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Chairman of the Basel Committee
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Dear Sirs,

Fortis Bank welcomes the more risk-sensitive approach that the Basel Committee has proposed in the Consultative Document The New Basel Capital Accord. Implementing the rules and requirements mentioned in the proposal will lead to better alignment of regulatory capital with economic capital concepts used by banks in the last ten years.
We consider the Basel proposal as a regulatory recognition of the changes in financial markets, the business of banking and most notably risk management practices that have taken place over the last couple of years.

We support the introduction of a mechanism for the allocation of capital, whereby banks with more sophisticated risk management may become eligible for a lower capital charge compared to similar banks with less sophisticated risk management. We also agree that certain qualifying conditions have to be met, before a bank may opt for one of the different options available under the New Basel Capital Accord.
The process of determining whether or not a bank qualifies for a more sophisticated option should also include an assessment of qualitative factors relating to the status of its risk management.

In this respect we feel that, among the elements of the risk assessment, the risk management structure and top management commitment mentioned under Pillar 2 are just as important as the computation methodology of the regulatory requirements under Pillar 1.

While we are appreciative of the work that has been done by the various institutions and market participants, we would also like to point to a number of hurdles that still need to be taken, before the aforementioned objectives of the New Basel Capital Accord will be fully achieved, namely:

- The level playing field is a goal shared by regulators and banks. The New Basel Capital Accord should, in our opinion, provide the guiding principles and adequate standards for the supervisory authorities in the different countries in order to ensure a level playing field, on the one hand between the financial institutions covered and those not covered by the New Basel Capital Accord and on the other hand between the financial institutions covered by the New Basel Capital Accord in different countries.
  Furthermore, the New Basel Capital Accord, mainly in Pillar 2, gives large latitude and discretionary power to local regulatory authorities in assessing the risk structure and organisation of banks.
  For an international group like Fortis, with subsidiaries in different countries, this situation could lead to different regulatory requirements and troublesome data collection and reportings.
  Obviously, the ideal situation would be to have one global worldwide supervisory framework or body.
  In the event that such an ideal situation cannot be implemented in the foreseeable future, Fortis Bank should be treated on a consolidated basis under the clear-cut home country control principle, that is to say it should be subjected to supervision by the Belgian regulatory authorities.

- In the current proposal, the incentive structure for progressing from one level of sophistication to the next is still unclear. As yet, banks can only guess about the extent to which the costs of upgrading the quality of the organisation in order to progress to a more sophisticated approach are compensated by the potential benefits of a relief on regulatory capital. We recommend that the incentive structure of the New Basel Capital Accord be further clarified, including the specification of minimum and maximum levels for the capital charge (caps and floors) for each of the options. Whether or not there may be an overlap between the capital charge (caps and floors) for the different options still has to be decided as well.

- Obviously, it is important to safeguard a structure that provides incentives for banks to improve their risk control environment and management, both in absolute terms and in comparison to their competitors. Care should however be taken, to prevent the incentive structure from becoming overly biased towards particular groups of market participants (no cherry picking).

In more specific terms we would like to add a few comments and to draw your attention on particular elements of the New Basel Capital Accord text.

- Thus, in Pillar 1, as far as credit risk and related issues are concerned :

  - *Capital Cover for both Expected and Unexpected Losses*: The new capital framework is structured so as to create a capital cushion to cover both expected loss (EL) and unexpected loss (UL). Capital (regulatory or economic) should not cover EL because EL tends to be covered by a combination of pricing at the front end of a transaction and general provisioning. For impaired loans, EL is covered by specific provisions where impaired deals are specifically assessed based on Exposure at Default and Loss Given Default on specific collateral. Therefore, a weight of 150 % of the remaining exposure after provision is too heavy because this exposure is covered by collateral. For non-impaired loans, EL is covered by general loan loss provisions and should therefore not be included in the new capital framework. One way to solve this difference is ensuring that capital requirement should be equal to the amount calculated within the proposal less general loan losses provisions.

  - *Granularity Index/Credit Risk Models*: Granularity index is applicable for each sub-portfolio by segment and country. Assembling the data necessary to operate the Granularity Index will be extremely costly. Fortis believes that it would be better to wait for recognition of credit risk models reflecting portfolio risks and would suggest moving this factor of diversification to Pillar 2.

  - *The w Factor/Enforceability*: Almost all major forms of collateral will be subject to an additional 15% discounting *w* factor ostensibly to cover residual risks. This will create a double counting with operational risk framework and would penalise collateral policies (see remarks on operational risk).

  - *Application of* the *methods (standardised, IRB foundation and IRB advanced)* : the proposal advocates a full application of the approach chosen by the institution across all exposures and countries in order to avoid cherry picking ; we understand this motivation but we fear that this will have an impact on the willingness of institutions to go forward in sub portfolios for applying IRB methodology if not recognised by local regulators. Efforts of institutions to go towards best risk management

practices by applying IRB (foundation or advanced) should be better recognised by regulators.

- As far as operational risk is concerned we would like to point out the following :

  - Since operational risk is present in all activities of a financial institution, there is a risk of overlap in the measuring of elements of operational risk. We would like to stress the importance of avoiding the double counting for operational risk elements. For example, in the proposed credit risk calculation a so-called “w” factor is introduced to cover risks, which are in fact part of operational risk. These risks should not also be counted under the operational risk capital charge.

  - The current proposal assumes that there is a linear relationship between the size of an operation and the extent of its operational risk. We recommend that appropriate work and research be done in order to determine and validate the various (assumingly non-linear) relationships and risk parameters in the current proposal.

  - In the current proposal, the parameters for determining a capital charge are backward looking, as these are based on extrapolations of either the industry or the bank’s past performance. We recommend that an assessment of the quality of the bank’s control environment and of recent improvements in the bank’s risk management infrastructure also be taken into account when the capital charge is being determined.

  - The current proposal does not provide sufficient detail in the definitions of the loss categories or of the different business lines, which can be applied across the various market participants. We recommend that clarity of definitions of loss categories and business lines be obtained in order to facilitate the collecting of relevant loss data on a consistent basis across the various market participants. Obtaining relevant quantitative data is a prerequisite for the development of appropriate risk parameters and their subsequent calibration for each business line and for each risk category.

  - The framework for capital charge allocation should therefore provide for the opportunity to adjust certain quantitative parameters, as time progresses, in order to incorporate the outcome of various (existing and future) quantitative surveys. In the absence of sufficient data compiled on a consistent basis, we are unable to assess the validity of individual risk

parameters or the sub-allocation of a capital charge across various risk types (credit risk, market risk, operational risk).

- The internal measurement approach, possibly combined with expert systems technology, could become useful as soon as a minimum of major operational loss data becomes available at industry level in combination with internal loss data enabling frequency and severity models to calculate and calibrate the risk profile of the bank. It is suggested that the banks and the Basel Committee further evaluate in what manner the current methods used by insurance and bancassurance companies can be of use for determining a relevant loss distribution for operational risks in financial institutions based on extreme value theory.

- We would like to recommend that further consideration be given to allow for the separate identification of business lines which have not been specifically identified in the proposed business line categorisation (level 2), such as for example Stock Lending and Clearing Business, which may warrant a separate categorisation due to their specificity. The Private Banking Business is to a large extent more akin to the Asset Management Business than to the Retail Banking. Also, retail brokerage is not aligned to any categorised business of our bank. Moreover, ALM results cannot always be attributed to business lines. Furthermore, we recommend that the insurance business should not be included in the determination of a capital charge, since the insurance business of our organisation is subjected to its own specific regulatory framework.

- The Pillar 2 text gives rise with us to the following remarks and questions :

  - A holding period of 1 year for the VAR computation seems to us too long and not in line with economic reality, would it be the time needed to cover the positions or the time needed to raise new capital under Tier 1 and most specifically under Tier 2.

  - For the Economical Value computation, it is not yet clear which yield curve will be used for different currencies and different products.

  - The 2 proposed methods for computing the standardised interest rate shocks lead to different results. Will the banks have the choice of the method ? Will all banks be able to compute the risk according to the second method ? Since the interest rate shock is to be related to the interest rates of G-10 countries, it might be worthwhile to consider having an international organisation, like BIS or OECD, calculate or present the

standardised interest rate shocks. This would contribute to the level playing field.

- The Pillar 3 disclosure requirements raise concerns about :
  - the need to ensure coherence with the International Accounting Standards (IAS) and the national regulatory requirements, in order to avoid conflicts and duplication of information
  - the risk of misinterpretation by a less experienced public and consequent market volatility by reporting large volumes of data of highly technical nature
  - the need to avoid publication of confidential information (e.g. future strategies, planned acquisitions, ...)

For further and more detailed comments please refer to enclosure 1 (specific comments related to credit framework) and to enclosure 2 (specific comments related to operational risk).

We do hope that our comments and remarks on the New Basel Capital Accord will help the Basel Committee and national regulators to continue finetuning the Consultative Document in order to achieve the most suitable framework for regulators and banks alike.

Yours sincerely,

J.J. Verdickt,
Managing Director.

H. Verwilst,
Chairman of
the Management Committee