FEDERATION BANCAIRE DE L'UNION EUROPEENNE

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A NEW CAPITAL ADEQUACY FRAMEWORK

Response by the European Banking Federation to the Basel Committee's Second Consultation Document

May 2001

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1. Executive Summary

General remarks

The EBF agrees with the underlying philosophy of the proposals made by the Basel Committee. There has been considerable progress since the 1999 proposals. The EBF notes that many of its remarks made in March 2000 have been heard.

The EBF wishes to state for the record that it understands that the new Accord should not result in an increase in the overall level of regulatory capital. This is essential to ensure that the new rules do not have a negative impact on the ability of the banking sector to provide finance and thus a negative impact on the real economy. For example, it is essential that the new capital rules do not destroy the added value of emerging credit markets to support liquidity of credit risks. Liquidity will help banks to reduce their exposure to event and concentration risks, as was the case for structural interest rate risk in the last decade.

National discretion and consistency of application

EBF believes that the scope for national differentiation in the application of the new standards is the single most significant issue in the consistent application of the new Accord. As the Accord shifts toward a greater reliance upon internal risk assessment, supervisory review creates a vital structure for the consistent assessment of risk management standards and, in turn, a platform for equal implementation, and application. To this end, the EBF welcomes the requirement for supervisors to be "highly transparent" in the criteria on which they base their assessment of firms. For example, in the context of credit risk, this might include the minimum requirements in terms of data quality, data history and, most importantly, validation across countries.

To further strengthen this element, the EBF would propose that Basel co-ordinate the publication of key statistics, by national regulators, on the application, and take up, of the various elements of the new Accord. Without this safeguard, the significant degree of national discretion currently allowed for in the proposals could seriously damage the level playing field. This should be avoided at all costs, if not, regulatory arbitrage will become a widespread practice given the easy relocation of financial activities.

Moreover, to ensure a level playing field, the differing scopes of consolidation whether in Europe, Asia or in the USA should be aligned. Therefore, the EBF welcomes the Basel Committee's intention of extending the scope of the Capital Accord to achieve greater harmonisation of consolidation at the international level. The inclusion, on a fully

consolidated basis, of holding companies that are parents of a banking group is also an important step. However, the proposed definition of a 'banking group' should be clarified.

At the very least, the EBF asks that any capital requirement that prevails within a given country should equally be accepted by any national regulatory authority whenever one or several of its constituents operate within this country.

Standardised Approach

Turning to the standardised approach, the EBF fully endorses the concept of preferential treatment for short-term claims. It is appropriate for risk-management purposes. The EBF therefore thinks that the preferential treatment of short-term claims to banks, which is currently available only under Option 2, should be extended to Option 1, if that is the retained option. Moreover, the EBF strongly prefers to see a twelve-month cap based on residual, rather than original, maturity.

To reduce the scope for regulatory arbitrage, the EBF requests that the Basel Committee decide which option must be used for all banks in all countries. The EBF recommends that option 1 be selected.

The EBF objects to the blunt imposition of a 150% weighting (net of specific provisions) for any asset 90 days past due. This would have a particularly heavy and disproportionate impact on bank lending to SMEs.

The EBF would argue that all commitments that are cancellable at any time without prior notice by the bank should, regardless of their maturity, be assigned a credit conversion factor of 0%.

To ensure transparency at the international level, the EBF proposes that ECAIs which are recognised in one country should be automatically recognised in all other countries (mutual recognition) and that the Basel Committee should publish, on a regular basis, a list of recognised ECAIs.

Risk Mitigation

The EBF welcomes the greater recognition of different types of collateral that are currently taken by banks. Nevertheless, the EBF thinks that physical assets, such as industrial premises and equipment, ships and aircraft, should be added to the list of eligible collateral, as should precious metals and precious metal certificates, and leasing and factoring.

Finally, the EBF argues that the risks claimed to be captured by “W” are already subject to a capital charge through the separate operational risk charge. “W” therefore represents the double counting of risks and should be removed.

Evolution from the Standardised Approach to the Internal Ratings Based Approach

The EBF welcomes the central role of the IRB approach in the new proposals. However, the incentive to switch to the IRB approach is completely insufficient. The economic level of credit risk is not as high as calculated according to the current proposals. The calibration is too conservative.

In the view of the EBF it is essential that the Basel Committee remedy the shortcomings of the foundation IRB approach so that banks are given a strong incentive to move to it from the standardised approach. It is important that all mortgages on commercial and residential properties are considered as risk reducing collateral in the foundation IRB approach.

The EBF would urge the Basel Committee to review and revise the requirement that progression into, and within, the IRB approach be subject to an “all or nothing“ requirement. The imposition of a blanket application of the IRB approach goes too far. It is insufficient to mitigate it by means of the materiality of the different portfolios, a concept that, in any case, is too vague. Excluding any possibility of returning to a method that is less complicated could be counter-productive, because new situations (merger) or strategies (activities becoming marginal) might justify opting for a return to a method that is less complicated.

The time schedule for the coming into effect of the IRB approach is too long, with statistical series having to be achieved over a period of at least seven years. Development in the field of capital requirements should be progressively taken into account in order to reach the level implied within the IRB approach.

In sum, the EBF proposes a common five-year data history requirement for PD, LGD and EAD, a three-year transition period and a one-year usage test.

Operational Risk

The EBF is committed to working with the Basel Committee throughout 2001 to develop a workable and equitable operational risk charge. The EBF is concerned that the operational risk charge has the potential to distort competition between regulated institutions and those that are either unregulated or regulated with no capital charge for operational risk.

The EBF suggests that the final wording of the Basel Committee's recommendations be flexible enough to accommodate future developments in operational risk issues (measurement, modelling, data etc). Moreover, the Basel Committee should formally commit itself to a thorough review process of the impact of the new rules on operational risk, including the issuing of interim papers to all interested parties and the formal possibility for corrective actions should they prove necessary.

Along with the industry, the EBF continues to believe, as it has argued in the past, that qualitative criteria related to procedures, external and internal controls, and environment should be integrated into the process for determining the operational risk capital charge.

The EBF encourages the Basel Committee to move forward and set up prescriptive standards for risk mitigation purposes, at least with insurance policies.

Further Work

The EBF is continuing to work on those areas in the proposals that are only partially defined. The EBF formally asks the Basel Committee to provide interim papers on these areas, for example retail exposures, project finance and equity exposures, counter party risk in the trading book, securitisation, operational risk and the Third Pillar. Without such interim papers it will be impossible for the industry as a whole to respond to the work of the Basel Committee in the ongoing dialogue after 31 May 2001.

2. Introduction

The EBF welcomes the opportunity to comment on the Basel Committee on Banking Supervision's second set of proposals to develop a new capital adequacy framework. Unfortunately, given the scope and complexity of the new proposals, which in many areas put forward entirely new concepts and techniques, that were not flag in the first consultation document issue by the Basel Committee in June 1999, the deadline set for comments from the industry, 31 May 2001, is insufficient for a complete response based upon thorough testing of the impact of the proposals. Therefore this response focuses on what the EBF has identified as key areas, whilst flagging those areas that will require further work after 31 May 2001.

At the same time that the Basel Committee issued its questionnaire (known as QIS-2) aimed at internationally active large banks, the EBF launched its own industry simplified impact study to produce data on the impact of the current proposals on a much wider range of banks in Europe. Unfortunately the results of this study will only be available at the end of June 2001. The EBF will therefore revert to the Basel Committee on the issue of calibration in the summer.

3. Scope of application

With the growing integration of financial markets, diverging consolidated capital requirements have become more and more of a negative competitive factor, especially for internationally active banks confronted with local institutions not subject to similar consolidated capital requirements. Therefore, *the EBF welcomes the Basel Committee's intention of extending the scope of the Accord to achieve greater harmonisation of consolidation at the international level*.

Since the level of consolidation is already far more extensive in the European Union than elsewhere, and the European Commission has recently published proposals for the enhanced supervision of financial conglomerates, which will extend consolidation further, the EBF suggests aligning the scope of consolidation envisaged by the Basel Committee with the European framework.

To ensure a level playing field, the scope of consolidation whether in Europe, Asia or in the USA should be aligned. The inclusion, on a fully consolidated basis, of holding companies that are parents of a banking group is an important step. *However, the proposed definition of a 'banking group' should be clarified.*

The EBF is very concerned by the Basel Committee's proposal to require sub-consolidation at every tier below the top banking group level of investments in financial institutions, to ensure adequate capitalisation and distribution of capital within a "banking group". Sub-consolidation can be waived if the Accord is applied to the stand-alone bank (internationally active bank) and the book value of the investments is deducted from the bank's capital.

The EBF is opposed to the obligation to provide for sub-consolidation. Such a regime of sub-consolidation would impose a considerable burden on banks without bringing any additional supervisory insight or benefit. As it is already the case with European regulation, supervisory

authorities should have the ability to closely monitor on an individual and/or sub-consolidated basis those institutions that are deemed not to have an appropriate structure of own funds.

Under the Basel Committee's proposals, supervisors are to be free to decide whether and to what extent third-party minority interests may be included in the regulatory capital of the group. *The EBF believes that third-party minority interests should continue to count towards group capital*. Since the risks of subsidiaries will be fully included in the group by way of full consolidation, it is vital for assessing the capital adequacy of the group that, for systematic reasons, these risks be matched in full against the entire capital of the group. It would be wrong to unilaterally reduce the capital available to cover these risks. Through the controlling relationship between parent and subsidiary, third-party minority interests can also be used, if legally permitted, for the purposes and the benefit of the entire group (e.g. for investments in other group entities). The capital of the subsidiary is available in full to cover any losses that may arise.

To boot, the EBF thinks that the deduction of third-party minority interests would also be inconsistent with the aim of treating the group as a single entity for consolidation purposes.

Allowing national supervisors discretion in connection with the recognition of third-party minority interests should be avoided in any event as it could lead to significant distortions of competition. The level playing field would be jeopardised if a tougher treatment of third-party minority interests than that proposed under the discretionary powers granted by the Basel Committee were to be stipulated at EU level. Any discretionary powers granted to national supervisors by Basel would have to be incorporated into the corresponding EU rules.

The Basel Committee believes that "at this stage it is, in principle, appropriate" to deduct majority interests in insurance subsidiaries from the capital of the bank holding the interest.

The EBF believes that the requirement for banks to deduct their interests in insurance subsidiaries must be rejected, firstly for competitive reasons, since insurance entities are not required to deduct majority interests in banks, and secondly, the Basel Committee's proposal is inappropriate from a risk angle.

The risks insurance companies are exposed are different from the credit and market risks to which banks are typically exposed. Consequently, the risks associated with insurance are outside the scope of prudential banking rules. The deduction from capital of interests in insurance subsidiaries envisaged by the Basel Committee would be the equivalent of a risk

weight of 1,250%. The risk resulting from an interest in an insurance subsidiary would thus be grossly over-exaggerated. Full deduction of an investment in an insurance subsidiary would imply, under prudential risk management rules, that the subsidiary uses the capital made available by the investment to conduct 12 ½ times as much business carrying banking risks. This assumption is completely unrealistic. The volume of business carrying credit and market risks conducted by insurance entities is low compared with the volume of actual insurance risks. Insurance entities should, at most, be required to meet the prudential requirements applying to their “banking activities”.

The EBF believes that there is a need to define thresholds beyond which a group shall be considered as a financial conglomerate.

Such thresholds must be cumulative and take into consideration the control of a financial group over a company, for example:

- 50% or above of capital or of voting rights, or
- between 20% and 50% of capital or of voting rights, plus significant influence.

The significant importance of the investment in relation to the financial condition of the holding company (i.e. holdings of an amount above a percentage to be determined of the parent company’s stockholders’ equity; de minimis exception) should also be considered.

Defining these thresholds calls for the following comments:

- generally speaking, thresholds chosen to define a financial conglomerate cannot be stricter than those applied to banking groups on a consolidated basis,
- since the goal is to prevent major incidents involving the institutions’ solvency, it seems normal to align this threshold with rules for “large risks” in banks and “diversification” in insurance companies, as well as with the “de minimis” exemption,
- if the company acting as majority stakeholder for the financial group is not a regulated entity, regulatory authorities will be able to demand a consolidation at the appropriate level so as to obtain a realistic assessment of the available prudential capital.

The EBF considers that there is no need to develop special rules concerning double counting of equity. However, should such rules be imposed, the EBF wishes to stress the

following points. First, it is important that the computation of a capital charge for each institution be done on a solo basis in accordance with appropriate prudential rules. Second, the so-called "solo plus" test should have no impact on the ratios which must not be required to be computed anew. This derives from the generally accepted principle that monitoring rules must be adapted to the structure chosen by a company, and not vice-versa. Therefore any deficiency identified at the "solo plus" level that leads to prudential authorities recommending that the situation be corrected must not impose a recapitalisation of one entity rather than another. Were this to occur it would constitute interference in equity allocation or activities within a financial group.

The method preferred by the EBF is :

- that prudential equity such as now computed for banks and insurance companies be aggregated and reduced by the accounting value of stock holdings and other items of regulatory capital that the parent company holds in its affiliate(s),

- and that the resulting amount must be at least equal to the total of regulatory requirements (solo) computed for banks and insurance companies in accordance with solvency rules in force. This "solo plus" test would have no impact on the computation of regulatory "solo" ratios. This method also takes into account any solvency surplus in the affiliate(s).

The Basel Committee proposes that any surplus regulatory capital available to an insurance subsidiary may be included in the group "*under limited circumstances*". Under the deduction approach, the amount deducted would be reduced by the amount of surplus capital. The "*limited circumstances*" for assessing the amount and the availability of surplus capital that may be recognised in bank capital are to be determined at the discretion of national supervisors.

The Basel Committee leaves all the crucial points on this question to the discretion of national supervisors. This appears to be due mainly to a lack of acceptable concepts for prudential recognition for capital adequacy purposes of equity investments in insurance subsidiaries. Important questions concerning the measurement of the consolidated capital of banking groups have considerable competitive implications and call for in-depth discussion. They should not be addressed under an apparently unbalanced approach that provides for broad national discretionary powers.

Overall, the Basel Committee should postpone any activities in connection with the prudential treatment of investments in insurance subsidiaries until appropriate rules for global supervision of financial conglomerates have been adopted.

The new proposals are also unclear on the treatment of capital deductions for insurance companies. It could be the case that the total amount deducted from capital is reduced but deductions will need to be expressly made 50% from Tier 1 and 50% from Tier 2. For some EU Member States this would be different from the current requirement to deduct from total capital. Clearly this would have a negative impact on Tier 1 and the Tier 1 ratio. Deduction of 50% from Tier 1 would result in a serious reduction of the total capital base for many banks, as the amount of Tier 1 capital is decisive for the amount of Tier 2 and 3 capital that can be included in the regulatory capital base. Given the complexity of the reform of the Accord, the EBF thinks it would be wise to leave reform of the definition of the capital base till after the impact of the new Accord has been fully ascertained.

4. First Pillar: Minimum Capital Requirements

4.1 Credit Risk: Standardised approach

4.11 Claims on banks and other financial institutions

The EBF is concerned that the current national discretion to use options 1 or 2, allowed in the Basel Committee's proposals, would lead to distortions of competition at the international level. If one option were to be used uniformly, banks would, moreover, be unable to practice regulatory arbitrage by shifting their lending operations to subsidiaries in countries with a "more favourable" option. *The EBF therefore requests that the Basel Committee decide which option must be used for all banks in all countries. The EBF recommends option 1*.

The preferential treatment of short-term claims is appropriate for risk-management purposes. *The EBF therefore thinks that the preferential treatment of short-term claims, which is currently available only under Option 2, should be extended to Option 1, if that is the retained option*.

Moreover, the EBF is concerned with the proposal to reduce the short-term maturity cap to three months. The result would be to reduce liquidity and to distort the market, creating a perverse incentive for banks to fund themselves short-term. The proposal also raises considerable practical issues in terms of the necessity of demonstrating the absence of

intent in rolling contracts. *The EBF strongly prefers to see a twelve-month cap based on the <u>residual</u>, rather than original, maturity*.

4.12 Claims on corporates

The proposed sovereign floor on the risk weighting of corporates should not apply to exposures in, and funded in, the domestic currency of the corporate. This is particularly important in the case of corporates residing with the euro zone. Such corporates are no longer subject to a sovereign cap by the external credit rating agencies but are able to achieve the same rating as the euro area itself (AAA).

4.13 Retail assets

The EBF welcomes the statement from the Basel Committee, in the supporting document on the standardised approach, that it will review the appropriate treatment for retail portfolios in the standardised approach. The EBF would like to see a risk weight below 100% for diversified retail portfolios in the standardised approach (i.e. portfolios other than mortgage loans). However, the crafting of such a preferential risk weight should not hampered the more important objective of ensuring the IRB approach is more attractive to banks than the standardised approach.

4.14 Higher risk categories

The EBF objects to the blunt imposition of a 150% weighting (net of specific provisions) for any asset 90 days past due. The passing of 90 days past due does not automatically imply that an economic loss has been or will be suffered by a bank. In reality, the definition of a default is much more complicated for banks, and varies from sector to sector. The impact on lending to sectors such as SMEs could be particularly damaged by the imposition of such a risk weighting.

4.15 Other assets

Under the 1988 Basel Capital Accord, premises, plant and equipment as well as other fixed assets constitute risk assets and accordingly carry a capital charge of 8%. However, under the definition proposed by the Basel Committee ("*The danger of direct or indirect loss resulting from failed internal processes, people or systems or from external events*") the risk of depreciation in the value of fixed assets is an operational risk which presumably should fall under the separate prudential treatment of operational risk. Moreover, provisions for depreciation are intended to cover any shortfall in fixed assets values. A capital charge for these assets is therefore no longer appropriate. *The capital requirement for premises, plant and equipment and other fixed assets should therefore be deleted*.

4.16 Off-balance sheet items

The Basel Committee appears to propose that unconditionally cancellable (at any time) credit commitments and commitments for which automatic cancellation without prior notice by the bank are assigned a 0% conversion factor provided the original maturity is one year or less. A credit conversion factor of 20% is to be applied to other commitments with an original maturity of less than one year. Commitments with an original maturity of more than one year are to be generally assigned a 50% credit conversion factor.

The EBF supports the assignment of a higher credit conversion factor to uncancellable commitments compared with cancellable ones; however, the maturity of a cancellable commitment is of no significance in assigning a lower credit conversion factor. Even accepting the assumption that the longer the maturity of a commitment the more likelihood there is that it will be drawn on does not effect the ability of the bank to cancel the commitment. *Therefore, the EBF would argue that all commitments that are cancellable at any time without prior notice by the bank should, regardless of their maturity, be assigned a credit conversion factor of 0%*. For other commitments, a credit conversion factor of 20% would be appropriate.

In the banking book repo transactions and stock lending will be treated as exposures to a counterparty collateralised by the securities/cash received. However, it is unclear how repo transactions and stock lending will be treated in the trading book. Transactions must meet the collateral minimum standards before offset is permitted. If offset is permitted the proposed treatment will apply haircuts to the value of securities received (according to the volatility of the exposure, collateral and any currency volatility). The value after the haircut will be compared with the exposure amount and a charge applied on the uncollateralised element of the exposure, plus (usually) 15% of the gross amount (the “W” factor).

This approach is inappropriate for repo transactions and stock lending undertaken for liquidity purposes, rather than funding. The EBF asserts that:

- the nature of these transactions (where both sides are part of an indistinguishable whole) does not demand a significant level of capital to be held;
- the standard documentation is sufficiently robust to negate the need for a “W” factor;

- the proposed levels of haircuts are excessive and should be based on a holding period of less than 10 days;
- the range of eligible transactions is unduly limited.

4.17 External credit assessment institutions (ECAIs)

Under the Basel Committee's proposals, the decision on whether an ECAI satisfies the eligibility criteria is to be left to national supervisors. National supervisors should disclose how they assess the suitability of ECAIs to ensure transparency. Moreover, the EBF is concerned that this level of national discretion could lead to distortions of competition. *To avoid this risk, the EBF proposes that ECAIs that are recognised in one country should be automatically recognised in all other countries (mutual recognition) and that to improve transparency the Basel Committee should publish, on a regular basis, a list of recognised ECAIs*. The BIS might maintain such a list. The various categories used by the ECAIs should also be mapped to a common scale to achieve maximum transparency between different ECAI ratings.

To qualify for recognition by supervisors, an ECAI must satisfy certain criteria. It should be ensured, in this connection, that ECAIs meet at least the same requirements as internal rating systems. The EBF notes that the standards concerning the disclosure of information on ECAI assessment methodologies and time horizons are less detailed, and thus lower, than the disclosure standards for the use of IRB systems. It must be ensured that disclosure requirements are not used to make external rating more attractive than internal rating. Provision should also be made for the recognition of specialised agencies that provide ratings for limited sectors of the economy.

The EBF questions whether the eligibility criteria outlined present a barrier to recognition that even the major credit rating agencies might fail. Of particular concern are the Disclosure and Resource criteria that in the view of the EBF are unrealistic as drafted.

4.18 Credit risk mitigation in the standardised approach

The EBF notes that the general approach is intended to be 'top down' to ensure consistency between techniques but is 'bottom up' in practice. There are inconsistencies in the approach that are likely to lead to unintended consequences, including transactions being structured or documented to obtain more favourable treatment. The transaction-by-transaction basis brings into doubt whether portfolio approaches (particularly for collateral) will be eligible.

The increase in the range of collateral instruments eligible for credit risk mitigation is to be welcomed. However, *the EBF thinks that physical assets, such as industrial premises and equipment, ships and aircraft should be added to the list of eligible collateral, as should precious metals and precious metal certificates, and leasing and factoring*. Moreover, the EBF believes that non-physical assets, such receivables, should also be accepted since they are very important for SME business. In order to clarify the rules on eligibility in the simple approach the EBF would welcome a list of “main indexes”.

Under the comprehensive approach the calculation of the capital requirement for collateralised exposure is subject to a system of haircuts. The adjusted value of the collateral should depend exclusively on factors that are determined by the type of collateral. It is therefore illogical to create an “add-on” for the exposure. Stipulating that an add-on is only to be applied to such risk assets if they have been collateralised would clearly discriminate against collateralised as opposed to uncollateralised exposures, thus providing a disincentive to prudent credit risk management.

The EBF also rejects the general application of a haircut for currency volatility in the event of a currency mismatch between collateral and exposure. Certain types of collateral have to be included in the overall currency position. Applying a haircut would therefore result in the double counting of the foreign currency risk. For this reason, a haircut should only be applied to collateral that is not already captured in the overall currency position.

The Basel Committee proposes that supervisors should be able to permit banks to calculate haircuts using their own estimates of market price volatility and foreign exchange volatility. Permission is to be conditional on the banks meeting certain qualitative standards and satisfying the quantitative standards set out in the 1996 Market Risk Agreement for the use of internal market risk models.

The EBF is of the opinion that internal estimates, on the basis of externally calculated or pooled data, should be allowed. The regulatory recognition of an internal market risk model should be dropped as a requirement as such models are not necessary for a sound estimate of market volatility. The requirement to reflect non-linear market risks, for example, goes far beyond the qualifications necessary to describe volatility. Moreover, banks that do not use an internal market risk model, due to their low trading volume, should still be able to use their own estimates to calculate haircuts. *The EBF would therefore ask that the Basel Committee set appropriate qualitative standards for calculating internal haircut estimates, which could be monitored under Pillar II*.

The Basel Committee proposes a “W” factor for the calculation of capital requirements for collateralised or guaranteed exposures. “W” would depend on the counter party’s credit rating and is intended to capture the uncertainty of the effective value of collateral and guarantees. It is in effect an operational risk charge, the justification of which is based on the argument that related documentation might prove to be less robust than envisaged. However, another argument could be that “W” is a proxy for an inherent LGD element in collateralised transactions and, given the operational requirements involved in the standardised and IRB approaches, is unjustified. A similar argument is applied in the section on Guarantees and Credit Derivatives: “W” is equal to zero for sovereign or bank guarantees, but 15% for other guarantees. *The EBF therefore argues that the risks claimed to be captured by “W” are already subject to a capital charge through the separate operational risk charge. “W” is therefore double counting of risk and should be removed*.

4.2 Credit Risk: Internal Ratings Based Approach

4.21 General comments

The EBF welcomes the central role of the internal ratings based approach in the new Accord. The general structure and the conceptual framework proposed are in line with the ideas presented by the EBF in its earlier responses to the Basel Committee. The internal ratings based approach has the potential to create a risk based regulatory capital regime that rewards good practice and is broadly in line with economic reality. Unfortunately however, the rules as currently drafted will not allow the realisation of this objective.

The current foundation internal ratings-based approach does not provide any incentives for banks to move to it from the standardised approach. Indeed the opposite is currently the situation. Many banks will not desire to place themselves in the position of having to expend considerable financial resources on implementing an internal ratings system that will generate higher regulatory capital requirements and increased supervisory intrusion. The advanced internal ratings-based approach may offer a better option but will be unattainable for many years for the majority of banks.

The EBF is concerned that the proposals could divert resources from the development of internal risk management practice, creating a process focused upon compliance rather than risk management. The result might be that banks develop dual systems; one to comply with the regulatory standard and another to manage risk. The creation of a single risk management system within the confines of the standards rules rather than the risk management purposes would be the worst outcome. On both counts, banks would fail the proposed usage test.

The introduction of standard rules, at the level of detail proposed, would create a network of boundaries marking significant breaks in the regulatory capital regime. However, these boundaries would not match a constant economic reality. A clear example can be seen in the issues raised by the reference definition of default.

The EBF agrees that minimum standards are necessary; however, these standards should be focused upon the delivery of sufficient consistency to allow comparable performance analysis and to provide standard inputs into the regulatory model. A regulatory reference definition of default, for example, is an absolute requirement. Overall a better balance should be struck between minimum operational standards and minimum output standards. Currently

these proposals concentrate too heavily on prescribing how banks undertake credit risk assessment and insufficiently on testing the output.

In the view of the EBF it is essential that the Basel Committee remedy the shortcomings of the foundation internal ratings-based approach so that banks are given a strong incentive to move to it from the standardised approach. If this does not happen, the EBF is concerned that the majority of banks will refuse to move from the standardised approach and thus the aims of the new Accord will not be met.

Prior to discussing the detail of the proposals the EBF would like to register a general point on the presentation of the IRB approach and the supporting technical background. A general feeling exists that there has been a lack of transparency in terms of the underlying data and analysis. This has made a full analysis of the proposals difficult. Issues of concern include:

- in the documentation, it is stated repeatedly that the equations and coefficient values have an empirical basis, yet there is no reference to available published empirical studies or evidence;
- in the documentation, many coefficients and formulae are presented without any background discussion or references.

The EBF therefore requests that in future the Basel Committee provide more underlying details. The EBF would particular like to see the input data, for example, what data was used and how it was estimated, rather than just the model structure itself. This would allow a full analysis and response from the industry.

The EBF places particular emphasis on an early release of the data and analysis generated by the second Quantitative Impact Study. The full and early documentation of the basis of these calculations is an essential foundation to the credibility of the new Accord.

4.22 Adoption of the IRB approach

The EBF would urge the Basel Committee to review and revise the requirement that progression into, and within, the IRB approach be subject to an "all or nothing " requirement. The industry accepts that the Committee has a legitimate interest in policing progression between the standardised and IRB approach but would argue that the introduction of a simplistic rule is not the best way to proceed. Such a requirement does not mirror industry

practice and may well lead to perverse risk management and investment decisions. For example banks may be:

- pressured not to undertake beneficial acquisitions
- reluctant to enter new markets
- reluctant to develop new products
- pressured to sell business segments or close business segments for which an IRB approach is not appropriate.

To avoid these problems, the EBF would suggest a twin track approach. First, the retention of a general presumption that all material portfolios should migrate to the same approach over time. Second, the development of regulatory procedures and principles that would have to be met to authorise exceptions to the general rule. In essence banks would have to demonstrate and disclose “good reason”.

For example:

- New market: a bank that enters a new market will not be able to implement an IRB approach for a significant number of years, especially if there is slow growth and the initial years do not provide enough robust data.
- Inappropriate: there are specific markets, either sectoral or geographical, for which the use of an IRB approach would be inappropriate or undesirable. For example, an emerging market where historical PD data is either unavailable or unreliable. Consequently it is not practical, nor would it make prudential sense, to apply an IRB approach.
- M&A: a bank may purchase a significant business entity and this may take some significant time to be brought into the rest of the bank’s IRB risk management system. The "all or nothing requirement" should not act as an artificial barrier.
- Immaterial: a small book of business (irrespective of whether it is within a non-significant business unit) that has limited exposures and limited risk would not warrant a sophisticated and expensive IRB system.

In these instances there should be no general presumption of a +100% risk weighing. Also, in the instance of good reason the general prohibition on intra-group transactions should not be applied.

Finally the EBF seeks clarification of the phrases "a reasonably short period of time" and "aggressive, articulated plan". The tone implies swift adoption of the IRB approach. This may

be impractical. The development of an internal ratings approach of the required quality is a substantial project; moreover, banks must meet the requirement of PD data over five years. Therefore a 5-7 year roll out plan would appear to be a minimum timeframe.

4.23 Transitional data requirements

The EBF notes that the progressive increase of data requirements in parallel with the entry into force of the new Accord means, *de facto*, that rating systems can only be recognised for prudential purposes either in 2004 or 2008. A bank that fails to meet the internal rating system requirements, or has failed to capture and rate its total loan exposure at the end of 2001, will not be able to establish the required historical observation period by 2004. A retroactive extension of the data history would not be possible as subjectively assessed elements of a rating cannot be determined or reproduced *ex post*. Moreover, the requirements in many areas will be unclear until the end of 2001. Therefore, stipulating that rules that will be unknown until the end of 2001 must be implemented by that date is an impossible requirement. *The EBF therefore suggests that, at least until the end of 2006, a two-year data history should be stipulated for internal ratings, without any increase in requirements during the transition period.*

Furthermore, until the end of 2006 banks should only be required to demonstrate that they have been using a rating system that is broadly inline with the new rules for a period of twelve months within the two-year data history. This would facilitate access to more sophisticated methods of risk measurement and would provide an incentive for improvement in internal risk management.

After the expiry of the transition period the original requirements (five-year data history and three-year usage test) would apply. It must, however, be ensured that once recognition of an IRB system has been obtained it is not subsequently invalidated by higher data quality and usage test standards set after the end of the transition period.

The transition periods for establishing a data history should be extended to cover LGD and EAD. There is no economic reason for a longer data history for estimating LGD and EAD than for PD. EAD, in particular, is a secondary credit risk parameter. The EBF also suggests that where the parameters in question are concerned, statistical sampling should be eligible for recognition.

In sum the EBF suggest the adoption of a common five-year data history requirement for PD, LGD and EAD, a three-year transition period and a one-year usage test.

4.24 Minimum operational requirements

a. Categorisation of exposures.

The EBF accepts all the proposed exposure definitions except those for retail and project finance. On project finance, the EBF welcomes the Basel Committee's recognition in the supporting document on the IRB approach that the preliminary definition of project lending without amendment is likely to be too broad, and that additional qualifications are required to exclude some forms of lending that do not conventionally form part of project finance.

EBF is strongly against all income producing investment in commercial real estate being excluded from eligible real estate collateral for corporate exposures. Completed multi-purpose commercial buildings, which can be used by third parties, should be recognised as eligible collateral in the IRB approaches for corporate exposures even if the property itself is the primary source for servicing of the debt. The same should be the case for rented residential buildings. Lending to property investment companies should not be excluded from the corporate approach. It would be inconsistent to allow recognition of such collateral for corporate exposures in the standardised approach and not in the IRB approach. The EBF recognises, however, that when the performance of the underlying project serves as the primary source of repayment the nature of risk associated with lending to such sectors can differ from lending to the corporate sector in general. *Inter alia* the risk attached to some projects will be high during construction and development but will fall significantly once the projects have come into use, thus having a 'vintage' or 'seasoning effect'. If the IRB treatment seeks to take account of the high risk of projects in early phases, it must also (to be incentive compatible) recognise the reduced risk in later phases.

b. 30% per grade rule

The Committee currently requires that "no more than 30% of the gross exposures should fall in any one borrower grade". The EBF believes that such an arbitrary standard is unhelpful and, in view of the ease with which it could be sidestepped, meaningless. There are various sound reasons there might be concentrations in niche markets, for example the inter-bank markets. If the requirement persists then regulators should instead use 30% as a guide and have confidence in the application of all the other minimum requirements.

c. Rating per legal entity

The current proposals require that "each separate legal entity to which the bank is exposed should be separately rated." This requirement is unnecessary and unhelpful. Various examples can be advanced where this rule should not apply, for example group overdrafts.

Unless addressed, the industry believes that this requirement could substantially add to the costs of implementation with no corresponding prudential gain.

Rather the request for a separate rating should be based on a ‘per credit agreement’ basis. The key is the scope of risk that has been taken by a bank. The scope is normally defined in the agreement with the borrower (regardless of whether multiple separate legal entities are allowed to draw under one and the same agreement).

d. Independent review and internal audit:

The EBF understands and is supportive of the review of ratings carried out by an independent unit or individual. Again we are concerned that in the creation of a rule the Committee must be aware of those circumstance that do not, for good reason, fit the model approach. This model works well in an environment in an organisation that has a centralised mechanistic rating process, functionally separate from the business. This is the norm in a number of markets, notably in lending to large, listed and externally rated counterparties. The ratings process in organisations that operate cross border or which have substantial middle market exposures is often more diffuse. For the accurate rating of middle market clients it is necessary to have staff who understand the local market, the quality of financial information available, and have a good knowledge of the customer. In this environment delegation of authority below agreed materiality limits is an absolute operational requirement.

All of this has implication for an independent review model based upon a central process and unit. This requirement needs to be made sympathetic to risk rating process that deviate from the model. This would include an appreciation of delegated authority, the necessity of sample testing, materiality limits and market efficiency. This could best be achieved by changing the proposed rule to guidance.

e. Annual review or re-rating.

Related to the above, the current proposals suggest that borrowers should be reviewed by an independent unit on an annual basis, or sooner if new information comes to light. In addition a process should exist to update risk ratings within 90 days of the receipt of new information, or within 30 days if the information suggests deterioration. *This requirement should be redrawn as guidance*. Bank management should have the discretion to re-rate. In the instance of low risk exposures, in particular, this requirement is inappropriate.

f. Senior management oversight.

The board should demonstrate an understanding, and approve, all material aspects of the internal-rating system. This requirement is to be supported by detailed reporting. This represents a misunderstanding of the role of the board and the number and complexity of rating systems that a bank might operate. Management discretion should be the basis of all board/senior management reporting in terms of scope, frequency and presentation.

g. Borrower risk assessment

The proposed minimum criteria for borrower risk assessment were considered appropriate only as a guide rather than a rule. The factors that are relevant to the assessment of borrower risk are varied and prescription of standard analytical inputs is unhelpful. Again we suspect that these requirements have been drafted in the context of lending to large, publicly listed corporates. It is difficult, for example, to understand the relevance of these factors in middle market lending. *This requirement should be redrawn as guidance*.

h. Minimum requirements for the estimation of PD

The EBF is concerned that there is currently no clear articulation of the conceptual basis of a PD based rating system. The current requirement for a forward looking, conservative, one-year long run average, based upon historical experience PD, is confusing and in places contradictory. It is also unclear whether PD is borrower or transaction specific. Clarity is required.

i. Reference definition of default

As noted earlier the EBF believes that consistency in the measurement, and therefore the definition, of the probability of default is an absolute requirement of the new Accord. In broad terms, the EBF would support the intent and the formulation of the current reference definition of default. It is right to attempt to strike the difficult balance between consistency and flexibility. Within this general welcome the EBF would note a number of significant concerns.

The proposed reference definition of default is in fact a definition of impairment. This means that banks will have to record a regulatory default in instances where no economic loss is envisaged and no provision allocated. The cumulative effect of such exceptions will have a distorting effect upon certain credit markets or internal risk management. For example it could lead banks to keep loan indebtedness current (or rather within 90 days) at the expense of overdrafts. Or, depending upon how banks decide to collect data to calculate PDs, it could

force banks to transfer assets to realisations/recovery functions, which would not add value and would not be an economically justifiable use of resource.

The preferred EBF solution is to enable banks to apply broader judgement as to when default is called. The objective being to ensure the regulatory breakpoint matches an economic reality. The process will, after all, be subject to far greater internal and external scrutiny in categorising defaults as such and calculating PDs robustly. There is no automatic linkage between the reference definition and the treatment of non-performing loans.

If that option is not available then the EBF would propose that the current reference could be amended to overcome this and associated issues. The amendments are as follows:

- limit 'defaults' emanating from restructured credits to those that carry terms which are more onerous or more heavily priced than open market credit terms

- limit defaults called where the borrower is more than 90 days past due to those situations where the debt is crystallised and the customer relationship is terminated.

The current reference definition also contains an implicit assumption of cross default. The EBF would note that there are, and should be, practical limits to this assumption. Clarity would be useful on this point.

The EBF has also given consideration to the relevance of the given reference definition of default across exposure class. The current definition is acceptable as the basis for corporate exposures but works less well for bank, sovereign and retail exposures. For banks and financial institutions an alternative might be that a default is considered to have occurred when one or more of the following events have taken place:

- entered administration;
- entered liquidation;
- received liquidity support from the national central bank;
- had its authorisation revoked, or
- voluntarily surrendered its authorisation, except when motivated by corporate restructuring (e.g. following take-over) or by a strategic review of the benefits of the licence.

Even with these amendments, it is clear that the implications for monitoring all four elements of the reference definition, across a global banking book segmented by business unit, will be considerable. To an extent this burden is an inevitable consequence of the reform process and an acceptable price relative to the cost of imposing a standard definition. To a degree banks will be able to build this requirement into planning their future systems.

The treatment of historical data sets is of more concern. *The EBF would argue strongly that the Basel Committee give consideration to grandfathering data series developed prior to the finalisation of the reference definition of default*. It would be unreasonable to penalise institutions which have invested in internal data collection. This concession would be rescinded upon finalisation of the new Accord.

j. Minimum requirements for PD estimation

The EBF welcomes the Committee's acceptance that PD estimation may be based upon internal default experience, mapping to external data or statistical default models. In an environment in which data is limited it makes sense to allow banks the flexibility to use what is currently available, within guidelines. In particular, the EBF expects that support for pooled data series will bear fruit in the near term.

The EBF understands that the mapping process should be undertaken on a conservative basis but would be concerned if this resulted in undue restrictions. For example, it is not clear whether US corporate default data would be considered relevant to the assessment of European corporate risk under the terms outlined. It can be anticipated that the impact of a narrow interpretation would be particularly felt in sovereign and bank debt markets where default data is scarce. This low incidence of default makes it unlikely that an institution will be able to meet the current IRB requirements on the basis of internal data.

k. Usage test

The EBF is convinced that the usage test should be the foundation of the IRB minimum operational requirements. As currently constructed the minimum operational requirements make this an unachievable objective for the majority of banks. Unless modified we believe that the result will either be the maintenance of dual systems or the constraint of industry practice. Neither outcome is desirable. Both would be barriers to the achievement of industry and regulatory objectives.

l. Internal validation.

The EBF supports the introduction of internal validation standards. Indeed, as noted above, we would recommend that the Committee should place more reliance on validation and, in compensation, revise the current reliance upon process standards. The industry argues for a balanced approach recognising the limitations of credit risk validation relative to standards articulated for market risk models. Validation should concentrate upon practical demonstration that the internal rating system delivers a robust assessment of credit risk rather than percentage point accuracy.

4.25 Calibration

The EBF is concerned that the current IRB risk weighting function results in a requirement to hold economic capital well in advance of economic necessity. Initial estimates suggest an increase over current level of regulatory capital in the region of 50%. The EBF does not believe that this reflects the true risk profile of the industry and its under reporting by the current Accord, rather the EBF is concerned that this is the result of the inclusion of two crude additional factors in the risk weighting function intended to buffer against measurement error (+20%) and the difficulties of raising capital over the economic cycle (+30%). *The EBF unequivocally opposes the introduction of these factors. The result of these two factors is to reduce the risk sensitivity of the proposals. This must be against the commonly shared objective of this reform process.*

The EBF is also concerned that the inclusion of a 1.5 multiplier will amplify negative cyclical effects, already identified as a concern by the Basel Committee. This would create restraint on bank lending, unrelated to bank management, which could potentially have a significant impact on the real economy. Moreover, the assumption, argued by a number of regulators, that any increase in regulatory capital can be accommodated within current economic capital holdings is unsupportable. The market will expect banks to maintain the current differential between economic and regulatory capital. Thus any over-calibration of the regulatory minimum will be exaggerated by market pressures.

Finally the EBF would question the need for an overarching capital buffer given the number of factor buffers built into the calculation model. The IRB approach is based upon conservative assumptions and conservative operational standards. Conservative elements identified included:

- calibration of various risk components (PD/LGD/EAD)
- calibration to UL **and EL**
- through the cycle definition of PD

- no recognition of risk diversification

4.26 Relative calibration

The current tentative calibration does not provide an incentive to banks to advance from the standardised to the foundation internal ratings-based approach. The industry strongly supports the introduction of an evolutionary path, in which banks are rewarded for developing their risk management. The EBF has always seen this pedagogical aspect as a fundamentally important element of the new Accord. It is therefore unfortunate, and presumably cannot be the aim, that the current calibration creates a counter prudential incentive to remain on the standardised approach.

It should also be noted that there are concerns that the foundation approach, juxtaposed to the standardised approach, could have a negative, and significant, impact on SME financing. In particular, exposures to SMEs that do not fall with in the retail treatment but which are of insufficient size or length of track record to warrant a good internal rating could attract a very high PD, translating into a very high risk weighting. The EBF suggests that this would result in an overstatement of required capital, driven by four primary factors:

- 1.5 multiplier within the IRB risk weighting function;
- IRB risk weighting function based inappropriate correlation assumption for SME portfolio;
- property and physical collateral not well recognised;
- no recognition of credit risk mitigation of less than one 1year maturity.

A further area for concern is the calibration to UL **and EL**. This raises some fundamental issues as to the function of regulator capital. In the past regulatory capital has been held to cover UL, whilst EL was covered by pricing and provisioning. To accept a move away from this traditional situation the EBF would require the removal of the 1.25% cap on general provisions as Tier 2 capital and recognition of expected margin income against EL especially in the retail portfolio as minimum requirements. The EBF would also like to see the EL element of regulatory capital isolated from the UL element and separately identified.

4.27 Credit risk mitigation in the IRB approach

The arguments against application of the “W”-factor for collateral and guarantees in the IRB foundation approach are similar to those presented under our comments on the standardised approach above.

Under the foundation approach for exposures to banks the LGD factors for corporate exposures are used. Clearly, the 50% LGD for senior claims on banks is much too high. We understand that BIS has estimated LGD at 20% for banks. The EBF therefore requests that a separate LGD factor for senior claims on banks, more in line with this estimation, be introduced in the New Accord. The EBF is also of the opinion that the LGD value for sovereign exposures in the IRB foundation approach should be reduced from the proposed value of 50%. It is proposed that securitisation tranches issued by other institutions are given a 100% LGD in the IRB approaches. This number is also too conservative and it should be set below 50%.

4.3 Retail exposures

4.31 General remarks

The new proposals on retail portfolio are welcome and represent a substantial advance on the June 1999 proposals. As argued in the EBF/ISDA Retail Portfolio Study it is right to include retail portfolio within the internal ratings based approach but on a basis that recognises the difference in risk profile and risk practice.

Broadly, these proposals are moving in the right direction and have the right objective but, in common with other areas, there are significant problems with the realisation. To a large degree the current retail proposals are an adaptation of the developed approach to corporate exposures. This extension works in general terms but in some instances it is unsustainable and a new approach is required. The EBF would hope that these issues can be addressed as part of the continuing consultation on this area over the remainder of 2001.

4.32 Retail risk weighting function

The EBF supports the proposed 50% adjustment to the corporate risk weighting function when applied to retail exposures as proposed by Basel. It is line with the previous position of EBF as expressed in the March 2000 response and in the BBA/EBF/ISDA Retail Portfolio Study of September 2000. However, the EBF did not anticipate a calibration to the sum of both expected and unexpected loss.

The EBF believes that the impact of the current calibration of the corporate risk weighting function to the sum of expected and unexpected credit losses bears relatively harshly on retail portfolio characterised by a stability of both expected loss and core margin income. If the current relative calibration persists un-amended then EBF would be concerned that this will have an unreasonable impact.

To address this potential imbalance, the EBF would argue for recognition of expected margin income or provisions against expected loss in the retail book. Specifically the EBF would propose that banks, subject to a Pillar II review process, apply a risk weighting function that excludes expected loss. That Pillar II assessment process should satisfy regulators that either core margin income or provisions are available to cover expected loss. It is right that this process should focus upon the stability of both margin income and expected loss over a reasonable period.

4.33 Risk components

The EBF supports the Basel Committee's decision not to use the 'foundation' approach for retail banking portfolios but to limit it to the advanced approach. In contrast to corporate portfolios, applying LGD benchmarks would automatically produce clear distortions in competition to the extent that they would not be representative of the quality of the recovery process. Each bank has its own definition of default that reflects the nature of its lending portfolio and its recovery procedures, with the main aim being to minimise eventual losses. Thus for this type of business, linking prudential capital rates to a single component of the PD/LGD equation would be illusory.

4.34 Definition

A clear consensus exists that the definition of retail should be risk based and not focused on either absolute values or an absolute definition. Rather the definition should be based on portfolio characteristics and methodological approach. EBF would propose the following primary portfolio characteristics:

- homogenous product group;
- granularity.

The methodological approach reflects these factors and suggests loss-forecasting methodologies that have a tendency toward objective statistical analysis based upon loss data. In addition, EBF believes that a defining feature of retail portfolio is a concentration upon customer behaviour and the use of behavioural models.

There is no appetite for further differentiation of the retail portfolio and no need for the disaggregation of the mortgage portfolio.

4.35 SME exposures

The term “retail banking” is generally taken to refer to lending to individual clients. This field is typified by the low unit amount of loans and the large numbers of loans within a portfolio, allowing a near-perfect statistical mutualisation. However, for many banks, lending to very small companies (including the self employed) is closer in nature to lending to individuals than it is to corporate lending, which generally implies a long-term continuous relationship and multiple loans to each counterparty. Thus it is often the case that statistical decision support tools used in loan issuance (scoring, expert systems, etc.) and recovery, are similar to those methods commonly applied in the individual lending market. It is therefore very important that the differentiated treatment of retail exposures is applied to all lending portfolios in which the methods applied to risk control follow the same industry approach to loans, both at issue and in recovery.

4.36 Definition of default

The EBF opposes the adoption of the proposed reference definition of default in the retail portfolio. The reference definition proposed is, as outlined above, broadly relevant to corporate portfolio but not to retail exposures. Certainly the almost un-amended carry across of the corporate definition will only create problems in a different environment. For example, unlike in the corporate book, the concept of cross default does not apply in the retail book. There are also doubts as to whether the concept of default has the same relevance in the retail portfolio where default more often marks an analytical break point than an economic event.

The EBF would propose a simple operational criterion to define default. The definition of default should be limited to a single criterion, to be selected by each establishment. Imposing four criteria, as suggested, creates a *de facto* threat to systems using a different, more operationally based definition of default[1]. Restrictive criteria for the definition of default are even less necessary for retail banking in that the approach chosen by the Basel Committee obliges each establishment to estimate its own LGD, which is strongly correlated to the notion of default used. Thus in the recovery process, the longer the classification of default is delayed, the greater the LGD.

4.37 Segmentation

The EBF believes that any rules on the basis of which segmentation should be undertaken would be counter productive. Rather, beyond a minimum number of buckets, the EBF is strongly in favour of a completely flexibility of approach. Such an approach would resolve a

number of difficult issues: inclusion of behavioural scores, customer orientated risk management, absence of application scores on old accounts. It would also allow banks to pursue a purely risk based approach.

The division of exposures into homogeneous segments is an important part of the risk management of retail assets. Each segment should be as homogenous as possible with respect to the credit characteristics of the assets within it. However, each segment must also contain a sufficient number of assets to allow statistical estimation of default probability, severity, and exposure at default. There is therefore a tension between achieving homogeneity, which would naturally tend to increase the number of segments, and having statistical significance, which would tend to restrict the number of segments. Achieving the right balance between these two is extremely important.

The suggested segmentation in the draft proposal may not be appropriate for all portfolios. The most ideal segmentation is likely to differ between products, jurisdictions, and even between banks within the same jurisdiction. The key test is that the characteristics chosen by the bank should be those used internally to manage the business. Each institution should be free to choose the segmentation it deems most appropriate, and specific segments should not be made compulsory. The institution should justify its chosen scheme (on the basis of performance) to the regulators in the supervisory review process.

Not allowing an institution to choose its own segmentation will lead to a number of problems:

- The most appropriate variable to distinguish borrower quality may well change over time. For example, an application score may be appropriate for the initial few months, after which a behavioural score may be a better estimate of default probability.

- New techniques for assessing the risk of a portfolio are being continually developed. The proposals are not sufficiently flexible to allow for this.

- New products are also being continually developed. It is important that the proposals are able to accommodate such market developments.

- The "tension" described above implies that a bank should optimise its choice of segments by using those which are most discriminating. However, if compulsory

[1] Standardised default by number of payment failures is a particularly delicate step, as each establishment has its own

segments are set which are less discriminating, then banks will either have to use a sub-optimal segmentation, or have unduly small populations in some parts of the overall segmentation.

- The current proposal uses “product” as one of the segmentation factors. This does not fit with a single/whole customer orientated risk management view.

- Assets, which do not have the requisite attributes, may lead to these assets being unfairly penalised. For example, assets originated prior to the introduction of scorecards may be unscored. However, because they are “old” assets they are likely to have performed for an extended period, and therefore be of very high quality. A more flexible segmentation scheme would allow for these assets, where it can be established (e.g. from delinquency rates) that they are of higher quality, to be treated favourably.

The key point is that, whilst a bank should be free to choose its own segmentation, it must be capable of mapping each of these segments to a probability of default, LGD, and an EAD. This mapping will ensure that capital levels are consistent over time, across products, across jurisdictions, and across individual banks.

4.38 Other issues

For retail banking, internal rating systems are based to a large extent on credit scoring techniques. This has a number of consequences:

- Ratings draw on details of the borrower (age, family situation, salary) but also on the type of loan (personal contribution, type of surety, etc.). Thus one cannot claim that this is a counterparty rating in a strict sense.

- For certain types of loan (particularly property loans) the relationship with each client can be limited to making the loan, assuming that there are no subsequent payment problems. However, in more extensive relationships, behavioural scoring allows continuous rating of the client base.

- Depending on the type of loan, the time horizons for default probabilities, associated with scoring ratings, can vary considerably.

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standard, which, moreover, varies according to the type of portfolio.

Thus excessively strict standardisation of internal rating systems would be a *de facto* condemnation of banks whose credit scoring systems did not perfectly match the criteria issued by the Basel Committee, or at the very least would oblige them to rebuild their systems for the sole purpose of meeting regulatory requirements. This is clearly not the aim of the Basel Committee. The EBF would therefore suggest a general relaxation of criteria, to bring the effects into line with the regulator's goal of encouraging the development of tools for evaluation pricing and lending risk control.

A general concern exists in relation to the proposed requirement for a standard annual review period. For consumer lending, including revolving credit, no review frequency should be imposed. For other types of lending (property loans, loans to small businesses) it is essential that the review of the rating is limited to an update, taking account of new factors affecting the credit quality of portfolios and of the ageing of outstandings[2]. Where possible this should draw on behavioural scoring. For consumer loans and those to very small companies, the yearly period can be retained. For property lending a three-yearly period would clearly be more suitable.

The regulator's attention must immediately be turned to the methods of monitoring that will be applied to internal rating systems, particularly where these are based on scoring. Given that scores are used in the calculation of capital adequacy, under no circumstances should each change to the system be subject to a request for authorisation from the regulator. Such a situation would severely impair the responsiveness of banks. However a system of checking would be desirable at regular intervals, based on results that allow verification of the discriminatory power of credit scoring systems. Such a system of checking would clearly be of more operational value than a full audit of systems.

Regulators will face something of a conundrum when setting validation standards for retail models and scorecards. The Basel papers frequently refer to, or call for, long run data series to validate models and assumptions. On the other hand, they also want models to pass the “usage test”. In practice however, retail scorecard builders make regular adjustments to their models, believing this to be necessary in order to keep up with rapidly changing customer behaviour in the retail marketplace. In other words, it is widely believed that scorecards need frequent modification in order to remain predictive and useful.

[2] During a transitional phase – of, say, three years – it would be advisable to create a database of property loans for each national regulator. This could be used to produce standard curves of risk emergence, allowing banks which do not yet have the necessary data to modify the rating of outstandings as their portfolios become older.

Additionally it does not make sense that risk assessment techniques built for their predictive value be tested on the basis of their performance when applied to historical situation. It is simply not legitimate, except within a very limited retrospective period, to test current models by reference to how they would have performed in the past.

4.39 EL or PD/LGD

The EBF thinks that each bank should have the ability to choose, for each of its portfolios, one or other of the methods suggested by the Basel Committee (PD/LGD or direct move to EL). Depending on the nature of loans and the channels of their distribution, several internal rating systems can co-exist within a single establishment.

However, direct application (with an LGD of 100%) of the table of weightings created for the PD/LGD approach could penalise banks. For a loan with a PD of 1% and a LGD of 50%, the PD/LGD approach would give a rating of 64%, against 80% under the EL approach. One solution could be to allow banks to apply their own fixed LGDs by type of portfolio (property, consumer, very small businesses). Moreover, estimating effective losses by integrating all their components seems unlikely to be practicable by 2004, as developments of analytical accounting systems will be absolutely essential. A five-year transitional period will be essential for this.

Whatever else happens, and whatever approach is used – EL or PD/LGD – it is essential that the calibration of weighting coefficients encourage banks to prefer the IRB over the standard ratio.

4.4 Project Finance

The EBF welcomes the Basel Committee's recognition of the fundamental difference between project finance and other types of finance and that project finance should be subject to a differentiated treatment.

However, the EBF believes that there are other forms of asset finance that warrant a similar treatment and therefore suggest that these should be included in the Basel Committee's further deliberations and consultation.

4.41 Definition

We agree with the definition provided by the Basel Committee, subject to three minor comments:

- "loans" is a rather narrow term for the range of financing instruments used; a better word might be "financing transactions";

- a further characteristic of the market, and one which speaks to the quality of risk management, which is one of its characteristics, could be reflected in the addition of the words, "The performance of the project is, typically, monitored against projections on a regular basis."

- the term "warrant" could be interpreted as meaning "guarantee", which we assume was not the Committee's intention. If it was so intended, we believe that this is misguided and unacceptable.

4.42 Regulatory challenges

The EBF believes the Basel Committee has identified the main challenges in arriving at an appropriate capital regime. In particular the unique nature of each project precludes validation of gradings through historic data.

Before considering the types of rating or grading systems currently used by banks, there are two important points to make.

The nature of project financing is that projects are structured against cash-flow and are generally subject to frequent review of progress against projections and forecasts, via coverage ratios, performance targets and other covenants. From these, the probability of a problem is identified and an assessment made of the likely loss. This may, and often will, result in a restructuring of the project or of its financing, rather than be reflected in crystallisation of the position and lead to a work-out.

In addition, default may, and frequently is, called as a result of a covenant breach, which can reflect the failure to provide information on the due date. Usually, this does not reflect an increased probability of loss. The concept of default is therefore very different from that used in the corporate lending field.

4.43 Rating and grading criteria

In general, project financing are graded on a basis which, in its attempt to reflect the probability of project default, is necessarily different from that used for the corporate book.

It will be derived from an assessment of a number of elements. These range from objective, quantitative elements such as cash flow and debt service coverage, including assessments of the robustness of those projections, to assessment of such risk factors as: technology; supply contract; demand (off-take) contract; completion risk; operating risk; country risk; environmental risk. Most of these are subjective and reflect the various parties to the contract as well as the legislative framework and jurisdiction in which disputes will be resolved. In sum, the grading ascribed will largely reflect experienced judgement. The important factor to bear in mind is that, as a result of the regular reviews to which projects are subject, all of these factors are probably being reviewed on a rolling basis, the trigger for action being a material change to the EL which has been assessed. Given the unique nature of projects, however it is not easy to validate this EL with a high degree of accuracy. As shown by an industry study conducted through the IIF, this has led a majority of institutions to using a PD/LGD framework instead of an EL approach.

To answer the Basel Committee's specific questions, therefore: rating grades are assessed from a basis of objective and subjective elements to reflect the bank's existing loan grade structure; the assessments are primarily aimed at assessing cash-flows and their vulnerability; the orientation of the system is to a 2-dimensional (EL and EAD) approach; the nature of projects means that they are subject to more frequent review than the generality of corporate lending.

4.44 Project and asset finance and the IRB approach

Though the EBF recognises the difficulties highlighted by the Basel Committee (measurement of PD, EAD and LGD, data limitations, higher correlations among PD, EAD and LGD), it suggests that institutions be allowed to utilise either framework (PD/LGD and EL) thanks to a specific mapping.

The EBF strongly believes that experience shows that projects have an extremely good loss record. Even though the EBF would welcome the opportunity to work in the future with the Basel Committee in identifying criteria that can be used to identify projects that deserve relatively favourable treatment, it proposes that specific LGD classes be introduced as of now in order to reflect the high degree of risk mitigation brought through good structuring and collateral.

To summarise, the EBF proposes that the corporate risk weights apply to structured financing along with specific LGD classes, while leaving up to the institutions the choice of their grading framework, whether EL or PD/LGD.

4.5 Asset Securitisation

The EBF concurs with the Basel Committee's focus on asset securitisation and its objective of introducing consistency between different national supervisors in their treatment of such techniques. In particular, the proposal that the ratings of ECAIs be used in setting capital requirements is helpful. The ability to set lower levels of capital against highly rated asset-backed securities (ABS) is a recognition of the real risk of such instruments and should result in more appropriate portfolio management decisions by originators and investors in ABS alike.

4.51 The rationale for securitisation

The Basel Committee's proposals reflect the general view of the regulators that the primary motivation for securitisation is *capital arbitrage*. The EBF would argue that this view is mistaken. The primary benefit of asset securitisation is that it promotes better *capital management* by:

- creating the freedom to exchange financial assets amongst market participants, thus enhancing liquidity;
- facilitating portfolio management so that issuers can match liabilities to the tenor of assets;
- diversifying sources of capital, allowing an issuer to minimise funding costs, even in a deteriorating environment, reducing its dependency on traditional financial routes;
- focussing an institution's attention on the quality of its origination process, so that it has appropriate systems, documentation and organisational structure to manage its asset portfolio;
- stimulating functional specialisation by separating origination, administration and funding which maximises the efficiency, flexibility and responsiveness of the financial system.

As currently structured the Basel Committee's proposals on securitisation will provide a disincentive for banks to manage their risks via asset backed or synthetic structures. Securitisation potentially transfers risk out of the banking system, bringing a net increase in systemic stability. The imposition of further capital to the ABS process would act as a brake on this beneficial risk transformation process.

4.52 Standardised Approach: a general comment

The EBF believes that the differential approach proposed by the Basel Committee, dependent on whether the bank is an originator or investor, is unwarranted. The Basel Committee should focus on the nature of the risk retained or transferred and the concomitant amount of capital that is required or released.

4.53 The Standardised Approach: the treatment for originating banks

The Basel Committee claims that a clean break has occurred only if "the transferor does not maintain effective or indirect control over the transferred assets". This excludes situations where a transferor is "able to repurchase from the transferee the assets to realise their benefits and is obliged to retain the risk of the assets". The EBF would argue that a clean break is achieved so long as the transferor does not have any contractual obligation to repurchase assets in case of financial distress. Only where a firm has entered into a contractual obligation, permitting an investor to put assets back to the originator should regulators be concerned about implicit recourse.

4.54 Securitisation under IRB: A Hybrid Approach

The suggestion of the Basel Committee that the full amount of retained first-loss positions should be deducted from capital is unwarranted as it would mean that the institution would not be allowed to use the outcome of its internal rating system, which is supposed to reflect the actual risk involved.

It is proposed that if an institution provides implicit support to trusts or SPVs then all of the assets within the structure will be treated as if they were a part of the bank's balance sheet if the action is taken once. If second case of support occurs all the securitised structures the bank has originated are to be treated in this way.

The EBF disagrees with this treatment. The Basel Committee should realise that firms take commercial decisions about whether or not to provide support, and that the providing of such support should not be regarded as a delinquent act.

4.55 Synthetic securitisations

The EBF awaits the Basel Committee's further paper on synthetic securitisations. The EBF supports the Basel Committee's proposal that there be a standardised approach for synthetics, subject to appropriate operational requirements since many less sophisticated banks use such structures to manage their portfolios.

Currently the Committee proposes restricting the size of any retained first loss position to the amount of the expected loss, an approach that is not proposed for conventional securitisations. For structuring purposes the size of the first loss piece must be flexible and is a function of the structure chosen by the bank to achieve particular economic targets. The first loss portion should not be limited in this way.

Similarly the EBF does not believe it would be a suitable operational requirement that a substantive piece of AAA-rated notes be sold to the market. The framework should concentrate purely on the amount of risk transferred and only allow capital relief if capital is fully transferred. This should be independent of which tranches with which ratings are purchased by third parties.

It is essential, in order to facilitate the transfer of credit risk and foster liquidity in the market for credit risk instruments, that the regulatory treatment of synthetic securitisation is risk sensitive and flexible.

The EBF does not believe that originators should only be allowed to retain risk purely in the form of first loss and/or super senior tranches. More flexibility should be provided enabling originating institutions to retain any level of risk on the underlying portfolio, provided that the amount of capital held in relation to this risk is adequate. This would notably mean that if the institution transferred no risk at all, then its capital requirement should, in principle, equal that applying on the unhedged portfolio.

Where transactions are tranched using rating agencies' models, regardless of whether or not the tranches are effectively rated, the implied capital requirement on the liabilities side of the structure will be at least equal to that on the unhedged portfolio. This is because the approach taken to tranching by the agencies is more conservative than that implied in the IRB function, notably as far as correlation is concerned.

The EBF would therefore suggest that capital be held by originating banks as a function of the IRB charge on the tranches retained, capped at the capital charge on the unhedged portfolio.

First loss should not systematically be deducted.

The EBF submits the idea of a transitory period, or "grandfathering" period, during which existing structures would still be granted the current treatment, while new issues would be subject to the new rules. This would avoid banks having to absorb significant unwinding costs in case that call options are not built into the existing structures.

4.6 Operational Risk

4.61 General Comments

The EBF considers the introduction of an operational risk charge as one of the most fundamental changes of the proposed new Accord, with potentially wide ranging consequences.

EBF appreciates that the Basel Committee consultative document follows industry proposals as to the definition of operational risk and the choice of a spectrum measurement approach with four options designed to satisfy varying degrees of sophistication. The EBF response[1] to the first consultation paper, issued by the Basel Committee set out the minimum characteristics of an acceptable methodology for operational risk. For ease of reference, EBF reproduces the minimum standards as previously enunciated i.e.:

- **Definition** – a positive, bounded definition restricted to direct balance sheet loss.
- **Calibration** – calibration of the charge to an objective measure of soundness.
- **Measurement** – a risk focused and risk sensitive assessment methodology.
- **Mitigation** – recognition of the value of third part risk transfer products.
- **Incentive compatible** – firms have an opportunity to influence the charge through a positive change in their own behaviour.
- **Consistent** – level playing field between banks, internationally and non-regulated institutions.
- **Evolutionary** – an explicit commitment to the recognition and development of industry methodology.

EBF has considered the Basel Committee proposals on operational risk in terms of these minimum characteristics. However, there are a number of questions that need answering in reference to how this framework translates into functional processes, namely :

[1] New Capital Adequacy Framework Response by the European Banking Federation on the Consultation paper issued by the Basel Committee on Banking Supervision in June 1999 – March 2000

1. revisiting the overall calibration of the operational risk charge,
2. solving definitional problems with potential for capital charges overlapping,
3. steepening the gradient of capital change across the spectrum of proposed options,
4. capping capital charges under the basic indicator and standardised approaches,
5. allowing flexibility in leaving the business lines mapping up to national regulation,
6. offering a loss data classification menu under the internal measurement approach,
7. recognising the importance of qualitative factors in operational risk management,
8. paving the ground in a prescriptive way to account for risk mitigation techniques.

In doing so, EBF believes it is useful to evaluate these questions also in terms of the minimum characteristics set out above.

Such core issues of operational risk treatment and others are still very much open and will certainly not be resolved by year-end 2001. This situation leads the EBF to believe that the Basel Committee has committed itself, and the industry, to an unrealistic time constraint with its intent to release its final recommendations by year-end 2001.

If the Basel Committee holds to its initial objective, and given the time needed for amending EU directives, *EBF suggests that the final wording of the Basel Committee's recommendations be flexible enough to accommodate future developments in operational risk issues (measurement, modelling, data etc). Moreover, the Basel Committee (and equally the EU Commission) should formally commit itself to a thorough review process of the impact of the new rules on operational risk including the issuing of interim papers to all interested parties and the formal possibility for corrective actions should they prove necessary.*

In line with the concern expressed by the Basel Committee in its consultative papers (released in June 1999 and January 2001) that a continuing dialogue be maintained and expanded well beyond the implementation of the New Capital Accord, these suggestions are solely intended for the overall good of the regulatory community and the industry.

4.62 Competitive Issues

As set out above the industry position is that there must be consistency of application of the rules i.e. level playing fields between banks, internationally and domestically, and vis-à-vis non-regulated institutions. The operational risk charge has the potential to distort

competition between regulated institutions and those that are either unregulated or regulated[3] with no capital charge for operational risk.

The application of the Basel Capital Accord to internationally active banks only in non-EU countries (whereas all EU Credit Institutions and Investment Business Firms are to be made subject to the charge) will lead to a situation where EU banks with subsidiaries operating outside the EU may well be in competition with domestically active banks which are not subject to an operational risk charge. This will place them at a considerable disadvantage. This is a separate issue of course from the effects on competition within the EU itself for example between EU regulated investment business firms and non-EU regulated investment firms and between banks and insurance companies.

Furthermore, the exercise of national discretion by regulators within the EU must not lead to competitive disadvantages arising between banks regulated in different EU countries. This will be particularly important if the operational risk capital charge is allowed to be reduced due to qualitative factors and the use of risk mitigation techniques. EBF supports strongly the suggestion that regulators would be required to disclose on a differential basis their national policies in areas where they use their discretion. This would assist in ensuring harmonisation of treatment for banks in different countries and thereby reducing the incentives for regulatory arbitrage.

4.63 Overall calibration of the operational risk charge

The industry position is that the calibration of the charge must be to an objective measure of soundness.

In reality only a few banks[4] reported to the Basel Committee that they had recently started to allocate a given amount of capital to operational risk, but these amounts were related to economic capital and not regulatory capital and intended to cover a wide range of operational and non-operational risks. Moreover, few if any of these banks apply rigorous and comprehensive mathematical analysis to the issue. Furthermore, one should not forget the reducing impact of the diversification among credit, market and operational risks, even if techniques (convolution of loss distribution for example) for measuring such an allowance are still to be proven.

[3] Though regulated, insurance companies -they compete heavily with banks in asset management- are currently exempted of any operational risk capital requirement.
[4] See § 21 on page 5 of the document "Operational Risk" from the Basel Committee (January 2001).

The EBF thinks that the proposed 20% over states the risk, and that only with the inclusion of expected loss would such a level be credible. It is widely thought within the industry that the level for unexpected loss is below 10%.

At this stage, and short of the results that will come out from the QIS-2, a 20% overall calibration should only be regarded as a basis for discussion's sake.

4.64 Definition of operational risk and potential for double-counting of capital charges

In general, the EBF welcomes the definition[5] of operational risk as proposed by the Basel Committee since it reflects the industry position that is a positive, bounded definition restricted to direct balance sheet loss. The EBF also welcomes the specific exclusion of strategic and reputational risks from the definition.

The EBF understands that business risk is also explicitly excluded, from the definition of operational risk but the EBF believes this should be clarified by clearly stating that business risk along with strategic and reputational risks are not included in the definition of operational risk for the purpose of a minimum regulatory operational risk capital charge.

There is a considerable potential for double-counting of capital charges in the new Accord, therefore, the EBF would like to see clear boundaries be set up in a pragmatic[6] manner regarding operational risk events for regulatory purposes, especially whenever these events materialise in losses that are rightly qualified as credit losses by firms.

For example, when a loss originates primarily from a default it is usually categorised as a loss related to a credit risk event, though additional losses can be generated due to legal mistreatment or any other operational risk event. Should this added amount be disaggregated from the credit loss total figure, many losses already classified as credit losses would have to be recategorised. This could create havoc for many banks in the already sensitive area of credit loss data.

Such boundaries would certainly avoid the type of overlapping that generates the "W" factor or any other similar concept. As set out earlier in this paper, the 'W' factor should not relate to credit/market risks, but only with operational risk.

[5] See § 6 on page 2 of the document "Operational Risk" from the Basel Committee (January 2001)
[6] If it were not the case, many losses already classified as credit losses would have to be recategorised and that could create havoc for many banks in the already sensitive realm of credit data.

Regarding market risk losses, the EBF would like to remind the Basel Committee that the multiplier is intended to cover operational risk losses, such as model risk, and that therefore this is another possibility for double counting.

Finally, *as to the proposed inclusion*[7] *of certain indirect losses* the EBF argues that this should not be done given the impossibility of assessing such losses, let alone measuring them.

4.65 Capital charge gradient

To move from option to option, there are relatively stringent criteria pertaining to effective risk management, controls, measurement and validation. From this one would expect that the gradient of capital charges across the spectrum of approaches would be quite steep. However this is not the case, at least at this stage. This is mainly due to the impact of the relative weightings of the business lines as computed by the Basel Committee[8] from a combination of size and risk.

The EBF believes that only operational risk profile and not size is relevant to assessing a ranking of business lines with respect to operational risk. As an example, and based upon an industry (US risk profile) analysis, a possible ranking of business lines -in a decreasing order with regard to operational risk- shows the following risk profile: trading and sales, brokerage, commercial and retail banking, corporate finance, asset management and, finally, payment and settlement. *The EBF would suggest that results of any proposed calibration for option 2 be established from the results of QIS-2 and compared to such a risk profile or any other profile deemed satisfactory.*

Again and as it is already the case with the overall calibration of operational risk, *at this stage and short of the results that will come out of QIS-2, the preliminary indicators,* α *and* β *values to be used in options 1 and 2 should only be regarded as a basis for discussion's sake.*

The 'floor' concept introduced in option 3 -known as the Internal Measurement Approach (IMA)- is not only unwarranted but also it defeats the objective of rewarding greater risk management sophistication. The EBF thinks that there is no need for a floor.

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[7] See § 7 on page 2 of the document "Operational Risk" from the Basel Committee (January 2001).
[8] See Annex 3 of the Basel document « Operational Risk » (January 2001)

4.66 Linearity of capital charges under options 1 and 2 : request for a cap

In the Basel Committee consultative paper, options 1 and 2 are linear forms of operational risk sensitivity. However there is no evidence of a linear link between operational risk exposure and size or volume.

To the contrary, research currently conducted on this matter, notably by ISDA, tends to demonstrate a non-linear functional form[9] for the operational risk sensitivity. Such a linear form effectively entails a disincentive to grow and diversify. In other words, large firms are penalised relative to smaller firms. Even though, within an identical context many reasons exist for a large institution to experience a proportionately lower amount of loss than a smaller institution.

The EBF would like to see a capping mechanism on the operational risk charge when computed through options 1 and 2.

Since it appears that for some institutions (mostly monoline) some beta values will put them at a disadvantage vis-à-vis other institutions (mostly multiline)*, the EBF suggests that the capital charge computed through option 2 (SA) may never exceed the charge computed through option 1 (BIA)*.

4.67 Flexibility in mapping business lines

The industry position is that the chosen measurement approach should have a risk focused and risk sensitive methodology.

With options 2 and 3, built upon the business lines concept, flexibility is needed in order to achieve a good level of differentiation among risk profiles across institutions. In light of this, the EBF does not believe that there is a 'fit-to-all' canvas of business lines as would be the case were the eight categories that make up the level 1 mapping[10] proposed by the Basel Committee be implemented without sufficient discrimination. A recent study, conducted through the IIF, has shown a strong preference for a more granular set of business lines (similar to level 2 without however endorsing any specific one) than the proposed level 1.

[9] Losses Y relate to size indicator X according to: $Y = X^{0.25} – 0.5$
[10] See Annex 2 of the document "Operational Risk" from the Basel Committee (January 2001).

Furthermore, institutions change so often the scope of their activities, due to the intrusion of new products, mergers or acquisitions, that their organisation into business lines changes too and there is almost no possibility for a unique and permanent level 2 to level 1 mapping.

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

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

4.68 Operational loss data classification under option 3

Stopping short of making available option 4 -known as the Loss Distribution Approach (LDA)-, the Basel Committee has proposed option 3 (IMA) as a "critical step along the evolutionary path that leads to … the most sophisticated approaches" such as option 4 (LDA).

The EBF thinks that LDA has the potential to become the best available approach to operational risk measurement, should firms dedicate the necessary resources for its development. To this end, a definite timetable for its introduction would be very helpful.

Besides comments on the choice of indicators and the mapping of business lines, *the EBF thinks that commenting on option 3 -as it stands now- is not possible with the exception of the highly improbable linearity*[11] *of the gamma factor over time across firms.*

However, the EBF wishes to comment on the sole reference to the effect-type losses since there are at least two other categorisations (known as event-type and cause-type) that have gained wide industry acceptance.

These three types of loss data classification can be characterised as follows:

1. effect (write-downs, loss of recourse, restitution, legal liability, …) i.e. a P&L loss,

[11] The EBF has noted that the typical UL to EL ratio varies from 3 to 1 (theoretical and observed) for transactions to 10 to 1 (theoretical) and 50 to 1 (observed) for the more volatile operational risk categories.

2. event (criminal, sales malpractices, transaction processing, unauthorised activities, …) i.e. a single incident that leads directly to one or more effects,
3. cause (miscommunication, poor supervision, inadequate documentation, improper segregation of duties, …) i.e. one or more factor that increases the probability that an event will occur.

The EBF would argue that :

- given its thinking that the most important reason for loss data classification is to facilitate efficient operational risk management, effect based categories do not meet such a goal since they do not relate to the sources or causes of operational risk losses;

- though easier to apply, effect based categories cannot be used for option 4 (LDA) purposes and thus cannot support the evolution of risk measurement from option 3 to the next level, whether LDA or other.

However, though cause based classification will support the evolution from IMA to LDA or other modelling techniques, such as predictive modelling, there are currently unsolved important issues such as identifying the single most important causal factor through a necessarily subjective exercise.

In as much as the Basel Committee has recently indicated its willingness to include different sub-options, *the EBF suggests that a menu pertaining to operational loss types be offered within the final format of option 3* (IMA).

A very important issue relates to the stability of the estimation of the mean annual aggregate expected loss (EL), which is affected by several factors. The EBF wishes to offer some comments on one of them; the data observation period.

On one hand if there is a common finding within the industry through simulation that less than 3 years of data would entail a high degree of instability in the distribution and consequently for EL, but that on another hand going beyond 5 years could be a source of inconsistencies, given the likelihood of corrective actions taken in the wake of the oldest recorded losses, then one should consider some form of weighting with a bias for more recent events/losses as it may be safe to assume that the internal control environment

improves after each loss as people, systems and processes are improved through learning from mistakes.

The EBF wishes to recommend a sliding 5-year collection period for operational risk data with a weighting in favour of the most recent data.

Industry pooling of data is therefore a necessity. Since some institutions have expressed concerns vis-à-vis industry data pooling (mainly fear of legal liabilities), the *EBF wishes that the Basel Committee would word its final recommendations with a view to avoiding such potential problems for its constituents, such as offering protection through some sort of legal framework.*

Furthermore there are proposals to identify a PE and LGE for different loss events. The EBF has reservations with respect to these proposals because the denominator for the PE calculation assumes that a loss event is directly related to a transaction. Fundamental breakdowns in control, however, which are where some of the serious loss events have occurred, are difficult to align to particular transactions or types of transaction. As for LGE, this is materially affected by matters which are within bank's management to affect i.e. decisions to pursue or not to pursue compensation, decisions about whether to insure or self-insure and so on. As a result of these decisions the response of firms to hazards and exposures is likely to differ and influence the net loss that serves as the basis for the calculation.

4.69 Qualitative factors and risk mitigation

Operational risk management in banks is more directly linked to good overall management than with quantitative risk management alone. This shows why the recognition of qualitative factors is important.

Where qualitative factors do add value is in the 'management overlay' after the quantifiable things have been measured. Subjective judgment based upon a review of the 'fundamentals' is often better at forecasting future events and activity. So perhaps qualitative factors can be used after the database produces the initial capital rather than before.[12]

[12] See ISDA Discussion Paper "Operational Risk Regulatory Approach" (September 2000).

The EBF continues to believe, as it has argued in the past, that qualitative criteria related to procedures, external and internal controls, and environment should be integrated into the process for determining the operational risk capital charge.

There is a very important difference between operational risk and market/credit risks which is that all the data for market/credit risks relates to identifiable transactions - a deal or loan - and the key event - price or default - is objective and outside the control of the bank. Some operational risk relates to transactions and so it's easy to work out probabilities; however, more usually operational risk does not relate to transactions and is also heavily influenced either by human intervention or by external events, which makes the task of modeling difficult.

EBF supports allowing an adjustment in the operational charge due to qualitative factors that could be either positive or negative. This is consistent with the Basel paper of September 1998 (Framework for Internal Control Systems in Banking Organisations), which concluded that many if not all of the high profile operational risk losses it analysed could have been avoided if effective internal controls had been in operation. For this reason, there must be strong and explicit recognition of management and controls in the establishment of the regulatory capital requirement.

To be accepted, the EBF believes that the adjustment should :

- be capable of independent validation;
- be clear and transparent;
- be applicable to all sizes of institution;
- be related to sound operational risk practices (EBF awaits the Committee's paper on this subject);
- recognise internal risk management practices.

The EBF would also like to draw the attention of the Basel Committee to the fact that a number of banks use self-assessment procedures to assess their internal control environments. The EBF believes that it is important that the Basel Committee does not impede the development of such self-assessment procedures.

The EBF believes that there should be recognition of third party risk transfer products. The acceptance in principle by the Basel Committee that risk mitigation should be reflected in the

operational risk capital charge is therefore welcome. While acknowledging that operational risk mitigation is still very much under development, the EBF also recognises that insurance programmes of banks already address operational risk in part (general and professional liabilities, fraud, etc) even if several issues (inconsistent wording, various exclusions, different policy periods) remain to be fully addressed.

Nonetheless, the EBF would argue that insurance products have real risk mitigation value; moreover, the involvement of insurance within the capital charge framework is likely to prompt institutions towards discipline and quality data gathering which will reinforce industry as well as regulatory efforts to better assess and manage operational risk.

The EBF encourages the Basel Committee to set up standards for risk mitigation purposes, at least with insurance policies.

On a more general view of insurance as a form of outsourcing, the EBF believes that the Basel Committee should make a link to outsourcing.

5. Third Pillar: Market Discipline

The EBF agrees that the new capital regime should be supported through enhanced disclosures on capital, risk, their management and the capital adequacy of an institution.

Our basic concern is, however, that disclosures be consistent with the frameworks for financial reporting which are being developed in conjunction with accounting standard setters. Preparations are underway to review IAS 30 which deals precisely with *Disclosures in the Financial Statements of Banks and Similar Financial Institutions*. The new IASC Board is likely to give the Steering Group which was established to that effect a remit to continue its work. We would therefore like to invite the Basel Committee to work through the Steering Group in which it is represented. Such co-operation would serve to ensure that the disclosures are understandable, relevant, reliable and comparable, which will best serve the purposes of Pillar III.

The quantity and detail of the proposed disclosures is another area of concern. The EBF believes that the interests of market participants would be better served by the type of summary information currently given in the financial statements of many leading institutions. Clearly, there is a need for blind spots in the current disclosure regime to be identified and

dealt with appropriately. However, such an exercise would need to take place with an awareness of the need to avoid duplication and excess. This, in turn, requires, among others, a clear view on the question of who are the expected beneficiaries of this information and what their needs are. The IASC Steering Committee which will be reviewing IAS 30 would be a valuable forum to consult on these issues.

Furthermore, we were surprised about the focus of the proposed disclosures on regulatory capital requirements. In general, we doubt whether the broad range of market participants would benefit from the publication of data prepared for regulatory purposes and are concerned that the disclosures could potentially obscure the financial standing of a bank for most readers. In any event, we believe that it would be a mistake to adopt an unduly prescriptive set of disclosures at this stage given the differences in the institutions to be covered and the need to allow disclosures to evolve under the new capital regime.

Finally, it does not seem realistic to require banks to make certain disclosures on a quarterly basis and encourage them to use electronic media to make available additional information. This seems hardly feasible in practice and might moreover not fit in the existing financial reporting frameworks of different jurisdictions. In any event, further consideration would need to be given to the costs and benefits of providing risk information more frequently and the use of electronic communication. Since the effective provision of this information must be within recognised financial reporting structures, consultation with listing authorities, preparers, auditors and users would be necessary before this could be enacted.

The EBF conclusion is that the IAS 30 Steering Committee should be closely involved in the development of a framework for qualitative and quantitative disclosures in support of Pillar I. Information provided should provide users with an insight into the way in which the business is managed, the institution’s risk appetite, the quality of the book, management performance and bad debt provisioning. Quantitative information provided should be compatible with information used in the management of the business on a daily basis, though there will necessarily be a limitation on the figures provided if the disclosures are to stop short of being proprietary in nature.

Of course, we are aware that a further paper on Pillar III will be provided in the summer. We look forward to reviewing this paper and obviously must reserve the EBF’s position until the new proposals have been studied in detail.

ANNEX – Proposed definitions for structured financing

Cash-flow finance

- ✓ *<u>Project finance</u> stricto sensu, whereby the financing is extended for the construction and/or operation of one or more tangible long term producing asset(s), via a special purpose vehicle (SPV) and with no or limited direct financial recourse to well-established corporate entities. Repayment of the debt obligations depends primarily on the project's operating cash flow. All or most of the assets and contracts of the SPV are pledged in favour of / assigned to lenders, who may benefit from sponsors' guarantees during the construction period and beyond. Projects are generally operating in one of the following sectors: natural resources, power generation, metallurgy, transportation infrastructure, environmental services, media, and telecom.*
- ✓ <u>Real estate non-recourse project financing</u>, whereby the underlying asset is a property and the financing technique complies with the above definition.
- ✓ <u>Leveraged acquisition financing</u>, whereby the purpose of the transaction is to finance an acquisition. Repayment of the debt is based on the acquired company's cash flows and is usually secured by a pledge on all its tangible and intangible assets.

Non-recourse asset-based finance

- ✓ <u>Shipping</u>, whereby the financing is extended to an SPV, which operates a single asset the cash flows of which are used to repay the debt. The debt is usually non-recourse to the operating shipping company and is secured by a first lien on the asset and assignment of contracts.

Asset-based finance with recourse

- ✓ <u>Aircraft financing</u>, whereby the financing is extended to the airline company or an SPV with recourse to the airline company. Repayment of the debt is based on the airline company's cash flows and is secured by a first lien on the aircraft.
- ✓ <u>Commodities Trade Financing</u>, which includes
  - Self-liquidating transactions whereby proceeds from sale of goods are used to repay the financing (transactional financing);); the financing is usually secured by the collateralised goods, assignments of contracts and pledge on accounts.
  - pre-export financing set up with major commodity producers in emerging countries, whereby proceeds from export sales are assigned to lenders, exposing them only to performance risk of the producer.

  Financed commodities are usually traded on a liquid market: energy (oil, refined and petrochemical products, natural gas, electricity); metals (ferrous and non-ferrous); "soft" commodities (foodstuffs); pulp and paper pulp.

The EBF believes that the particular features of the above categories do not come only from collateraliization but from the overall structure of transactions. Such structure allows for anticipating financial or operating problems and provides effective techniques to re-organising the transaction in a way that minimises the risk of loss for lenders. Beyond the control of assets and critical contracts, the transaction structure usually includes structural and financial covenants such as:

- Limitation of drawing rights under the loan agreement to the compliance of some precedent conditions, either technical or commercial
- Tight financial ratios on financial structure, repayment capacity, limitation of capital expenditures, …
- Cross-default, material adverse change, ownership clauses…
- In some situations, step-in clauses may allow for the replacement of the project operator if its performances are poor.