the LGDs.
- The amount of the LGDs should consequently also be adapted to the banks' definition of "default".

The risk weights should therefore be calibrated on the basis of each bank's definition of "default". A uniform definition of "default" as a uniform risk measurement method for banks by the regulatory authorities would in many cases mean that the procedures applied by each of the banks would not be in line with such a system. This would therefore strongly interfere with the risk management procedures already applied by the institutions. In addition, individual default-related data that is readily available could then no longer be used.

<u>(b) – (g)</u>: One-year PDs must be estimated for each grade. For this purpose, the historical long-term average (over and beyond the cycle of a loan) of the relevant grade is to be used as a basis for a forward-looking estimate. These need to be considered as soon as new information becomes available. Furthermore, all estimates need to be reviewed on an annual basis.

Qualitative subjective elements should be used with a conservative bias (personal judgements) in addition to the application of quantitative procedures. It is not at all clear why the quantitative results should be adjusted only with a conservative bias. It is equally conceivable that the bank making a judgement may consider the quantitative results to be excessively high and make downward adjustments. This may be based on a very favourable forecast for the market in question and the anticipated market position of the borrower.

The process of mapping to external data makes it difficult for banks to provide evidence for the comparability of external and internal rating criteria because rating agencies are reluctant to furnish details of their rating methods. In this connection the ESBG again requests that the requirements for external rating agencies be the same as those for internal rating models.

The ESBG has already commented on the length of the historical time series.

<u>(vii) Data Collection and IT systems</u>

Para. 284. - 288.

All data collected over the period must be stored, and they constitute the basis for supervisory reporting and for the disclosure requirements under Pillar 3. The periods for the storage of data should be defined.

<u>(viii) Use of Internal Ratings</u>

Para. 289. – 301.

The regulatory authorities require that the internal rating systems are in fact also used by the banks, which generally makes sense. However, the requirement by the regulatory authorities that this information be used to determine the terms and conditions of a loan goes too far since this interferes with the banks' business policy. This decision must rest with the banks themselves.

It is not clear what is meant by the requirement for "*daily* risk measurement". In Para. 249 reporting on a monthly basis is required. For this reason, risk measurement should also be on a monthly basis. Shorter intervals are not expedient. The word "daily" should be replaced by "current".

The requirement for internal ratings to serve as input into a bank's credit risk model which is part of internal capital allocation is generally welcomed. However, this once again raises the question why then the models are not recognised by the regulatory authorities.

This non-recognition means that the internal and external calculation of equity will again diverge because only one component of internal risk management, namely the internal rating systems, are recognised by the regulatory authorities.

Regular stress tests should be performed by the banks. The requirements from the supervisors for stress tests should be seen as an evolutionary process, that means that bank internal stress scenarios have to be defined in accordance with the portfolio structure and stress test should be performed.

(ix) Internal Validation

Para. 302. – 308.

Comments: The validation requirements – especially the mandatory testing of this model by means of statistical tests – can be a major impediment for the implementation of the foundation approach. This field will receive significant supervisory attention prior to allowing a bank to adopt the IRB approach.

It is not clear what is meant by "rigorous statistical testing of the dynamic stability of the model and its key coefficients". The question here is how this is to be done for expert systems.

The requirements for carrying out the internal validation process are defined in very vague terms; the ESBG would recommend that discussions take place between the regulatory authorities and the banks to establish a common definition for these criteria.

(x) Disclosure Requirements

Para. 309.

The disclosure requirements, which must be met in order to be eligible for the IRB approach, constitute a minimum requirement for all credit institutions which select this approach. As such, these requirements must be complied with.

In principle, the European Savings Banks however believe that the very comprehensive disclosure requirements will result in substantial administrative work and high costs for the banks. In the final analysis, this will give rise to a massive flood of information. The ESBG therefore believes it is necessary to significantly reduce the number of disclosure requirements.

The requirements that are mentioned place heavy demands on data collection, data testing and on technical implementation, which are for the most part out of all proportion to the actual information obtained.

The ESBG believes that the disclosure of all information that is stated is excessive. A sound understanding of risk factors and the models is necessary in order to properly interpret this plethora of complex information. The ESBG therefore request that such disclosures are not required <u>in combination with the application of the IRB-approach</u>, but the ESBG are in agreement that such analyses be made available to the national supervisors.

<u>(xi) Minimum Requirements for Supervisory Estimates of LGD and EAD</u>

Para. 310. – 323. and Para. 233. - 235. Supp. Doc.

Overall minimum requirements: The minimum requirements of the standardised approach as outlined in Para. 68-74 must be met (legal certainty, no material positive correlation, risk management). There are also other minimum requirements with regard to financial and physical collateral, especially liquidation of collateral.

The ESBG would propose a recommendation explaining how, at national discretion, supervisors are to choose the definition of subordination.

It should be explained what is meant when it states that collateral management should be contained within a "distinct" operational unit.

3. Minimum requirements for the advanced IRB approach

<u>(i) Own estimates of Loss Given Defaults</u>

Para. 326. - 365.

The minimum requirements listed here can be divided into a number of different categories These cover both the structure of the rating system, the LGD estimate for secured and unsecured loans, and operational requirements related to the employment of collateral. The LGD is defined as the expected loss given default, expressed as a percentage of exposure.

The definition of exposure in any event takes into account the deduction of collateral that can be recognised, as well as valuation according to the type and risk component of the transaction.

In this regard the comments on the IRB approach are fully appropriate, unless comments are explicitly provided below.

(a) – (c)

No specific comments.

(d) Criteria and Orientation of LGD Estimates

The bank must take all relevant information into account in assigning an exposure to an LGD grade. This information should be current. A bank must use risk factors that incorporate key characteristics of both the borrower and the product or transaction type. In particular, the bank should take account of the type of product or transaction involved and whether one of a set of key collateral types (as determined by the bank based on its analysis) was taken.

The bank should also consider aggregate factors such as country and industry, including jurisdictional features, especially the insolvency regime which may affect likely recoveries. Banks are encouraged to consider additional factors; as data become richer the bank must refine and expand its internal analysis with the goal of developing progressively more compelling LGD criteria and analysis over time.

Since the calculation is based on the definition LGD = 1 – Recovery Rate, and the requirements for a minor correlation between exposure and collateral must generally be met, the key characteristics of the borrower and of the product or transaction type are not factors which influence the LGD estimate. Instead, the LGD estimate should be based exclusively on the degree to which it is possible to recover the exposure through the realisation of collateral, as stated in Para. 334.

(e) Minimum Requirements for Supervisory Estimates of LGD

Each estimate of LGD must be grounded in historical experience and empirical evidence. At the same time, these estimates must be forward looking. In meeting these requirements, banks may incorporate relevant adjustments based on a variety of factors. Such adjustments must be applied through a well-developed and well-documented thought process and analysis. These adjustments themselves should be based on available empirical evidence and other historical information such as a material change in loss rates or in the key drivers of future loss. Where adjustments are made, the bank must ensure that such adjustments are applied conservatively and consistently over time. Supervisors will reject LGD estimates that are based purely on subjective or judgmental consideration and not grounded in historical experience and data.

As the regulations proposed by Basel assume that the LGD estimates will be made by experienced employees who are not involved in the bank's operational activities, subjective or judgmental considerations should be permitted. Especially in view of the fact that

- Estimates should be forward looking,
- Validations are made with the use of back-testing,

- Adequate information on the market is not available for all collateral.

Estimation using reference definition of default and loss

Consistent with the estimation of PD in the foundation approach, banks must use the reference definition of default articulated in Para. 271 and 272 in estimating LGD and collecting loss or recovery data.

The definition of loss used in estimating LGD is economic loss. This should include discount effects, funding costs, and direct and indirect costs associated with collecting on the instrument in the determination of loss. Banks should not simply measure the loss recorded in accounting records, although they should be able to compare the two.

In this connection too, the reference definition of default and loss is unacceptable, especially in regard to the regulation pertaining to any payment that is 90 days overdue.

Data sources and process for estimation

A bank must consider all relevant and available data in estimating LGD. This data must be robust. A bank may use internal data or data from external sources (including pooled data), provided that a strong link can be demonstrated between the key characteristics of the exposures to which the estimates are being applied and those captured by the external source, and the bank can demonstrate that the LGD estimates are consistent with the bank's lending standards. The definition of default retained in respect of the external data source must be consistent with the reference definition of default. For internal data, the bank must demonstrate that its estimate of LGD is representative of long run experience. Any changes in lending practice or the process for pursuing recoveries over the observation period should be taken into account.

(f) – (g)

No specific comments.

(h) Internal Validation

Banks must undertake plausibility tests on their LGD estimates through a comparison with external data sources.

The requirement that the definition of all data used for estimating the LGD must be consistent is welcomed. Consequently, internal data sources are preferred to external data sources. In this connection the ESBG cannot understand why there should be a requirement for a plausibility test with external data sources. This passage should therefore be simply deleted.

Banks must have in place sound stress testing processes for evaluating their estimates of LGD. An independent unit must carry out stress tests, which must be

conducted at least every six months. Stress testing must involve identifying possible events or future changes in economic conditions that could have unfavourable effects on banks' LGD estimates and the effect these might have on their overall capital adequacy. Three areas that banks might usefully examine are:

(i) economic or industry downturns;
(ii) (ii) market risks events; and
(iii) (iii) correlation in estimates of PD and LGD across exposures.

The ESBG cannot understand why there should be a requirement for tests every six months. The requirement should be changed to every twelve months (i.e. annually).

(i) Public Disclosure of LGD and Related data

For disclosure details see above.

There is no causal relationship between disclosure and the results of an LGD estimate. The ESBG therefore rejects any attempts to link the recognition of an LGD estimate with disclosure.

(j) Specific Issues in respect of the Treatment of Collateral

No specific comments.

<u>(ii) Minimum Requirements for Use of Own EAD estimates</u>

Para. 366. - 402.

EAD for an on-balance sheet or off-balance sheet item is defined as the expected exposure of the facility upon default of the obligor, as detailed below.

For on-balance sheet items, under both the foundation and advanced approaches, banks must estimate EAD at no less than the current drawn amount, subject to recognising the effects of on-balance sheet netting as recognised in the foundation approach. The minimum requirements for the recognition of netting should be the same as under the foundation approach. For the time being, no bank will be permitted to use its own estimates of credit equivalent amounts of interest rate, foreign exchange, equity and commodity derivatives – instead the current matrix of add-ons will continue to apply.

Exposure may be calculated not only by the application of on-balance sheet netting, but also by deducting collateral and by taking into account the bank's own estimates of credit equivalent amounts, as only this definition represents the basis for calculating the anticipated amount in the event of default, and thus the actual amount of the loss.

<u>Use of EAD estimates</u>

Banks must use and rely upon estimates of EAD as a direct input to well-established risk measurement and management processes.

The EAD estimates must be considered in the setting of internal (portfolio or sub-portfolio) limits.

Banks must have in place sound stress testing processes for evaluating their estimates of EAD. An independent unit must carry out stress tests, which must be conducted at least every six months. Stress testing must involve identifying possible events or future changes in economic conditions that could have unfavourable effects on a bank's EAD estimates and the effect these might have on its overall capital adequacy. Three areas that banks might usefully examine are: (i) economic or industry downturns; (ii) market-risk events; and (iii) correlation in estimates of PD and EAD across exposures.

The requirement for stress tests should be changed from every six months to every twelve months (i.e. annually).

C. Rules for Retail Exposures

As the provisions for retail exposures are generally incorporated within the IRB approach, all general provisions apply analogously. The relevant comments pertaining to IRB (General Provisions) are therefore fully applicable.

1. Risk Weighted Assets for Retail Exposures

<u>(i) Formula for Derivation of Risk Weights</u>

Para. 424. – 430.

A risk weight based on 50% for corporate exposures would appear to be somewhat excessive. Experience has shown that the risk in the retail segment is much lower than the risk in the corporate segment. A risk weight of at least 25% would therefore be expedient and can be substantiated. A lower basic weighting is strongly recommended.

Within the IRB approach for retail exposures, there has to be made the same comments as to the IRB approach for corporate exposures with respect to the inclusion of expected losses into the calibration of the benchmark risk weights (see above ***B.)***.

<u>(ii) Risk Inputs</u>

Para. 431. – 437.

Risk components: In our opinion the data for the expected loss approach (EL) is not sufficiently reliable (the relevant "framework requirements" require a bank to identify its historical experiences where a borrower has defaulted, and thus compel it to use the alternative PD/LGD approach).

2. Minimum Requirements for Retail Exposures

(i) Composition of Minimum Requirements

No comments.

(ii) Criteria to ensure a meaningful Differentiation of Risk

Para. 438. – 478.

Maturity:

The maturity factor must be included as a consideration in at least a few segments (especially mortgage loans/overdraft facilities). While the implicit approach of 3 years generally favours the risk weighting of mortgage loans, the disadvantage presented by the large mass of short term overdrafts puts the banks in a much worse position.

Delinquency status:

At least 2 rating grades are needed for delinquent loans, but nothing is said about the necessary grades for performing loans if a bank uses a rating system for retail exposures. Is the bank in this case free to choose at its discretion? Generally, the ESBG do not believe it is necessary to have 2 rating grades for retail exposures which have developed into problem loans; one grade should be sufficient.

Effects of seasoning:

What is actually meant by this term? The proposal states that where losses are distributed, portfolios with a high seasonal component may experience a change of less than one year. In this connection, what does the requirement for a capital buffer signify? The capital buffer is generally not acceptable.

(iii) – (v)

No comments.

(vi) Requirements for estimation of EAD, and either (a) PD/LGD or (b) EL

Definition of default: This passage supplements the reference definition of credit events by making provision for an extension of the maturity of mortgage loans and a reduction of the instalment payments if this prevents a default. However, this also results in a deterioration of the borrower's creditworthiness, and for this reason this addition is unacceptable.

Only Supporting Document 302.

The assumption of a correlation of 10% in the retail segment would appear to represent an upper limit, but the figure should actually be more in the region of zero. It should however also be pointed out that while correlations are to be used specifically only for risk models, these risk models – contrary to our requirement – are not yet recognised in the consultation paper.

(vii – x)

No comments.

D. Rules for Sovereign Exposures

The procedure for including sovereign exposures in the internal rating approach should be largely identical to the procedure which applies to corporate exposures. Any deviations should be limited to the following cases:

For the purposes of assigning the internal rating, banks must constantly monitor the economic and political developments of the relevant countries. The political dimension must include the possibility that a country might be unable or unwilling to repay its obligations, or may not have access to foreign currency. Forecasts should be conducted for key macroeconomic variables (e.g. GDP growth, exports, imports, external debt, external current account, and fiscal balance), which must be taken into account as a key input in the rating assignment of a country.

Banks must use information on spreads from traded securities. For estimates of LGD under the advanced approach, banks must differentiate between domestic and foreign currency lending.

Comments: It is questionable whether spreads are always a meaningful indicator for PD, especially for securities with lower liquidity.

E. Rules for Bank Exposures

The rules are identical to those which apply to corporate exposures.

Excursus I:
Inclusion of equity in IRB

The supporting document merely touches superficially on the question regarding the inclusion of equity in the internal rating approach. It appears that the Basel Committee at present intends to develop two approaches for the treatment of different equity items.
The ESBG will await the Committee's proposal.

Excursus II:
Inclusion of project finance exposures in IRB

Work on the inclusion of project finance exposures is still in its initial stages. For this reason the Basel Committee is in particular identifying problems which arise through the inclusion of project finance exposures in the internal rating approach. Here too, the European Savings Banks will await the Committee's proposal.

F. Calculation of IRB Granularity Adjustment to Capital

1. Definitions and Scope of Granularity Adjustment

According to the Basel Committee, the granularity adjustment is an addition or subtraction to the baseline level of risk weighted assets which are not included in the retail approach. The Committee explains this by stating that the baseline risk-weights are calibrated assuming a bank with exposures of "typical" granularity. Accordingly, banks with a disproportionately high (disproportionately low) concentration of single-borrower risk, should require additional capital (demand a smaller than average capital requirement).

The calculation for this adjustment as proposed in the Accord raises the question why the credit risk models developed by banks are not recognised, since this would solve in a consistent manner both the problem of adequate risk weighting and the granularity factor. The underlying approximation approaches (MtM model, DM model) between risk weights and the granularity factor are based on disparate assumptions, which rely on a variety of appraisals.
On the contrary, Banks who are using credit risk models specify the parameters and make assumptions for correlations according to their *own* portfolio structure, which enables them to measure more accurately concentration risks for specific portfolios. This in turn makes a more accurate appraisal of capital requirements possible.

2. Methodology for Calculations

Para. 507. – 515.

It was a nuclear demand of the ESBG within the first consultation period, to acknowledge the granularity of a portfolio adequately. First calculations of reference portfolios with an average risk diversification show, that there is only a little capital reduction in case of optimal granularity (max. 4 %). On the other hand, already little deterioration in risk diversification of a portfolio leads to considerable add-ons onto an anyway much to high calibration basis.

Therefore, the ESBG strongly demands for an adequate correction of the granularity adjustment formula.

IV. ASSET SECURITISATION

1. The Treatment of Explicit Risks Associated with Securitisations under the Standard Approach.

(i) Treatment for Originating Banks

Para. 516. and Footnote 40.

Synthetic securitisation.

The second consultative paper shows no progress with respect to synthetic securitisations. Given the evolution in this market, clarity in the regulatory treatment of this type of transactions is required.

The treatment of explicit risks associated with securitisations under the standardised approach.

(ii) Treatment for Investing Banks

Para. 518. – 530.

Although the treatment for banks' investment in ABS is based on the ratings of ECAIs, the risk-weights associated with the different credit ratings differ from the weights used for corporate debt. This is especially the case for the lower/unrated tranches. Consider the 150% risk weight of BB-rated tranches with the 100% for similarly rated corporate debt, and the full deduction of capital of B+ and below rated tranches, compared to a 150% weighting for corporate debt. The ESBG does not see a justification for the severe difference in treatment for the lower rated tranches.

(iii) Treatment for sponsoring banks

Para. 535.

The ESBG favours an approach in which the general risk weighting of liquidity facilities depends on the the underlying assets. For example, a liquidity facility which complies with the liquidity criteria written against a pool of 20% weighted assets, should have a capital charge of 20% (conversion factor) times 20% (risk weighting), instead of 20% times 100%. Otherwise, banks have an inherent incentive to put relatively low quality assets in their conduits vs. high quality assets.

2. Securitisation under IRB: A hybrid approach.

(i) Issuing Banks

No comments.

(ii) Investing Banks

Para. 541.

In the standard approach more work is needed on the relationship between default expectation and expected LGD. Under the advanced approach banks should be allowed to model the LGD on securitisation transactions in a more realistic manner.

The conservative estimate of a LGD of 100% is not in line with market observations and offers little incentive to switch from a standardised approach to an IRB approach.

3. Treatment of Implicit and Residual Risks arising from Securitisation

Para. 545.

In the view of the ESBG an ex ante charge for addressing implicit and residual risks is not desirable. These risks, which apply to all complex transactions, are already part of operational risk. An additional explicit requirement would lead to double counting of capital charges.

4. Disclosure Requirements
No comments.

V. OPERATIONAL RISK

Para. 547. – 565.

1. General Remarks

The different methodologies proposed by the Basel Committee to assess the capital requirements for operational risk do not yet permit an adequate conclusion on the final quantity of regulatory capital for these risks. The Committee has frequently stressed the point, that the average regulatory capital ("overall capital") has to be maintained on the present level. Expected reductions in the credit risk area should be compensated by new requirements for operational risk. Thus, from our point of view, it can be discussed the adjustment of capital requirements for operational risk not before the capital effects in the credit risk area can be assessed reliably.

But the Basel Committee intends to align the capital requirements for operational risk at a "prefixed" level of 20 % of the capital required for credit risk. This seems to be arbitrary, not risk adequate and – after preliminary calculations - much too high.

Furthermore, the operational risk appears in other sections of the consultative document. For example, the "w"-factor in the risk mitigation must be applied for all risks resulting from the possible inadequate realisation of collaterals because of insufficient agreements, realisation processes etc. This risk however is a legal or processing risk an thus an operational risk. This capital requirement for "w" must be acknowledged in the calibration of operational risk.

In addition, a part of the credit risk sector is also operational risk. At the moment, credit defaults or losses are not classified in original credit risk and operational risk (fraud etc.). Because of this, we call for a treatment of these operational risks in the credit risk section also in future. This also has to be acknowledged.

In the ongoing discussion on the future treatment of operational risk, the focus must be set on the a much more risk sensitive solution for the measurement of this risk to avoid an increase of overall regulatory capital. It must be paid attention not to give wrong incentives to the institutes by choosing not enough risk sensitive methodologies for the measurement of capital requirement for operational risk. Thus, we advocate in general the continuum approach of the Basel Committee.

The "gross income" is not risk sensitive, because there is no proof for a significant relationship or connection between the "gross income" and the operational risk exposure. And, this approach would lead to the effect, that operational losses reduce the capital requirements for operational risk. This approach gives no positive incentives to the institutions for the use of prudent risk management techniques.

For this reason, the ESBG proposes as risk indicator for the basic indicator approach a fixed percentage of "administrative costs" instead of "gross income".

The administrative costs reflect by its components staff expenses, material expenses, operating expenses and depreciations all relevant abstract economic processes of a

credit institution and its complexity. The administrative cost position is also less volatile and more internationally comparable than other possible indicators.

For qualitative aspects of this indicator we propose in addition a qualitative adjustment of the administrative cost indicator. This adjustment could be reached by a factor which reflects the fulfilment of certain qualitative criteria set by the supervisors.

2. Risk Mitigation

The ESBG believes that the Basel Committee should move forward in a prescriptive way and set up standards for risk mitigation purposes.

3. Flexibility in mapping business lines

The ESBG suggests that the Committee leaves up to national regulation the different ways and means for developing a level 2 mapping intended to be applied to firms for specifying in details which business lines and activities correspond to the categories of its proposed (level 1) general framework.

Should the Basel Committee decides not to allow for flexibility, then ESBG wishes that level 1 mapping be more granular : at the minimum, the ESBG strongly supports the set-up of an 'Agency Services' business line that risk-wise must stands at the same level as 'Payments & Settlements'.

VI. TRADING BOOK ISSUES

A. Definition of the Trading Book

Para. 567.

The definition as it is proposed in Para. 567., second sentence, should be completed in the following way:

“*To be eligible for inclusion within the trading book, financial instruments or its underlying asset must either be free of any restrictive covenants on their tradability or able to be hedged completely.”*

B. Prudent Valuation Guidance

No comments.

C. *Trading Book Capital Treatment for Specific Risk under the Standardised Methodology*

1. Specific Risk Capital Charges for Government Paper

No comments.

2. Specific Risk Capital Charges for Positions Hedged by Credit Derivatives

Para. 583. - 585.

In recognition of the proposed position, the ESBG propose to add the following Para.:

“ Banks may adopt a model approach to the maturity mismatch. It is appropriate for banks to develop their own models that reflect their own risk management and trading practices for submisson to the regulator for approval on a case by case basis.

An appropriate model needs to take into account the following factors:

- *extent of the mismatch*
- *time until the residual exposure*
- *size of the residual exposure*
- *riskiness of the spread exposure*

A simple formula for an overall position comprising a long risk position of longer maturity than a short risk position of the same size in the same name that combines the factors is :
Discount Factor x Residual tenor/Tenor of longer position x Nominal.

As to extend this approach to a more complex position with a range of longs and shorts an appropriate formula might be :
Average discount factor for offsetting shorts x {[Average tenor of offset longs – Average tenor of offset shorts] / [Average tenor of offset longs]}x Nominal of offset positions. ”

The ESBG wants to point out that at present, the regulators do not recognize any maturity mismatch in the trading book.

A trading book is a book where traders try to make money by buying and selling products, here Credit Default Swaps (“CDS”). Although there is liquidity in CDS market, it may happen that, for one reason or another, the trader decides not to cover the underlying position with the perfect mirror position. The remaining risk is function of the portion of the time that is not hedged.

This mismatch can be limited or significant. The importance of the mismatch, so to say the importance of the risk, should drive the related capital consumption. For instance, a position 7 year could be covered by a mirror position having a 6 year and 10 month maturity. That mismatch is really small and it seems not logical to treat those two positions apart from each other, by simply adding the two position’s specific and counterpart risks.

At the moment, although only the highest of both specific risks is taken into account, no offset is recognized although it is obvious that there is significant economic risk offset between a short 7 year trade and a long 6 year and 10 months trade in the same credit. Without recognition of such an offset for regulatory capital purposes, the function of the credit market is likely to be significantly impaired.

PART 3: THE SECOND PILLAR - SUPERVISORY REVIEW PROCESS

The ESBG agrees that supervisory review should be recognised as a separate pillar of the capital adequacy framework, particularly in light of the development of internal rating based approach under Pillar I. A general concern, however, is that supervisors will differ in their approach to this pillar and thus create unlevel playing fields for banks.

The ESBG notes that the view of the Basel Committee is not to harmonise supervisory processes under Pillar II, as different legal regimes, powers and styles of supervision will persist. The ambition is to encourage consistency and that supervisors share experiences. This aim is in our opinion too vague because encouragement will not alone lead to harmonisation and consistency. As long as Pillar II is a key element of the future regulation, it is difficult to see how a level playing field between banks from different countries can be achieved without the Committee issuing relative precise operational guidelines for supervisory approach.

In its response to the 1999 Consultative Paper, the ESBG is opposed to the part of Pillar II which will give supervisors the powers to require individual banks to hold more capital than the minimum ratios. This is still the position of the ESBG. It is to be noted that the Committee maintains the idea of individual set capital requirements. The tools proposed to be given to supervisors under principle 4 are powerful, and will in our view easily get into conflict with the responsibilities of the management of the bank set out in principle 1. Given that supervisory authorities receive these powers in the revised Capital Accord, the ESBG argues that supervisors may find it difficult to determine how risk profiles or possible flaws in the risk management process can be assigned higher capital charges. Flaws in the risk management process require a qualitative assessment which cannot be directly translated into a quantitative charge. At the same time persuasive arguments will be required of the supervisory authorities if a capital charge higher than the minimum is to be imposed on banks operating well-founded, complex risk management systems. Such a power therefore calls for detailed harmonised criteria for supervisory intervention.

The ESBG agrees on the importance that criteria used in supervisory review of bank’s internal capital assessments should be publicly available.

PART 4: THE THIRD PILLAR - MARKET DISCIPLINE

General Remarks

A lot of information that has to be published according to the new capital accord, neither is not relevant for the financial market, represents secrets of the enterprises nor can cause difficulties on the financial markets which can cause problems for the banks.

We therefore suggest differentiating the information according to the following criteria:

Information which has to be reported to the supervisory authorities:

- Core information which has to be published on a regular basis (quarterly reports or annual report).
- Additional information (same addressees as core information).

Due to the aim of the consultative document to address to internationally active banks (which are using more or less internationally accepted accounting principles like IAS or US-GAAP) and which have dominant influence to the world-wide financial markets, small and medium sized financial institutions, which act just on a regional market and therefore do not have any influence to the international financial market should be treated separately – especially in EU-regulation. The reporting requirements for small and medium sized financial institutions should be reduced to the importance, which they have to the financial markets.

The reporting requirements will heavily burden internationally as well as regionally active banks due to the data requirements, the data control and the EDP implementation, which is disproportionate to the usefulness of the information. We therefore demand a reduction of the reporting requirements.

Additionally, the reporting requirements have to correspond to the various provisions of law. Sanctions, which are not based on national regulations, have to be rejected. The ESBG also asks for internationally co-ordinated reporting requirements and sanctions to avoid competitive disadvantages.

Due to the different revaluation methods, the risk weighted assets as well as the calculation of own funds will differ immense. The ESBG therefore asks for a far-reaching coherence between accounting principles and supervisory disclosure requirements.

Generally, the suggestion of the consultative paper just to recognise collateral, netting and guarantees/credit derivatives if the disclosure requirements are completely fulfilled have to be rejected. Disclosure requirements do not have any influence of a specific risk position.

Specific Remarks

A. General Considerations

Para. 634.

According to 634, the banks should implement a “process for assessing the appropriateness and the frequency of disclosure”.

Which “process” has to be established to be appropriate in regard of disclosed information and frequency of disclosure? BIS has to define, which process is – according to their point of view - adequate for a bank to define its disclosure policy (especially due to the possible sanctions).

1. Core and Supplementary Disclosure Recommendations

No comments.

2. Materiality

Para. 636.

The ESBG agrees to the definition of the consultative paper, that just material information should be disclosed. In this case, BIS is in line with IAS.

3. Frequency

Para. 637 (and 22 of Annex)

The European Savings Banks demand that small and medium banks, which act just on a regional basis and do not prepare their financial statements according to IAS or US-GAAP should have minor disclosure requirements than internationally active banks.

Starting in 2005, listed enterprises are obliged to use IAS according to EU-regulation (discussed at the moment). So, the intention of BIS that internationally active banks have to disclose more (and more detailed) information will automatically be implemented. For small and medium, regionally active banks minor disclosure requirements can be defined outside IAS.

The consultative paper suggests that – additionally to annually, semi-annually and quarterly reports the banks should be prepared to disclose “general material changes” as soon as possible after the event.

It has to be defined

- what are “general material changes” and
- which medium for publishing has to be used.

Otherwise, additional and not defined reporting requirements will be created which are both dependant on national authorities and arbitrary measures can be taken by authorities

(including corresponding sanctions) – which are not based on the national legislative systems.

Para. 638. + Annex 23

BIS suggests half-yearly and quarterly reports in some cases and a flexibility of the banks to disclose these information. **Audited** half-yearly or quarterly reports have to be denied because that will create additional costs for the bank.

Additionally Basel recommends electronic media without defining the standards.

To create /sustain a fair competition, the requirements should be established at the same time world-wide. Nevertheless, due to the burden of the requirements the ESBG recommends that BIS reconsiders the requirements again and reviews the requirements on a more cost-benefit-minded view for banks.

Para. 639. and 12. of Annex

BIS recommends supervisory responses for banks which do not comply with the disclosure requirements The level of reaction shall depend on the type, impact and length of time of the infringement. The recommended sanctions reach from appeals to fines. This raises several questions:

- According to which criteria should these sanctions be imposed?
- Which sanctions for which infringement?
- How to guarantee an international level playing field?
- Which reporting requirements are imposed to investment firms?

B. Disclosures – Scope of Application of the New Accord.

1. Core Disclosures

Para. 643.

<u>Bullet Point 5</u>

This information has to be rejected due to the consolidation requirements according to national rules or according to internationally accepted standards such as IAS. This would result in a duplication of accounting, is not necessary and a heavy administrative burden. Additionally, compared to the deduction of own funds the full consolidation is the more exact method. This would only lead to misunderstandings in the market.

<u>Bullet Point 4-6</u>

Banks have to explain their valuation methods in the annual report. Additional information with regard to effects of other valuation methods have to be rejected. This would result in double accounting.

<u>Bullet Point 6</u>
According to IAS, banks already have to show minority interests. Additional calculations have to be rejected (no material additional information)

<u>Bullet Point 7</u>

Reduction to subsidiaries "with major significance" according to IAS.

C Disclosures – Structure of Capital

1. Core Disclosures (Quantitative)

Para. 645.

This information is already shown in the valuation methods used for preparing the financial statements. See comment to IAS.

2. Core Disclosures (Qualitative)

No comments.

3. Supplementary Disclosures

No comments.

4. For both Core and Supplementary Disclosures

Para. 646.

This information is already part of the prospectus. A yearly, semi-annually or quarterly information will not lead to additional information. Due to the fact that this instruments are traded on the financial market it can be expected that the participants in this financial markets are already informed.

D. Disclosures – Risk Exposures and Assessement.

1. Credit Risk in the Banking Book

(i) Disclosures applicable to all banks

Para. 650.

(a) and (b) Core Disclosures.

The core information includes additional time bands which are not used under IAS (and which are additionally not useful (5-10 years and above 10 years)). Furthermore Information on industry sectors and counterparts is required which - in case of small and transparent markets - may injure the bank secret.

The ESBG suggests that this information has to be published only if the interests of third parties are not injured and the banks will not infringe any bank regulations.

The required information of assets before risk mitigation techniques has to be rejected. This information is not relevant for the market. The risk weighted assets are the basis for the calculation of the ratios after deduction of risk mitigation techniques.

The publication of non performing loans should be transferred to “additional information”. The publication of this information could result in instability of the financial market due to misinterpretations and therefore lead to the opposite effect of the aim of the consultative paper. The publication before subtraction of risk reserves and securities has to be rejected. Additionally, no generally accepted definition exists for “non performing assets”. Worldwide comparisons are therefore impossible.

(c) Supplementary Disclosures

The publication of average risk positions has to be rejected. First of all, risk positions as well as “average” is not defined, which may lead to a daily calculation (depending on the definition), and therefore resulting in additional high costs which are not justifiable compared to the information.

First of all information on risk concentration is already reported to the supervisory authorities (large exposure report) and secondly limited to a ratio of own funds (10% reporting requirement, 25% limit). This information – if it is more than

country- or industry specific information) will injure the bank secret. It should only be reported to the national supervisory authorities.

Single transaction related information has to be rejected in any case as on the one hand it injures the bank secret and on the other hand it is a competitive factor. Information about non-performing loans should be reported to the supervisory authorities but not to the public because of possible misinterpretations in the markets and the impossibility of international comparisons.

(ii) Disclosures applicable to Banks using the Standardised Approach

Para. 651.

Reports of loss quotas of unrated loans have to be refused as long as “loss” is internationally not defined and international comparison is impossible. Additionally this information can lead to misinterpretations.

(iii) Disclosures applicable to banks using IRB Approaches

Para. 652.

(a) Qualitative Disclosures: General Information on Methodology and Key Inputs

No comments.

(b) Quantitative Disclosure part (i) – required Information for Risk Assessment

The consultative paper states that PD, LGD and EL have to be published for retail portfolios. According to the paper, banks have to use either PD and LGD **or** EL. The reporting requirements are therefore contradictive. Either PD and LGD or EL has to be published. Because EL is the product of PD x LGD, EL is determined by the other two factors. If a bank uses EL, PD and LGD are not available.

(c) Quantitative Disclosure part (i) – ex post Performance as an Indication of Quality and Reliability

Bullet Point 6-8

The “distribution of debtors to rating classes” as well as changes of rating within 3 years should be subject to a transitional period.

Bullet Point 9

A comparison of economic capital, own funds and required capital has to be rejected. The calculation of economic capital is a result of internally defined criteria, a comparison with other banks is not possible.

(iv) Credit Risk Mitigation Techniques

Para. 653. - 658.

The quantity of required information – most of them subject to sanctions according to 639 – and the request of Basel that this information has to be reported on a quarterly basis (ad hoc information of market risks) results in considerable uncertainties regarding to data collection, auditing, publication and sanctions. This is not acceptable in respect of competitive reasons. Additionally, the sanctions defined are not based on national regulations of the different countries.

Reporting requirements have to be co-ordinated internationally and have to be compatible with national regulations to avoid competitive disadvantages.

Para. 658.

Bullet Point 6

Disclosure of main guarantors/ protection providers is according to our point of view not necessary because it does not show any additional information about the risk.

2. Market Risk

(i) Disclosures applicable to banks under the standardised measurement

Para. 663. b – Supplementary disclosure

Using a model mix (i.e. different calculation methods) the calculation of daily ranges of profit and loss of the trading positions are not possible because profit and loss is not calculated separately. This requirement has to be rejected.

ii) Disclosures Applicable to Banks under the Internal Models Approach

Para. 664 b – supplementary disclosure

Same as 663. b

3. Operational Risk

Para. 666.

Disclosure of operational events of loss (Pillar 3) has to be denied. The reason therefore is that the probability of heavy losses is very low thus such information may lead to possible misinterpretations of the market and uncertain investors. This would make the market unstable which is completely the contrary of what the accord tries to achieve

4. Interest Rate Risk (IRR) in the Banking Book

Para. 667.

The ESBG is of the opinion that the regulations for disclosure are extremely extensive and will lead to high administrative expenses and additional costs for the banks thus only resulting in an enormous flood of information. The European Savings Banks consider a noticeable reduction of disclosure-regulations necessary, especially the following:

The disclosure of internal limits is not sensible as this may lead to wrong signals and may create some sort of momentum in the markets (e.g. a bank that at the beginning has published very high limits probably will never have problems with its limit while those banks that have decided to publish realistic limits and under certain circumstances want to exceed their limits will be punished by the market).

In the support document to market discipline the “core quantitative disclosure” is the disclosure of absolute changes of income and present values in the standardised rate shock analyses, as well as the resulting correlation to regulatory capital. The ESBG believes that this de facto duty to disclose the banks’ own “outliers” will only result in evasion and, therefore, do not agree with it.

Publication of presumptions for embedded options:
The ESBG wants to point out that the definition is missing (see also above).

What is also required is the publication of ex-post-analyses. The ESBG thinks that such publications will lead to a flood of information and possible deviations usually have various and complex reasons. To understand these reasons needs a solid understanding of risk and model. The ESBG are prepared to make such analyses for the national regulatory authorities on request but rejects the general disclosure of such information.

E. Disclosures – Capital Adequacy

Para. 672. - 674.

Due to the fact that the calculation of economic capital is only based on internal methods and internally defined criteria, the disclosure of economic capital is rejected. This information will not lead to useful comparisons as long as an internationally accepted definition is not available. This information cannot be interpreted by the market participants and will lead to misunderstandings.

Requirements are not clearly defined (e.g. changes in capital structure please see above.) Basis for the calculation of capital ratios will be the regulatory capital as defined in the accord. A different calculation of capital ratios is not necessary and therefore has to be rejected.