NEW CAPITAL ADEQUACY FRAMEWORK

Comments by the French Banking Federation on the Consultative Document of January 2001

May 2001

I - Introduction

The 1988 Basel Accord on capital adequacy has proved extremely effective because it is simple and can be applied on a quantitative basis by all credit institutions.

The French Banking Federation nevertheless supports reviewing the Accord, because this will make it possible to align the notion of regulatory capital with that of economic capital (also called capital at risk), a notion widely used by credit institutions.

The FBF also adheres to the method put forward in the consultative paper for the following reasons:

- It provides a better measure of credit risk on the basis of pertinent criteria, in particular the probability of default;

- It improves the way in which collateral and other risk-reducing measures are taken into account;

- It represents an approach offering several solutions: standardised method, internal ratings (foundation and advanced approaches), that should eventually lead to internal credit risk models, thereby enabling institutions to shift progressively according to their activities from the foundation to the advanced approach.

To make this approach even more effective, the FBF suggests:

- defining a consultation mode whose deadlines for application correspond to the review's objectives. The Basel Committee should provide for a sufficiently long period after the consultation in January 2001 to calibrate the different proposed methods, both in terms of credit risk and operational risk, on the basis of successive QIS in 2002 and 2003;

- avoiding distortions in competition, the scope for which is in no way comparable to that of the previous capital adequacy framework. According to the new framework, only banks are subjected to very significant capital adequacy requirements. Furthermore, bodies which are not subjected to capital adequacy requirements, such as investment companies, insurance companies or non-regulated bodies, may carry out the same activities as banks, which are subjected to such requirements;

- creating an environment that will enable the majority of credit institutions to set up a system of internal ratings. This would involve, on the one hand, creating incentives for credit institutions to apply the method (which is not currently the case), and bringing the validation conditions for LGD and EAD data in line with those for PD data on the other (5 years with a transition period);

- improving the way in which retail banking and risk-reducing techniques are taken into account.

- taking account of instruments for reducing risk (insurance policy, recognised control standard, etc.) when measuring operational risk;

- As far as the treatment of insurance subsidiaries is concerned, before recommending a prudential capital adequacy requirement, the Basel Committee must make sure that the chosen mechanism has a totally neutral impact on the two existing types of financial conglomerates (i.e. a bank with a participating interest in an insurance company or an insurance company with an interest in a bank). If the impact is not neutral and in the absence of any harmonisation, the Committee should reaffirm the current rules for banks. Moreover, the FBF contests the relevance of deduction banks'investments in insurance subsidiaries because there is no correlation between banking risk and insurance risk.

Respecting these different points is one of the keys to the successful implementation of the new framework.

Furthermore, in line with the rationale behind the Basel Accord, the FBF hopes that the Committee will be able to start working on anticipated provisioning of expected losses and on how such provisioning can be taken into account in capital adequacy. This approach would be consistent with the proposed review concerning internal ratings.

This approach would offer a more welcome response to the criticisms generally levelled by the advocates of fair value accounting, given that the accounting methods currently under consideration, as part of the move to full fair value accounting for financial intermediation activities, have adverse consequences from a prudential point of view. According to this accounting method, banks' earnings and own funds would be allocated according to market fluctuations on the basis of an approach unrepresentative of banks' management modes. This is in contradiction with the Basel Committee's objective of ensuring greater stability in the international financial system. Furthermore, the FBF urges the Basel Committee to reaffirm its opposition to the move to full fair value accounting.

In view of the above, the French banking sector would like to make the following remarks in response to the consultation launched by the Basel Committee.

II – Summary of proposals

1 - Scope of application

1.1. Relevant supervisory authority

1.1.1. The French Banking Federation believes that the Basel Committee should not step up its regulatory requirements without initially ensuring that there is no competitive distortion. To avoid this risk, the new framework should apply equally throughout Europe, the US and Asia. To ensure fair treatment, the capital adequacy requirements set by the authorities of a country for a given portfolio category must be accepted by the bank's home authorities if it holds a lending portfolio of the same type in this country.

1.1.2. Scope of consolidation

The French Banking Federation questions the appropriateness, and indeed the need, for the new prudential measures regarding equity investments in insurance companies, given that the existing rules — under which they have a 100% risk-weighting — appear perfectly adequate. As regards financial conglomerates, investments in insurance companies should no longer be deducted from a bank's capital. The regulations should maintain a qualitative approach, i.e. one based on an observation ratio without any specific conditions in addition to solo capital requirements.

1.1.3. Harmonisation with the European Directive

To avoid any competitive distortion, the French Banking Federation feels it is essential to ensure that there is no divergence between the regulations established by the Basel Committee and the European Directives.

1.2. Expected losses/Unexpected losses

In the IRB approach, the Basel Committee proposes to calculate capital charge on the basis of the sum of expected losses (EL) and unexpected losses (UL). According to our point of view, such a system does not seem appropriate for two reasons: (i) it does not suit with the practices of the industry and (ii) it has an important statistical bias, giving advantages to the less good portfolios or those with important maturity. We rather propose a system in which two different risk weighting functions would be created: one to calculate the amount of regulatory capital required for EL and another to calculate the amount of regulatory capital to cover UL. Moreover the different amounts of capital allocated to those components should be disclosed separately.

1.3. Equity in the banking book

The PD/LGD approach does not seem practical for equity because it does not run as a corporate debt, with any possibility of default. We would like to propose an alternative approach based on two main concepts: (i) the use of weightings, differentiated according to relevant characteristics of the equity holdings (in terms of liquidity, nature of control, type of intervention and rating) and (ii) a two-stage calculation process with the application of weightings on both market value and book value.

1.4. Treatment of fixed operating assets

Fixed operating assets are free from any counterparty risks but could carry a depreciation risk, which may be covered by provisions. As a result, we believe fixed operating assets should not generate any specific capital charges.

2 - Standardised Approach

2.1. Rating granularity

The number of rating grades should be increased to better reflect the granularity of default probabilities and avoid excessive volatility. The FBF proposes the introduction of a 75% weight between BBB^+ and BB.

2.2. Weight applicable to bank claims

FBF favours option 1 for the treatment of bank claims. Under this option, the risk weight assigned to banks is based on that assigned to claims on the sovereign of incorporation. This approach provides a more accurate reflection of the default probability observed for the banking industry. However, the proposed weight is considered too conservative.

2.3. Standard ratio should take into account the statistical mutualisation of portfolios

2.3.1. Definition of retail banking activities

These activities are typified by the low unit amount of loans and the large numbers of loans within a portfolio, allowing a near-perfect statistical mutualisation. As stated in the text of the Accord, it is important that differentiated treatment of retail banking is applied to all lending portfolios where the methods applied to risk control follow the same 'industrial' approach to loans, both at issue and in recovery.

2.3.2. For retail banking, the FBF proposes an average reduction of 50%, in line with the weighting factors used for the IRB approach: for the same level of LGD and with an identical probability of default, the capital charge in retail banking is, on average, half the level seen on a corporate banking loan.

These mutualisation effects explain the low historic volatility of losses observed on the following generic portfolios, based on internal data from French banks:

- Property lending:	0.007-0.02%
- Consumer loans	0.06-0.10%
- Lending to small companies	0.12-0.20%

2.4. Financial leasing

Due to the corresponding ownership rights and recovery times, financial leasing guarantees absolute security for the lessor, which incurs the risk of the transaction but can recover the asset in the event of a default by the lessee. The lessor can subsequently resell this asset to cover any losses incurred as a result of the default.

The Basel Committee does not plan to apply a risk weighting of under 100% to financial leasing transactions, which would reflect their specific risk profile. Based on the internal data from French banks, a 50% risk weight seems totally appropriate for both property and equipment leases under the Standardised Approach and Foundation IRB Approach (see 3.2.1.2. and 3.2.2.).

3 - IRB Approach

3.1. For retail banking

3.1.1. In terms of calibration, the FBF stresses the need to provide a greater incentive for banks to switch from the Standardised Approach to the IRB Approach by maintaining a significant gap between risk weights across the entire PD spectrum.
The FBF supports the Committee's decision to limit IRB to the advanced method and thus not to use the 'foundation' approach for retail banking portfolios. Consequently, for this type of business, linking prudential capital rates to a single component of the PD/LGD equation appears illusory.

However, the terms for applying this advanced method must be made more flexible:

- A straightforward criterion should be used to define the notion of ‘default’. The definition of default should be limited to a single criterion, to be selected by each establishment.

- The segmentation required for LGD needs to be different to that for PD. It should reflect recovery prospects and introduce additional areas for LGD, notably the type of guarantee (e.g. mortgage or deposit).

- LGD estimates should reflect expected improvements in the recovery process.

3.1.2. A more effective interface is required between internal models and credit scoring techniques:
- No review frequency should be imposed for consumer lending. For other types of lending, the review of the rating should be limited to an update, taking into account the ageing of portfolios and the credit quality of outstandings.
- For property lending, calibration based on a three-year period is clearly more suitable.
- A different weighting framework should be provided for each type of lending (e.g. property loans, consumer loans, loans to small businesses).
- A one-year maturity should be adopted for consumer loans.
- Regulators’ checks should be based on tests that verify the discriminatory power of credit scoring systems.

3.1.3. Calibration based on EL for some types of portfolio.
The FBF insists that each establishment should be able to choose, for each of its portfolios, one or other of the methods proposed by the Committee (PD/LGD or direct move to EL). Depending on the nature of the loans and their distribution channels, several internal rating systems can co-exist with a single establishment. The BRWs proposed by the Basel Committee unduly penalise the EL approach as they give an LGD of 100%, which corresponds to the highest BRW of the PD/LGD combination for a given EL.

However, estimating effective losses by integrating all their components seems unlikely to the practicable by 2004, as developments in cost-accounting systems will be essential, requiring a five-year transitional period.

In any event, and whatever approach is used (EL or PD/LGD), the calibration of weighting coefficients should encourage banks to opt for IRB over the standard ratio.

3.2. For corporate, bank, sovereign and project portfolios

3.2.1 Calibration

3.2.1.1 A calibration method with uncertain results

The FBF suggests that the final calibration process specified in the new Accord should not be based on QIS 2 alone and that additional studies should be carried out at a later stage. Due to the major implications of the reform and its potential impact on the global banking system, the final calibration process should not be introduced before 2003 in order to minimise uncertainties.

3.2.1.2 Risk of distorted competition for certain customer segments

The FBF notes that banks adopting the Standardised Approach could benefit from an unfair advantage when financing the riskiest customer segments due to: i) the different weights used under the Standardised Approach and Foundation IRB Approach; and ii) the fact that both approaches treat risk reduction techniques in the same way. The FBF also notes that the conversion factors applied to unused committed credit lines differ under the Standardised Approach and Foundation IRB Approach.

To reduce the risk of distorting competition, the FBF makes the following recommendations:

- The Committee should ensure that its proposed widening of risk reduction techniques is confined exclusively to the Foundation IRB Approach, with the exception of financial leasing techniques (see 2.4).
- The Committee should align the conversion factors applied to unused committed credit lines under the Standardised Approach with those applicable under the Foundation IRB Approach.

3.2.1.3.Risk of excessive calibration

a – Inadequate incentives

The FBF approves the Committee's wish to provide incentives for banks to adopt the Foundation IRB Approach. However, the 0.2 or 0.3 ratio advantage mentioned by the Committee seems inadequate in relation to the investments required to implement an internal rating system. The French banks also recommend that the Committee introduces a stronger incentive for the Foundation IRB Approach and removes the 90% floor in the Advanced IRB Approach.

b – Excessive BRWs

The BRWs (Benchmark Risk Weights) in the Consultative Document seem far too high. This situation appears to stem from the cushions that the Committee has included in its formula, although it seems inappropriate to set these cushions on an *a priori* basis, without knowing the final impact of the reform. Based on their own simulations, the French banks recommend that the Committee significantly reduces its BRW and does not set cushions in advance. If required, the Committee can subsequently determine an adjustment factor which will maintain the banking system's overall capital at its current levels, based on the results of further studies in addition to QIS 2.

c – Credit default
Given the lack of a suitable method for calculating capital charges for credit defaults, the FBF recommends that the IRB Approach is brought into line with the Standardised Approach.

3.2.1.4.Maturity

For the IRB Foundation Approach, the French banks recommends that each bank has the option of choosing between an 'effective maturity' of 3 years and the 'explicit maturity'. The FBF therefore recommends that the minimum maturity be lowered to 3 months for bank claims and 6 months for other transactions.

The French banks agree that BRWs should be adjusted using the approach known as 'MTM' by the Committee, without expressing a subjective preference for either of the two underlying philosophies behind the MTM and DM approaches. They suggest that this adjustment should only apply to the UL function and not to the EL function.

3.2.2 Risk reduction techniques in the IRB Approach

The FBF proposes a widening of eligible risk reduction techniques. This would only apply to the Foundation IRB Approach (with the exception of financial leasing techniques – see 2.4) in order to reduce inconsistencies with the Standardised Approach.

3.2.2.1 Eligible collateral

Minerals and metals. The French banks suggest that the Committee's list should include minerals and metals traded on liquid commodity markets, e.g. oil, aluminium, silver, copper, tin, nickel, lead and zinc.

Property. Based on the experience of French banks, the FBF suggests that the 40% floor applied to the LGD should be replaced by a 10% floor, which would correspond to a ratio of at least 200% in terms of *current value of collateral/nominal outstanding balance*.

Other collateral. The FBF proposes that techniques involving the use of other types of collateral (e.g. receivables, vehicles, plant and stocks) should be fully recognised by the Committee, provided that these techniques are regulated by an appropriate national legal framework and the banks adopt adequate procedures to monitor and call in this collateral. This may involve the introduction of new LGD classes, which would depend on the quality of the assets taken as collateral.

3.2.2.2 Guarantees and credit derivatives

Substitution and double default. The French banks believe that the capital charge should depend on the probability of a simultaneous default by both the debtor and the guarantor. This probability depends on the credit quality of the guarantor and debtor, as well as the existing correlation between the debtor's default and that of the guarantor.

The FBF recommends:
- Full substitution of PDs if there is a maximum correlation between the debtor and the guarantor.
- Recognition of the benefit of double default if this correlation is low. In this case, a joint PD should be applied which is lower than the guarantor's PD.

Credit insurance. The FBF recommends that credit insurance should be considered an eligible form of guarantee, in the same way as credit derivatives.

3.2.2.3 Removal of the *w* factor

The FBF notes that this factor is supposed to cover the risks involved in calling in collateral and invoking guarantees, which would appear to fall under the category of operational risk. The French banks are concerned that this risk would be covered twice, overlapping with capital charges for operational risks. They therefore recommend that the *w* factor is dissociated from credit risk.

3.2.3 Eligibility criteria

The FBF approves the Committee's desire to confine access to the IRB Approach to those banks whose rating systems satisfy minimum performance requirements. However, it notes that the proposed framework includes certain rigid criteria and asks national regulators to remain flexible in assessing the eligibility of rating systems.

Furthermore, the FBF considers that certain requirements may prove problematic:

- The Committee has no grounds to demand that a bank's rating system must have two dimensions (PD and transaction) to be eligible for Foundation IRB. On the other hand, the national regulators are responsible for ensuring that banks which only use the PD dimension do not incorporate any transaction-related features.
- Rather than setting the requirement that no more than 30% of gross exposures should fall in any one borrower grade, it would be more appropriate for each national regulator to ensure that rating grades are discriminatory enough for each bank's activities.
- Although the involvement of senior executives is vital, while the day-to-day use of ratings in each bank's management operations is also essential, banks should be given greater flexibility in these areas.
- The FBF agrees with the Committee's recommendation that each one-year PD estimate must represent a long-run average PD. However, it notes that the Committee appears to contradict this position in §217 of the IRBA support document. The FBF suggests that the Committee should eliminate this apparent contradiction by confirming that the long-run average should be used, unless PD estimates are totally incorrect.
- The FBF advises the Committee that it is absolutely essential for regulators to guarantee that the definition of 'default' is applied consistently worldwide to avoid any competitive distortion.
- Lastly, the FBF suggests that consistent validation criteria should apply to PD, LGD and EAD data (5 years plus a transition period).

3.2.4 Project finance

3.2.4.1 From project finance to structured finance: a fair treatment under IRB

The French banks believe that a fair treatment would consist in addressing issues for all structured credits, not only for project finance. Structured financing would encompass project finance, including real estate, LBO financing, asset-based financing, such as aircraft financing or shipping, commodity financing.

3.2.4.2 A part of the Corporate portfolio

The French banks do not believe that it is materially possible in the proposed timeframe to rigorously determine specific risk weights that would reflect structured credits' specificities, in particular given the lack of historical data. Moreover, they observe that most banks use the same rating framework for structured credits as for plain vanilla corporates. They propose to use Corporate risk weights, as for the Bank or Sovereign portfolios.

3.2.4.3 Introduction of differentiated LGD classes

The French Banks consider that structured credits have a strong low loss track-record thanks to tight transaction structures that aim to mitigate the risks for lenders. Consequently, they propose that the Basel Committee should recognise such risk mitigants by introducing specific LGD classes. To substantiate this proposal, the French banks are undertaking historical loss studies.

As some banks do not use a PD/LGD framework but an EL one, they should be allowed to map their internal EL to PD buckets through these specific LGD classes.

4 - Securitisation

The French Banking Federation strongly supports the Committee's view that it is important to develop a comprehensive capital framework for asset securitisation as this product has experienced steady growth the last few years and will experience the same in the future. The French Banking Federation believes that securitisation is a major tool for liquidity and credit risk management and therefore it should not be penalised.

Our view is that the new capital framework should comply with the following guiding principles:

4.1 The framework should address all forms of Portfolio Credit Risk Transfer Techniques in a consistent way. These techniques today include Cash and Synthetic Securitisation, as well as Basket Default Swaps.

4.2 Originating banks and third party investing banks should be applied the same capital treatment. Considering that the capital charge should be representative of credit risk only, the French Banking Federation believes it should be recognised that the Credit Risk of a given tranche is the same, irrespective of the status of the holder of this tranche.

4.3 The framework should be defined on the basis that securitising a pool of assets does not create additional Credit Risk, but rather reallocates the pre-existing Credit Risk among the various tranches and investors. Therefore, the total capital charge potentially applied to all tranches of a given securitisation should be equal to the capital charge that would have been allocated to the pool of securitised assets.

4.4 The clean break criteria set for the proposed framework should not be defined by reference to accounting/consolidation rules to ensure a level playing field between institutions that are not subject to the same GAAP (Generally Accepted Accounting Principles). Moreover, the Committee should define minimum requirements to achieve risk transfer.

4.5 The early amortisation clause for revolving structures is not a credit enhancement and consequently should not generate capital charge as such. The liquidity risk that a bank may face if one or more of its securitisation vehicle enter into early amortisation concerns short term assets and is only material for banks that rely massively on securitisation as their primary source of funding. However, a low diversification of funding sources does not modify assets quality and therefore does not concern Credit Risks. Specific liquidity risks incurred by those banks should be addressed under Pillar 2.

4.6. The LGD to be applied to the securitisation tranche should be equal to the LGD defined for unsecured corporate exposure of the same rating: therefore, it should not be set at 100%, but at 50% like for corporate exposures. The French Banking Federation strongly believes that the 100% LGD suggested by the Committee is not acceptable, as it would roughly double the capital charge required for all securitisation tranches. This would also create a significant bias in the conceptual framework, as well as penalising the IRB method compared to the standardised approach, where no explicit LGD assessment is required.

4.7 Case of ABCP conduit: The analysis which considered that first losses are generally borne by the sellers and that the sponsoring bank is generally placed in an investment grade position should prevail when the assets of an ABCP conduit are ABS that already benefit from a first loss or a credit enhancement at the level of the SPV from which these ABS have been issued.

4.8 Liquidity lines granted to ABCP conduits should attract a lower conversion factor than similar lines granted to corporate (for example, 10% for a less than one year liquidity line) because of (i) their low probability of drawing and (ii) the large number of structural features that generally mitigate their credit risk.

5 - Operational Risk Charge

5.1. Level playing field

FBF would like to underline that with this new charge there is a risk of distorting competition[1] between regulated institutions and those that are either unregulated or regulated[2] with no capital charge for operational risk.

5.2. Revisiting the overall calibration of the operational risk charge

Although FBF agrees with the general consensus that operational risk is somewhat costlier to firms than market risk and much less than credit risk, FBF calls into question how the Basel Committee came up with a level of 20% of total regulatory capital for the majority of banks.

FBF wishes that the charge component that relates to expected losses be expressed in an explicit format allowing for its prompt removal (if and when ex-ante risk provisioning becomes reality), notwithstanding the fact that already some existing provisions[3] should be recognised immediately and allowed for deduction from the minimum capital requirement.

1 Its implementation in the European Community will have a significant impact on investment firms, small institutions and specialised firms.

2 Though regulated, insurance companies -they compete heavily with banks in asset management- are currently exempted of any operational risk capital requirement.

3 Model risk provision for instance.

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

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

Though it is the perception of FBF that business risk is also implicitly excluded, it would be best addressed if it were clearly mentioned along with strategic and reputational risks as being "… not included … for the purpose of a minimum regulatory operational risk capital charge."

Since there is a strong potential for double-counting of capital charges, FBF wishes that clear boundaries be set up in a pragmatic manner regarding operational risk events for regulatory purposes, especially whenever these events materialise in losses that are rightly qualified as credit losses by firms.

Such boundaries would certainly avoid the type of overlapping that generates the w factor or any other similar concept. The w factor has nothing to do with credit/market risks, but only with operational risk.

Finally, as to the proposed inclusion[4] of certain indirect losses (as nebulous as "near-misses" or "latent"), FBF argues that this should not be done given the impossibility of assessing if not defining such losses, not to mention measuring them.

5.4. Capital charge gradient

To move from option to option, there are relatively stringent criteria pertaining to effective risk managements, controls, measurement and validation: therefore, one would expect that the gradient of capital changes across the spectrum of approaches be quite steep and this is not the case at this stage.

FBF would suggest that results of any proposed calibration for option 2 be compared to such a risk profile (see attached Appendix IX).

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[5], α and β values to be used in options 1 and 2 should only be regarded as a basis for discussion's sake (see attached Appendix VIII).

FBF thinks that there is no need for a floor.

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

FBF would like to see a sort of capping mechanism on the operational risk charge when computed through options 1 and 2 and suggests that the capital charge computed through option 2 (SA) may never exceed the charge computed through option 1 (BIA).

5.6. Flexibility in mapping business lines

FBF suggests that the Committee leaves up to national regulation the different ways and means for developing a level 2 mapping intended to be applied to firms for specifying in

4 See § 7 on page 2 of the document "Operational Risk" from the Basel Committee (January 2001).

5 With its Appendix X, FBF wishes to comment on the proposed risk indicators with a view to drawing the Committee attention to possible adverse.

details which business lines and activities correspond to the categories of its proposed (level 1) general framework.

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

5.7. Operational loss data classification under option 3

FBF thinks that, contrary to IMA, 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.

FBF thinks that commenting on option 3 -as it stands now- is not possible to the exception of the highly improbable linearity[6] of the γ factor over time and across firms.

However, FBF 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.

FBF suggests that a menu pertaining to operational loss types be offered within the final format of option 3 (IMA).

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

FBF wishes that the Basel Committee would word its final recommendations with a view to avoiding such potential troubles to its constituents, like offering protection through some sort of legal framework.

5.8. Qualitative factors

Along with the industry[7], FBF believes 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.

With respect to option 1 (BIA) and option 2 (SA), FBF is willing to offer for the Committee's consideration the following suggestion: for a given institution, α *or* β factors could be weighted down through its realised capital expenditures whenever those expenditures (systems, back-up sites, internal controls, etc.) are undertaken for the sake of reducing operational risk.

Under option 3 (IMA), FBF wishes to see the use of self-assessment and scorecards as a modifier to the Risk Profile Index (RPI) as FBF thinks that qualitative adjustments find their place within RPI.

5.9. Risk mitigation

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6 FBF has noted that the typical UL to EL ratio varies from 3 to 1 (theoretical and observed) for transaction processing to 10 to 1 (theoretical) and 50 to 1 or higher (observed) for the more volatile operational risk categories.

7 See ISDA Discussion Paper "Operational Risk Regulatory Approach" (September 2000).

FBF believes that the Basel Committee should move forward and in a prescriptive way and set up standards for risk mitigation purposes, at least with insurance policies.

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

6 Pillar III - Market discipline

6.1 THE FBF'S PROPOSALS ARE BASED ON THE OBJECTIVES OF THE BASEL COMMITTEE

The FBF is in full agreement with the Basel Committee on the introduction of a link between the new capital ratio and the disclosure of financial information on the risks borne by the banks. The proposals made below are based on the FBF's wish of implementing market discipline.

6.2 SUPERVISORY AUTHORITIES AND MARKET PARTICIPANTS: DIFFERING REQUIREMENTS

Within the Basel Committee framework, we must clearly define and distinguish:

- the respective aims of regulatory reporting and disclosure to market participants,
- the outline and the components of such information to the market.

Prudential information used in connection with the capital adequacy ratio computation is sent to the relevant regulatory authorities to enable them to fulfil their supervisory duties over lending institutions, including the follow-up of their implementation of sound management practices, and also to help them on their monitoring of systemic risk.

Such a mission is performed in particular through the monitoring of the ratio computation and, more generally, through the checking of the implementation by banks of prudential and management standards and regulations. Within such a framework , the FBF is convinced that the supervisory authorities must have access to the most precise information, to be able to perform its duties under optimal conditions.

At the same time, financial information is disclosed to the market in order to meet other requirements:

- investment decisions from individual or companies,
- risk control and management, mostly performed by financial intermediaries.

Such requirements must be met by banks through their disclosure of quality financial information, consistent with the elements passed on to the supervisory authorities, but in line with their needs. It must also respect the proprietary character of some of the data, in order to avoid distorting free competition between market actors. Finally, it must also be conforming with the principle of privacy of customer information:

- a level of aggregation of disclosed data enabling the user to get a clear picture of the condition of a bank (business, type and global magnitude of risks per large category, capital available to meet them),
- profitability of bank and of projected or performed investment (shares, bonds, etc).

Amongst this, prudential ratios and the quality of the monitoring of the data and the calculations of the banks by the supervisory authorities represent the main guarantee for the market. Further, the supervisory authorities participation makes it possible to protect the proprietary character of bank information whilst giving the market comfort about its quality.

This distinction made, the FBF fully agrees with the Basel Committee's proposals aiming at a greater clarity of information on risks, and its consistency with regulatory-based calculations.

The FBF wishes to allocate information within two large categories:

- those which disclosure contributes the quality of financial analysis, and thus the market discipline objective,
- those which support the accuracy and reliability of regulation-based prudential ratios, which are useful to the regulatory authorities.

6.3 THE BANKS WILL HAVE TO DEVELOP A PRUDENTIAL INFORMATION SYSTEM

The FBF established that the meeting of the new regulatory requirements on disclosure will lead banks to establish a prudentially-based information system, quite separated from the current accounts-based one. The implementation of disclosure constraints will thus require significant efforts by banks, hence extra expenditure.

Furthermore, a significant part of the information requested by the Basel Committee is not even asked for by the ratings agencies, which does not seem to prevent them from rating bonds and other debt securities. Nevertheless, the Basel Committee considers such ratings sufficiently reliable to propose that they are used as a reference in the weighting of credit risk.

This said, the FBF is obviously not opposed to the transmission of the requested information to the supervisory authorities.

The FBF also noted that financial disclosure will also be affected by the changes in accounting practice, in particular within the scope of the work by IASC to re-write norm IAS 39. The FBF wishes that that financial disclosure under "Pillar 3" is based on requirements consistent with the ones imposed by IASC, and do not lead to an increase in the number of separate required standards of reporting and disclosure.

6.4 THE RECOGNITION OF THE EXISTENCE OF PROPRIETARY INFORMATION MUST BE TRANSLATED IN THE BASEL COMMITTEE'S REQUIREMENTS

In paragraph 21 of "Pillar 3", the Committee acknowledges the existence of proprietary information and the need to protect it. Unfortunately, the proposals made under "Pillar 3" do not seem to be based on this statement of principles. This is the case with the requirements on credit risk, interest-rate risk of the banking portfolio, description of the methodology used for stress-test scenarios, and the description of the system of allocating economic capital.

This situation seems to result from the difficulty probably experienced by the Committee in its trying to ascertain the exact boundaries of market discipline, with references to the aforementioned objectives.

A – Pillar I	Capital requirements and consolidation
B – Pillar I	Standardised Approach
C – Pillar I	IRB Approach
D – Pillar I	Securitisation
E – Pillar I	Operational risk
F – Pillar III	Market discipline

A - PILLAR I - CAPITAL REQUIREMENTS AND CONSOLIDATION

1 Consolidation differences

We note various differences between the consolidation rules imposed by the Basel Committee and those adopted by Europe, particularly in the treatment of investment companies. Like the European Directives, ***the New Basel Capital Accord should apply to these investment firms***, even if they are not part of a financial group.

In addition, various financial activities may be carried out by companies that are not subject to the Basel Accord, such as US investment banks or the financial divisions of various European post offices. ***Given that these differences in treatment can significantly distort competition, they should be eliminated***.

2. Scope of the Accord

Clarification is required on the Basel Committee's definition of "internationally active banks", which are covered by the new framework.

If local banks are not subject to these constraints, competition will be distorted unless the national regulators impose similar minimum capital requirements on them.

However, the Basel Committee should not reinforce its regulatory capital requirements without initially ensuring that there is no competitive distortion. To avoid this distortion, the French Banking Federation makes the following recommendations:

- The new framework should apply equally throughout Europe, the US and Asia. To ensure fair treatment, the capital adequacy requirements set by the authorities of a country for a given portfolio category must also be accepted by the bank's home authorities if it holds a lending portfolio of the same type in this country.

- Due to the lack of rules that apply globally[8] to all non-European investment firms and insurance companies, it is dangerous to define capital adequacy requirements based on: i) regulations applicable to financial conglomerates; or ii) operational risk for activities carried out by these entities, which are not subject to the same regulations.

3. Consolidation methods

3.1. Level of consolidation

The industry has no objection to the Committee's proposal to extend the level of consolidation to include holding companies that are parents of banking groups, which would ensure harmonisation with the European regulations on this issue.

[8] The Basel Committee only sets rules for internationally active banks, while the European Commission issues directives applicable to banks, investment firms and insurance companies in the EU.

However, there are several objections to the Committee's proposals as regards sub-consolidation.

First, the regulator's objective of always ensuring that sufficient capital is present where it is required may run counter to a group's strategy and its capital allocation between various subsidiaries. For example, it would require capital to be allocated at sub-consolidated level to opposite and equal positions carried by different entities but which offset each other on a consolidated basis.

Secondly, extending sub-consolidation to certain lower levels would increase costs and impose greater time constraints on banks in terms of producing the required financial statements, without offering any real benefits from a prudential point of view. This would particularly be the case for:

- intermediate holding companies, which do not carry any risk;

- consolidated banking subsidiaries, which are not internationally active and which control other banking subsidiaries or investment companies. In these cases, we can assume that the parent company would automatically support its subsidiary if required in order to protect the group's image, facilitated by being governed by the same law.

The industry would therefore prefer to follow the principle enshrined in the European Directive, which gives national regulators the option of supervising on a solo or sub-consolidated basis as required, where they believe the capital allocation within a group is inappropriate.

3.2. Minority interests

Although the Basel consultative paper does not refer to the treatment of minority interests in the case of full consolidation, it would be logical to include them in full in the group's regulatory capital, given that the entire assets carried by the consolidated subsidiaries are included for the purpose of calculating capital requirements.

This comment also applies to the European Commission's proposals to modify the European Directive.

4. Scope of consolidation

4.1. Harmonisation of consolidation rules

From a prudential point of view, consolidation rules imposed by the Basel Accord and the European Directive should be identical. Extending the scope of consolidation would impose much greater constraints on banks and runs counter to the objective of releasing financial information within ever-shorter deadlines.

In this respect, it is important to understand the real impact of the Committee's requirement for regulated financial entities in which a group has significant minority-owned equity investment to be consolidated on a pro rata basis. If it means that all assets and liabilities must be consolidated on a pro rata basis, the industry does not believe it appropriate since this method is usually used only where there is joint control. Minority shareholders with no decision-making power should not have to assume risks in proportion to their holding.

Such an approach would also increase information flow requirements, especially with respect to internal transactions.

Finally, it is important to ensure that the proposed provisions regarding financial communications are consistent with those regarding prudential and accounting consolidation.

4.2. Treatment of equity investments in insurance companies

The banking industry contests the appropriateness, and indeed the need, for the new measures concerning investments in insurance companies, given that the existing rules – under which they have a 100% risk-weighting – appear to be perfectly adequate.

There is no proven correlation between the risks carried by banks and those carried by insurance companies. They are not of the same nature (being backed by liabilities), do not depend on the same factors, and are in any event subject to specific prudential supervision.

Double counting of capital and systemic risk, the two arguments generally put forward to justify new measures, are no more relevant for insurance subsidiaries than they are for investments in other business sectors.

4.3. Financial conglomerates

The banking industry has always regarded this risk as being adequately catered for by existing regulations for the following reasons:

- bank exposure (essentially obligor risk) and insurance exposure (essentially statistical risk) are by their very nature totally different;

- more importantly, the "large exposures" directive prevents a bank from investing more than 40% of its capital in insurance companies.

The industry proposes a number of principles which would meet the concerns expressed by the supervisory authorities.

4.3.1. First, it is essential to determine the threshold above which a group will be classified as a financial conglomerate and therefore subject to specific regulations. Developing this concept, it is proposed that a bank cannot be a financial conglomerate unless:

- it holds over 20% or more of the voting rights in an insurance company and exercises significant influence;

- the investee company has a material impact on the bank's operations and results.

Therefore, in the industry's view, only those holdings that represent more than a certain percentage of the parent company's capital should be taken into account (de minimis exemption).

4.3.2. Secondly, as regards supervisory methods and the need to prevent double-counting, the regulations should be simple and consistent:

- calculation of solo capital requirements, that is at the level of each institution responsible for control, according to the existing prudential regulations applicable to each business sector;

- application of the "solo plus" test, which consists of verifying that the total level of capital is adequate to meet all risks within the conglomerate and not just by business sector. However, any deficiency at conglomerate level should not lead to a decrease in the ratios for any one solo business activity. The supervisors should, if necessary, simply require the conglomerate to remedy the situation on an ad hoc basis, for example by stepping up its supervision, but without requiring the automatic and contractual recapitalisation of one or other of the individual entities.

4.3.3. If a banking group holds significant equity interests in one or more insurance companies, the national authorities should ensure that the group's total regulatory capital (banking + insurance) is greater than the group's regulatory capital requirements (banking + insurance), while avoiding double-counting of capital.

4.3.4. Finally, in order to avoid competitive distortion, it is essential to ensure that there is no divergence between the definitions and regulations established by the Basel Committee on the one hand and the European Directives on the other.

5. Cover for average risk

The Basel Committee proposes that capital requirements should be calculated based on the sum of average expected losses (EL) and unexpected losses (UL), subject to an additional charge. The Committee notes that capital should theoretically be allocated solely on the basis of unexpected losses, which is actually the solution adopted by banks' internal management information systems.

According to the Committee, the main justification for the additional capital charge is the difference in loss absorption capacity between Tier 2 and Tier 1. ***We do not feel this method is appropriate due to the different breakdown in regulatory capital from one bank to another***.

The Committee justifies its decision to use EL + UL by the fact that provisioning techniques can vary significantly.

However, ***we believe the system proposed by the Committee introduces a significant statistical bias that could encourage regulatory switching and hinder convergence with internal systems, which happens to be one of the key objectives of the reform***.

- Statistical bias: average expected losses rise as the quality of each counterparty decreases and the length of each loan increases. However, this rise is much smaller than the growth in unexpected losses. As a result, using the sum of average expected plus unexpected losses would tend to favour poorer-quality portfolios with longer loan maturities, which runs counter to the spirit of the reform.

- Obstacle to convergence: given that international provisioning policies are unlikely to be harmonised in the near future, it would be unwise to maintain a long-term divergence between regulations and industry practice, which tends to allocate economic capital solely on the basis of unexpected losses. A subsequent move by the Committee towards capital requirements based exclusively on unexpected losses would require all parameters to be recalibrated, generating a further round of major changes.

We also propose a separation between capital requirements based on average expected losses (EL) and unexpected losses (UL).

Capital requirements break down into two distinct components: one based on average expected losses (EL) and the other on unexpected losses (UL). Banks that use internal rating systems will publish their assessments of EL and UL, which will based on fixed regulatory figures for the Foundation Approach or their own estimates for the Advanced Approach.

Given that EL is taken into account, ***the ceiling of 1.25% of risk weighted assets applied to general provisions (which have a direct impact on earnings and, consequently, shareholders' equity) is not justifiable and should be removed***.

As a result, capital requirements for exceptional losses would need to be adjusted so as to meet the objective of maintaining the banking system's overall capital requirements.

In short, if we express the Basel proposal as follows:

Capital requirement = f(EL+UL),

The solution advocated by the French banking industry is as follows:

Capital requirement = f(EL) + g(UL)

where f and g would be calibrated based on QIS results.

6. <u>Equity in the banking book</u>

We have identified major issues in the two general approaches proposed by the Committee to determine capital charges for equity holdings below the materiality levels.

The PD/LGD based approach is attractive due to the possible integration of corporate debt and equity into the same risk measurement framework, but does not however seem to be practical. One of the main building blocks of this approach, i.e. the default, has neither been defined for equity, nor is a likely candidate to explain the full economic risk of equity positions.

The market risk approach is more likely to capture the intensity of potential losses associated to equity positions but does necessitate a number of heavy assumptions (e.g. holding period, volatility), in particular for illiquid holdings and private equity. This could lead to a strong heterogeneity in the capital requirements of different banking institutions.

The French Banking Federation recommends not to retain the size of the equity holding portfolio (in terms of percentage of the equity of the banking institution) as a factor to determine the weightings. A portfolio of larger relative size is not intrinsically more risky than a portfolio of smaller size.

The proposed alternative approach would combine the following advantages:

- a simple calculation process facilitating both implementation and the control of figures,
- use of objective criteria promoting a homogeneous execution of the calculations,
- relevant differentiation between different types of equity holdings by risk nature and level,
- consistency with an economic view of the capital.

The proposed approach is based on two main concepts:

- The use of weightings, differentiated according to relevant characteristics of the equity holdings,
- A two-stage calculation process with the application of weightings on both market value and book value.

1. Differentiated weightings

The following factors are proposed to define the weightings to be applied:

- Liquidity of holdings (differentiating listed stocks from private equity),
- Nature of control (percentage of shareholding, influence on management),
- Type of intervention (e.g. LBO versus classical holdings),
- Rating of the company of which the shares are held.

2. Two-stage calculation process

It is proposed to use two sets of weightings. The first set is applied to the market value of the holdings (or to the book value if smaller) while the second set of weightings is applied to the book value. The results of the application of these two sets are added together.

Market value

The first set of weightings is applied to the market value (or book value if smaller) of the holdings to reflect the risk of a strong drop in value. ***The unrealised gains are subtracted from the result***, to account for the cushion they represent. If unrealised gains are greater than or equal to the capital corresponding to the weighted market value, the result is set at 0, and this first stage does not generate any capital requirements. It is essential to deduct unrealised gains to account for the cushion they represent again a drop in market value in equity holding.

Book value

To account for events of a more exceptional nature, a second set of weightings (which should be significantly lower) will be applied to the book value of the equity holdings. This will also prevent equity holdings that have substantial unrealised gains from being charged zero capital.

See Appendix I for an example of the proposed approach.

7. <u>Treatment of fixed operating assets</u>

Fixed operating assets are free from any counterparty risks but could carry a depreciation risk, which may be covered by provisions. As a result, we believe fixed operating assets should not generate any specific capital charges.

B - PILLAR I - STANDARDISED APPROACH

For the Standardised Approach, the method proposed by the Basel Committee is not sufficiently distinct from the former Cooke ratio as the new treatment simply introduces new risk weights for banks (under Option 2 of their external ratings) and for very highly-rated companies only (20% risk weight for AAA to AA- and 50% for A+ to A-).

This overtly general approach only partially meets the Basel Committee's objective of treating default risk more effectively.

It creates an excessively wide gap between the Standardised Approach and the Internal Ratings-Based Approach. However, both international and domestic banks may wish to combine the Standardised or IRB approach according to their geographical locations and customer segments.

If the aim is to encourage a move towards internal rating-based methods, which should be the case, the Standardised Approach must be made credible in terms of the risks covered. This balance does not appear to have been achieved in the current proposals.

1 - Rating granularity

The FBF believes it is essential that the thresholds on each rating scale should provide a more accurate reflection of the default probabilities observed for corporates and should not produce wide gaps in risk weights, which could significantly destabilise the banking system by making its capital highly volatile. The matrix structure proposed in the January 2001 document introduces threshold effects. As a result, a small change in the rating grade for corporates could generate significant capital requirements for the bank, which would be particularly unwelcome in more financially unstable countries.

These comments are important enough to warrant improvements to the Standardised Approach by the Basel Committee.

As a result, the FBF proposes the following changes to the table.

For the sake of clarity, our table will use the external credit rating scale shown in the Basel Committee's consultative document. However, a more satisfactory solution for the Standardised Approach would involve basing the rating scale on default probabilities (which would vary according to the rating agency), so as to provide a correlation with the internal rating-based approach, rather than basing the scale directly on external rating schemes.

To take into account the default probabilities observed over a ten-year period, a new risk weight for corporates needs to be added:

Credit Assessment	AAA to AA-	A+ to A-	BBB+ to BB	BB- to B-	Below B-	Unrated
Risk Weights	20%	50%	75%	100%	150%	100%

2 - External ratings

The FBF would like to keep the option of using the Banque de France rating scheme, whose quality is appreciated by the French banks.

3 - Risk weights for banks

The FBF is in favour of Option 1 for the treatment of banks. This option takes into account the heterogeneous development of external rating systems in different countries, while providing risk weights that are correlated with the default probabilities observed.

For Option 2, the FBF suggests that short-term claims should be defined as those with a residual maturity of up to 12 months.

4 - Specific treatment of retail banking activities

4.1. Definition of retail banking

The term retail banking is generally taken to refer to lending business 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 establishments, lending to very small companies (including the self employed) is closer in nature to lending to individuals than it is to business 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.

As stated in the text of the Agreement, it is therefore very important that differentiated treatment of retail banking is applied to all lending portfolios where the methods applied to risk control follow the same 'industrial' approach to loans, both at issue and in recovery.

4.2. A standard ratio which takes account of the statistical mutualisation of portfolios

Once the scope of retail banking is defined, it is shocking that the standard ratio takes absolutely no account of what is the core of this type of lending: the statistical mutualisation of risk. Thus it would seem sensible to apply an average reduction of 50%, in keeping with the weighting factors used for the IRB: for the same level of LGD and with an identical probability of default, the charge against capital in retail banking is, on average, half the level seen on a corporate banking loan.

This reduction is required due to the very fact that a retail banking portfolio contains sufficient lines of credit to remove all statistical risk, leaving only the overall portfolio risk (sensitivity to exogenous factors such as the macro-economic climate or the regulatory framework). However, it must also leave enough encouragement to the move to the IRB approach over the full range of PD.

These mutualisation effects explain the low historic volatility of losses observed on the following generic portfolios, based on internal data from French banks:

- property lending: 0.007% - 0.02%
- consumer loans: 0.06 - 0.10%
- lending to small companies: 0.12 – 0.20%.

5 - <u>Financial leasing</u>

Financial leasing enables customers to finance the purchase of equipment (plant, vehicles and agricultural machinery) or property, while enabling the bank to maintain ownership of the asset throughout the term of the transaction (see Appendix II.a on the legal framework for financial leasing transactions).

This latter characteristic guarantees absolute security for the lessor, which incurs the risk of the transaction but can recover the asset in the event of a default by the lessee. The lessor can subsequently resell this asset to cover any losses incurred as no other creditor has preferential rights over the asset’s value (see Appendix II.b on asset ownership and its implications).

Financial leasing transactions are arranged in such a way that the lease payments and purchase option price enable the lessor to recover the total principal value of the asset plus a sufficient margin to cover its own refinancing costs, the cost of the risk, its overheads and its profit.

There is no need to assign a risk weighting of 100% to financial leasing transactions when calculating minimum capital requirements if: i) the useful life of the asset is greater than or equal to the duration of the contract; ii) the asset can potentially be resold; iii) the asset is located in a country whose legislation enables it to be recovered within a reasonable timeframe.

Experience in France shows that a much smaller risk-weighting is perfectly acceptable.

5.1. Property leasing

A survey covering the period 1996-2000, and conducted on a sample representing 47-60% of the industry's outstanding lease payments, reveals that the recovery rates after selling properties ranged from 65% to 79% (based on the ratio *selling price/residual financial value plus charges*) (see Appendix II.c: Weighting of property leasing transactions in prudential ratios).

Under these circumstances, a risk weighting of 50% seems totally justified. Furthermore, this weighting was adopted by the EU for the European solvency ratio in 1991 and was maintained in 1998.

Financial leasing companies obviously favour transactions involving conveniently-located properties. As well as enabling them to recover their initial investment if the lessee defaults, this policy also makes it easier to relet a property if the customer does not take up the purchase option (given that the lessor maintains ownership of the property).

5.2. Equipment leasing

Experience shows that a risk weighting of less than 100% should be used.

Recovery rates (i.e. *resale price/residual financial value and outstanding lease payments*) range between 50% and 90% for asset categories representing 87% of total leased assets (see Appendix IId for statistics from five representative establishments).

In addition, recovery and resale times tend to be short.

Given that leased equipment is crucial for the running of their business, lessees tend to prioritise payments to financial leasing companies in order to avoid losing this equipment. This incentive is reinforced by the fact that assets can be recovered very quickly (sometimes within a matter of days, especially in the case of aircraft, for example).

As a general rule, the typical recovery time for mass-market goods (with a buoyant second-hand market) tends to be under one month.

The recovery time for less common capital goods, such as large plant and machinery and heavy-duty printing and construction equipment, can be as long as six months.

For all these reasons, equipment leasing transactions, like property leasing transactions, should be assigned a risk weighting of 50% under both the Standardised and Foundation IRB Approaches.

Lastly, we should point out that, in several states, financial leasing services may be provided by companies which do not have a 'credit institution' status and may not be subject to the international solvency ratio. This factor could distort competition.

Financial leasing is a solution that has enjoyed considerable success in both France and abroad as it meets the requirements of many companies (see Appendix II.e for details on financial leasing in France and Appendix II.f for financial leasing in Europe and worldwide).

C - PILLAR I - IRB APPROACH

1 - Retail banking

1.1. Definition of retail banking activities

The FBF suggests that the Basel Committee uses the same definition under the IRB Approach as the one adopted for the Standardised Approach.

1.2. The need for an advanced IRB approach on condition of changes in the calculation of LGD

The profession supports the Committee's decision to limit IRB to the advanced method and thus not to use the 'foundation' approach to retail banking portfolios. In contrast to corporate banking 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 establishment has its own definition of default which 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 appears illusory.

It would however, be sensible to increase the flexibility of application of the advanced method:

- 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 by the agreement, creates a de facto threat to systems using a different, more operationally based definition of default[9]. Restrictive criteria for the definition of default are even less necessary for retail banking in that the approach chosen by the 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.

- Segmentation of LGD to reflect recovery prospects: The level of segmentation required for LGD needs to be different to that for PD. Thus it does not seem wise to estimate recovery rates differentiated by risk bands and date of loan issue. An average rate per market is more than adequate. However, additional areas will need to be introduced for LGD alone, notably the type of surety (mortgage, deposit).

- Estimates of LGD reflecting expected improvements in the recovery process: An estimate of LGD based solely on historical data could be misleading, as it would not reflect factors likely to make a significant difference in the recovery rate. It is worth bearing in mind that on average an establishment will modify its recovery processes every three years. It would be highly detrimental if LGD did not reflect this. This is why it would be preferable, rather than simply using historical data, for each establishment to establish, with its national controller, an estimate of LGD by sub-portfolio. Whilst based on

[9] Standardised default by number of payment failures is a particularly delicate step, as each establishment has its own standard, which, moreover, varies according to the type of portfolio.

recovery rates seen in the past this would also take account of factors likely to affect recovery rates in the future, both internally, in the form of modified recovery procedures, and externally, such as changes in macro-economic conditions. Such an approach would also help prepare the ground for LGD modelling.

1.3. – The interface between internal models and credit scoring techniques

For retail banking, internal rating systems are based in large part on credit scoring techniques, which 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 can not always say that this is a counterparty rating in the strict sense of the term.

- 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.

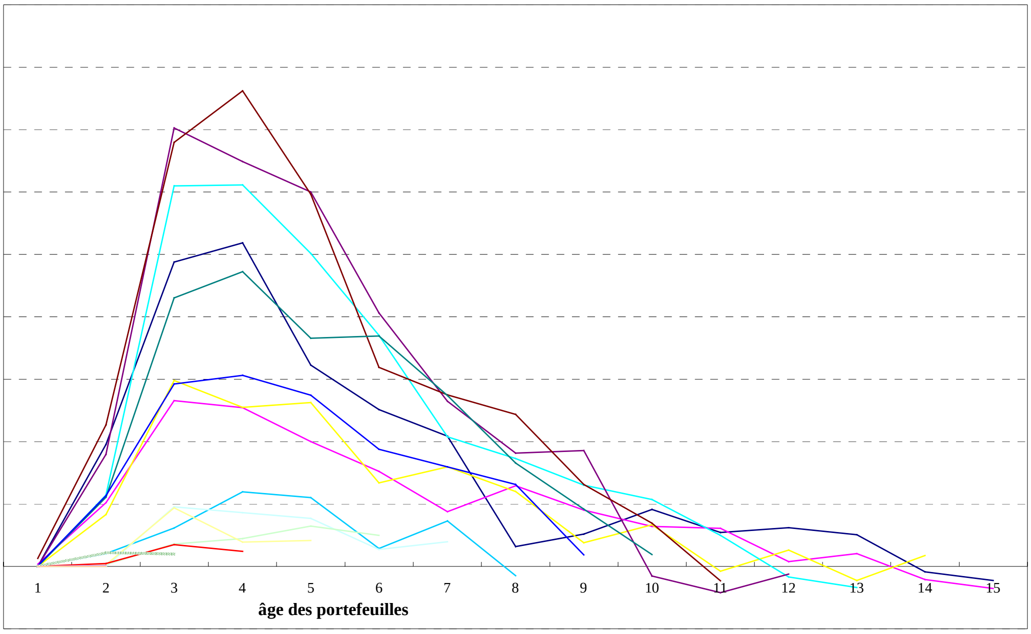
- Depending on the type of loan, the time horizons for default probabilities, associated with scoring ratings, can vary considerably.

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 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 Committee. The profession would therefore suggest a relaxation of certain 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:

1.3.1. 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[10]. Where possible this should draw on behavioural scoring.

1.3.2. 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 graph below shows default events for a representative portfolio of property loans by yearly production generations. In each case there is an identical profile, with a 'bell' curve peaking at the end of the fourth year. Thus using default probabilities after one year prevents a sufficiently reliable segmentation of loans, particularly for recently issued loans. A three-year period seems more suitable. It is important, therefore, that risk-weighting coefficients are estimated individually for the three main categories of loan making up retail banking portfolios.

[10] 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.



1.3.3. Although a period of three years seems appropriate for property and small business loans, it is clearly too long for consumer loans, where a one year period would no doubt be better suited. This clearly argues for differentiation in estimates of weighting factors.

1.3.4. 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.

1.4. – Calibration on the basis of EL for some types of portfolio

The profession insists that each establishment should have the ability to choose, for each of its portfolios, one or other of the methods suggested by the 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 establishments 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 encourages establishments to favour IRB over the standard ratio.

1.5 - Particular circumstances for mutual establishments

In France, the mutuals represent a considerable share of the banking market. Each of these groups consists of a large number of establishments of medium size, or a range of sizes, each with its own owners. For the calibration of internal rating systems the question of definition of portfolios arises – should one consider specific portfolios for each establishment or a single national portfolio?

Given the different internal support mechanisms of each group, their capital can appear as fungible, with each establishment having the backing of the capital of other members of the mutual group in times of trouble. It would therefore seem reasonable that national portfolios be used, on a national basis, to calibrate internal rating systems.

2 - For corporate, bank, sovereign and project portfolios

The FBF approves the general principles of the IRB Approach proposed by the Committee. However, it is concerned about certain aspects of the reform, which could undermine some of the Committee's objectives, particularly in terms of capital requirements under the new Accord, competitive equality and the promotion of sound risk management practices.

2.1. Calibration

2.1.1. A calibration method with uncertain results

2.1.1.1. The Committee plans to calibrate the new Accord based on the results of the quantitative impact study QIS 2. For banks, this study involves simulating the impact of the various methods proposed on their capital charges, based on the weights specified in the Consultative Document. However, this approach has two major drawbacks :

- Firstly, the planned reform is too complex to implement for many banks, whose rating systems and information systems have yet to be adapted to the new Accord. As a result, these banks will be forced to adopt short cuts, which will affect the quality of the final QIS 2 results.

- Secondly, the final Accord will contain a number of amendments to the current draft. The impact of any amendments cannot be assessed on the basis of QIS 2.

2.1.1.2.As a result, the FBF suggests that the final calibration process specified in the new Accord should not be based on QIS 2 alone and that additional studies should be carried out at a later stage. Due to the major implications of the reform and its potential impact on the global banking system, the final calibration process should not be introduced before 2003 in order to minimise uncertainties.

2.1.2. Risk of distorted competition for certain customer segments

2.1.2.1.The FBF notes that the weights used under the Standardised Approach — in particular, 100% for unrated borrowers and a maximum of 150% for the highest risk scores (vs 625% under the IRB Approach) — could give banks that use this Standardised Approach an unfair advantage when financing the riskiest customer segments. However, the risk of default in these segments is usually minimised by risk reduction techniques, whereas the Committee treats the Standardised and IRB Approach on a strictly equal footing.

2.1.2.2.The French banks also note that the conversion factors applied to unused committed credit lines differ under the Standard Approach (20% or 50% depending on the duration) and the Foundation IRB Approach (75%). They do not see any logical reasoning behind this difference and stress that these rules could distort competition, particularly for major corporate financing. The FBF also recognises that a factor of 75% is probably more representative of the actual risks in a corporate portfolio than factors of 20% or 50%.

2.1.2.3.Therefore, to reduce the risk of distorting competition, the FBF makes the following recommendations:

- The Committee should ensure that its proposed widening of risk reduction techniques is confined exclusively to the Foundation IRB Approach (with the exception of financial leasing techniques).
- The Committee should align the conversion factors applied to unused committed credit lines under the Standardised Approach with those applicable under the Foundation IRB Approach.

2.1.3. Risk of excessive calibration

2.1.3.1.Inadequate incentives
The FBF approves the Committee’s wish to provide incentives for banks to adopt the Foundation IRB Approach. However, the 0.2 or 0.3 ratio advantage mentioned by the Committee seems inadequate in relation to the investments required to implement an internal rating system. The FBF also notes that the incentives for switching from the Standardised Approach to the IRB Approach are much stronger for retail banking portfolios.

Furthermore, the FBF feels that the floor applied to the Advanced IRB Approach is ill--founded and could encourage banks with the most prudent risk profiles to increase their appetite for risk in order to optimise the portion of their regulatory capital below the 90% floor.

The French banks therefore recommend that the Committee introduces a stronger incentive for the Foundation IRB Approach and removes the 90% floor in the Advanced IRB Approach.

2.1.3.2.Excessive BRWs.
The BRWs (Benchmark Risk Weights) in the Consultative Document seem far too high. Initial estimates made by various French banks on their actual portfolios reveal an additional cost of between 20% and 40% under the Foundation IRB Approach compared with existing

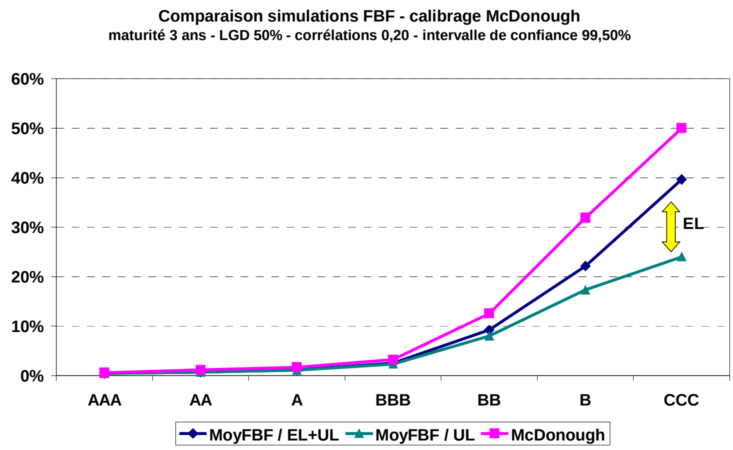
capital charges (excluding charges for operational risk). This situation appears to stem from the cushions that the Committee has included in its formula for the following reasons:

- To correct any potential errors in internal PD estimates.
- To compensate for the weaker protection provided by Tier 2 capital.

The French banks feel that it is inappropriate to determine these cushions on an *a priori* basis.

- It does not make sense to assume that the internal PD estimates made by banks are systematically incorrect, especially bearing in mind that these estimates will have been validated beforehand by the regulators.
- Given that the breakdown between Tier 1 and Tier 2 capital varies from one bank to another, the fact that Tier 2 capital provides less protection cannot be adequately dealt with by artificially boosting BRWs, which apply uniformly to all banks.
- By setting cushions on an *a priori* basis, without knowing the final impact of the reform, there is a risk that excessive charges will be applied to the banking system's overall capital due to the uncertainties surrounding QIS2 results.

Four French banks have attempted to evaluate BRW based on the Committee's main assumptions. The results, detailed in Appendix III, show that the Committee's BRWs have been overestimated by an average of 39% on the basis of EL+UL and 62% based on UL



alone, for a three-year maturity.

The FBF therefore recommends that the Committee significantly reduces its BRWs by not basing them solely on the results of its own simulations, nor setting a cushion in advance. If required, the Committee can subsequently determine an adjustment factor which will maintain the banking system's overall capital at its current levels, based on the results of further studies in addition to QIS 2. Moreover, if the regulator wishes to penalise a given bank for incorrect PD estimates, it can use Pillar 2 to raise the capital requirements for that bank.

2.1.3.3.Credit default

The Committee plans to calculate regulatory capital charges for the unprotected portion of credit defaults by applying the formula in §174 of the NBCA document. The FBF notes that this formula was originally defined for healthy portfolios and does not therefore seem appropriate for a non-performing credit portfolio. This is because the capital allocated to non-performing loans should only cover the risk of non-recovery over and above any specific provisions made, which rules out the Committee's formula. The FBF also notes that, in practise, the unprotected portion of non-performing loans would be subject to a capital charge of 50% vs 12% under the Standardised Approach.

The FBF therefore recommends that the IRB Approach is brought into line with the Standardised Methodology.

2.1.4. **Maturity**

2.1.4.1.For Foundation IRB Approach, the French banks would like each bank to have the option of choosing between an 'effective maturity' of 3 years, as anticipated by the current draft Accord (NBCA §228), and the 'explicit maturity' available under the Advanced IRB Approach (NBCA §225s) and mentioned in connection with the Foundation IRB Approach in the IRB supporting document (§126). The French banks note than the minimum maturity of one year associated with the 'explicit maturity' option is not justifiable when we consider that:

- Most national legislation generally allows short-term loans to be terminated within much smaller periods than one year. Neglecting this case would be tantamount to discouraging good risk management practice.
- For the Standardised Approach, the Committee acknowledges the impact of maturity by providing separate risk weights for short-term bank claims (NBCA §32, option 2).

The FBF therefore recommends that the minimum maturity be lowered to 3 months for bank claims (in line with the Standardised Approach) and 6 months for other transactions.

2.1.4.2.The French banks agree that BRWs should be adjusted using the approach known as 'MTM' by the Committee as the results from this technique are consistent with their own research (see Appendix 1). They do not express a subjective preference for either of the two underlying philosophies behind the MTM and DM approaches. They suggest that this adjustment should only apply to the UL function and not to the EL function, given that the average annual loss is not sensitive to the maturity (cf. A 1.5.).

2.2. Risk reduction techniques in the IRB Approach

FBF feels that the Accord would treat risks more realistically if the Committee were to widen the available risk reduction techniques. This widening would only apply to the Foundation IRB Approach (with the exception of financial leasing techniques) in order to reduce inconsistencies with the Standardised Approach.

2.2.1. Eligible collateral

2.2.1.1.*Minerals and metals*
The French banks suggest that the Committee's list should include minerals and metals traded on liquid commodity markets, e.g. oil, aluminium, silver, copper, tin, nickel, lead and zinc. The corresponding haircuts, calculated based on the Committee's own assumptions (10-day price volatility at 99% confidence interval), are shown in Annex IV.

2.2.1.2.*Property*
The FBF does not see any justification for the 40% floor applied to the LGD that the Committee uses for property collateral, regardless of the ratio *current value of collateral/nominal outstanding balance*. In fact, the default data available to the French banks shows an average LGD of 33% for corporate loans secured by commercial or residential property assets (see Annex IV).

The French banks recommend that property collateral should be widely recognised as eligible collateral. Based on their experience, they suggest that the 40% floor should be replaced by a 10% floor, which would correspond to a ratio of at least 200% in terms of *current value of collateral/nominal outstanding balance*.

2.2.1.3. *Other collateral*
Loans to certain types of customers, such as SMEs, are often backed by collateral that is neither financial nor property-related but comprises assets such as receivables, vehicles, plant, stocks, etc. Based on their available default data, the French banks have noticed that this type of asset-based collateral significantly reduces their average losses in the event of a default (see figures in Annex IV).

As a result, the FBF proposes that these techniques should be fully recognised by the Committee in order to promote sound risk management practice. To achieve this recognition, these techniques would need to be regulated by an appropriate national legal framework and the banks would need to adopt adequate procedures to monitor and call in this collateral. This may involve the introduction of new LGD classes, which would depend on the quality of the assets taken as collateral, for example:

- Category 1 (e.g. receivables and vehicles): LGD = 25-30%
- Category 2 (e.g. plant and stocks): LGD = 35-40%

2.2.2. Guarantees

2.2.2.1. *Substitution and double default*
The French banks believe that the capital charge should depend on the probability of a simultaneous default by both the debtor and the guarantor. This probability depends on the credit quality of the guarantor and debtor, as well as the existing correlation between the debtor's default and that of the guarantor.

- Assuming a maximum correlation between the debtor and the guarantor, and a lower risk of default for the guarantor than for the debtor, the likelihood of a double default is mathematically equivalent to the likelihood of a default by the guarantor. The capital calculation should therefore be based on the latter factor, without any restrictions on the type of guarantor (corporate vs bank) or its default probability (greater than or less than BBB).

- Assuming below-maximum correlation between the debtor and the guarantor, the likelihood of a double default is mathematically less than the smallest default probability. The French banks suggest that the debtor's default probability should be replaced by a joint probability calculated based on a correlation assumption (0.50), which is more conservative than that used by the Committee to calibrate its BRWs (0.20). Annex V shows one of the matrices included by the banks in their response to the initial Basel Consultative Document.

2.2.2.2.Credit derivatives

- Minimum conditions: the Committee sets as a minimum requirement the unconditionality of the contract, which is defined as the absence of clause in the protection contract that could prevent the protection provider from being obliged to pay out in a timing manner in the event

that the original obligor "fails to make the payments due". The FBF suggests to replace this last mention by "faces a case of credit event". Indeed, a protection must be effective upon the occurrence of all credit events cases.

- Risk weight: the deduction of a threshold on payment implies that in any case (whether occurrence of credit event or not) the protection buyer has a loss equal to this threshold. But this threshold may be comparable to a retained exposure and not assimilated to a certain loss. It may be a retained loss only if both following events occur:

  - existence of a credit event;
  - amount of default inferior to amount of threshold (if the default is superior to the threshold, the protection buyer will receive anyway the whole calculation amount). Moreover, the threshold may apply to a broad range of the borrower obligations and not only to the precise asset hedged by the protection buyer.

As a conclusion, the FBF believes that no threshold on payments should be deducted from capital.

- Mismatches:
  - The FBF asks the Committee to define clearly the cases in which it would be considered that an asset mismatch exists and to mention what the haircut would be in such cases.
  - The FBF welcomes the graduated calculation of haircuts in case of maturity mismatch. However, the FBF thinks that the same treatment should be applied to protection under one year.
- Settlement methods:

The Committee does not address the question of settlement methods. The FBF proposes to introduce a framework on fixed recovery protections in the IRB approaches, as it would be totally consistent with the use of internal models and especially with the use of own assessment of LGD in the advanced IRB approach.

2.2.2.3.Credit insurance

The FBF notes that the Committee does not explicitly mention credit insurance polices taken out with insurance companies to cover credit risk. The FBF draws the Committee's attention to the importance of this type of protection, which enables banks to structure complex financing projects which they would not otherwise have taken on and which account for a growing share of international banking activities.

The FBF acknowledges that an insurance policy is not irrevocable as the insured party could be disqualified if it fails to observe various obligations in terms of due diligence and disclosure. In addition, insurance policies are not unconditional as the burden of proof rests entirely with the insured party. However, because these exceptions depend on administrative tasks and disclosure requirements, they fall under the category of operational risk. Given that the Committee plans to introduce a statutory charge for operational risk which, by definition, covers losses resulting from the termination or invalidation of insurance polices, it would be unreasonable not to recognise the benefits of credit insurance.

FBF naturally shares the Committee's desire to oppose the development of credit activities that lie outside the scope of banking regulations. However, the FBF points out that the Committee plans to recognise the benefits of credit derivatives, including those sold by insurance companies, as well as guarantees, including those issued by insurance companies. As a result, it would be arbitrary to exclude insurance policies.

2.2.3. **Removal of the w factor**

The FBF notes that this factor is supposed to cover the risks involved in calling in collateral and invoking guarantees, which would appear to fall under the category of operational risk. The French banks are concerned that this risk would be covered twice, overlapping with capital charges for operational risks. They therefore recommend that the w factor is dissociated from credit risk.

2.3. Eligibility criteria

2.3.1 A strict framework?

2.3.1.1.The FBF approves the Committee's desire to confine access to the IRB Approach to those banks whose rating systems satisfy minimum performance requirements. However, it notes that the Committee also requires these banks to meet certain additional requirements in terms of resources (their system must comply with predetermined characteristics) and results (their system must demonstrate its predictive capacity). As the Committee states: "Banks that do not meet the minimum requirements will not be able to make use of the IRB approach." (NBCA §235).

2.3.1.2.An overtly strict interpretation of these requirements would eliminate banks with rating systems that are otherwise efficient. In fact, although most of the conditions set out by the Committee can be considered good practise, systematically combining them does not necessarily constitute best practice. Furthermore, certain requirements (see below) may prove problematic in practice.

Consequently, the FBF asks the regulators to remain flexible in assessing the eligibility of rating systems.

2.3.2. Some problematic requirements

2.3.2.1.Main difficulties

- The Committee has no grounds to demand that a bank's rating system must have two dimensions (PD and transaction) to be eligible for Foundation IRB. On the other hand, the national regulators are responsible for ensuring that banks which only use the PD dimension do not incorporate any transaction-related features.

- The requirement that no more than 30% of gross exposures should fall in any one borrower grade could force banks that specialise in top-grade customers to diversify towards poorer-quality counterparties. It would be more appropriate for each national regulator to ensure that rating grades are discriminatory enough for each bank's activities.

- Although the involvement of senior management is vital, the nature of this involvement should be left to the discretion of each bank and not subject to detailed requirements (particularly in terms of reporting).

- The day-to-day use of ratings as part of each bank's management operations is also essential, but the bank should be given a degree of flexibility. For example, there is no justification for requiring banks to conduct stress tests on all their portfolios every six months and incorporate the three scenarios recommended by the Committee.

- The FBF agrees with the Committee's recommendation that each one-year PD estimate must represent a conservative view of a long-run average PD (NBCA §270). However, it notes that the Committee appears to contradict this position when it states that banks must not use these long-run averages if current realised PDs are materially higher than the bank's long-run average experience; and that, conversely, it would be prudent to use the long-run average if current realised PDs are materially lower than the bank's long-run average experience (IRBA §217). The FBF suggests that the Committee should eliminate this apparent contradiction by confirming that the long-run average should be used, unless PD estimates are totally incorrect.

- The proposed reference definition of default is satisfactory. However, it would be advisable to modify the first event so that it states "…the obligator is *highly unlikely* to pay its debt obligations" rather than just "unlikely".

- Furthermore, given the diversity of current banking practices, regulators will be responsible for ensuring that this definition is applied consistently worldwide. If certain banks choose only to include purely objective events in their internal definition, they could artificially reduce their number of defaults, and hence their internal PDs, enabling them to benefit from lower capital charges than banks which apply the broadest definition.

- The minimum historic observation period of at least five years for internal PD data seems reasonable to the FBF, especially as it is supplemented by a transition period when the new Accord is implemented. However, the seven-year requirement for using internal LGD and EAD estimates is inconsistent. The French banks feel that this requirement should be aligned with that applicable to PD, LGD and EAD data (five years plus a transition period).

See Annex IV 4 for details on all the FBF's comments regarding eligibility conditions.

2.4 - Project Finance

2.4.1. From project finance to structured finance: a fair treatment under IRB

2.4.1.1.On the one hand, the Basel Committee considers that a separate treatment of project finance is warranted given unique loss distribution (correlation between PD/LGD/EAD; relationship between EL/UL) and data limitations. On the other hand, the Basel Committee does not address the specificities of other types of structured financing, whereby strong transaction structuring significantly mitigates the risk of loss, and the same issues of specific loss distributions, correlations or data limitations can be raised.

2.4.1.2.The French banks believe that a fair treatment would consist in addressing issues for all structured credits, not only for project finance. Structured financing would encompass project finance, including real estate, LBO financing, asset-based financing, such as aircraft

financing or shipping, commodity financing. The French Banks propose more precise definitions in Annex VII.

2.4.2. A part of the Corporate portfolio

2.4.2.1.The French banks recognise the difficulties highlighted by the Basel Committee in its support document on project finance: measurement of PD, LGD, EAD; associated data limitations (IRB 404-405); higher correlations among PD, LGD and EAD (IRB 406-409).

2.4.2.2.However they do not believe that it is materially possible in the proposed timeframe to rigorously determine specific risk weights that would reflect such specificities, in particular given the lack of historical data. Moreover, they observe that most banks use the same rating framework for structured credits as for plain vanilla corporates.

2.4.2.3.Therefore they propose to use Corporate risk weights, as for the Bank or Sovereign portfolios, both of which having specificities that could justify use of particular risk weights.

2.4.3. Introduction of differentiated LGD classes

2.4.3.1.It has been the French Banks' experience that structured credits have a strong low loss track-record thanks to tight transaction structures that aim at mitigating the risks for the lenders.

2.4.3.2.Consequently, they propose that the Basel Committee recognise such risk mitigants by introducing specific LGD classes. To substantiate these examples, the French banks are undertaking historical loss studies, although acknowledging the already mentioned issue of data limitation.

2.4.3.3.As some banks do not use a PD/LGD but an EL framework, they should be allowed to map their internal EL to PD buckets through the specific LGD classes (this is similar to option 3 for project finance - cf. IRBA §414).

D - PILLAR I - SECURITISATION

The French Banking Federation strongly supports the Committee's view that it is important to develop a comprehensive capital framework for asset securitisation as this product has experienced steady growth in volumes and increased sophistication in the last few years. The French Banking Federation believes that this growth and innovation trend will continue in the future and will be fuelled by the new Basel Capital Accord.

The French Banking Federation believes that the new capital framework should comply with the following guiding principles:

1. The framework should address all forms of Portfolio Credit Risk Transfer Techniques in a consistent way

These techniques today include Cash and Synthetic Securitisation, as well as Basket Default Swaps. They will most likely evolve into new forms of risk transfer as financial innovation continues in the Credit Capital Market area, both within the timeframe for the implementation of the New Accord, and during its live period. Therefore, the French Banking Federation believes that the Committee should not address specific structural features linked to current market practices but should rather build a framework that would conceptually be applicable to all forms of Portfolio Credit Risk Transfer techniques as they appear in the market.

2. The framework should be comprehensive and leave only a limited flexibility to local regulators

The French Banking Federation considers that the securitisation market has increasingly become a global market, as major players (structuring banks, rating agencies, major investors) are acting globally in this area. As a result, leaving room for national regulators to set additional operational requirements or set specific risk weights would inevitably lead to unfair competition between banks regulated in various countries.

3. The clean break criteria set for the proposed framework should not be defined by reference to accounting/consolidation rules

With the view of ensuring a level playing field between institutions that are not subject to the same GAAP (Generally Accepted Accounting Principles), our recommendation would be that the Committee only defines minimum requirements to achieve risk transfer, so that the transaction can benefit from the securitisation treatment, rather than link it to clean break criteria referring to deconsolidation rules. If a structure (whether ABS or ABCP) were to be consolidated, the debt issued out of that structure should be treated for regulatory purposes, as a Credit Linked Note in order to ensure consistency between the treatment of cash securitisation and other forms of credit risk transfer such as CRM or synthetic securitisation.. More specifically, clean up calls should be authorised without consultation of national supervisor once the outstanding of securitised assets falls below 10% of the initial amount

4. The Capital charge should clearly address the Credit Risk aspect only of holding a securitisation tranche

The French Banking Federation believes that risks other than credit risks should be left aside for the sake of consistency with the rest of the New Basel Capital Accord. This concern addresses two types of risks described in the Consultative Document.

4.1. Implicit recourse:

The French Banking Federation fully supports the Committee's view that an originating bank must fully use the risk transfer mechanisms as defined per the contractual documentation of each structure, and must not provide any sort of additional support beyond what the bank is legally authorised to (as approved at the inception of the structure by the Regulator). We believe that the measures proposed by the Committee are strong enough to dissuade the originating bank to provide implicit support. However, we would like the final Document to be amended such that:

4.1.1 Public disclosure of implicit support should not be required:
the French Banking Federation feels this measure is inappropriate and unjustified. Pointing out inadequate procedures or behaviours is part of the day-to-day duties of Regulators and their conclusions have never been subject to public disclosure so far. The French Banking Federation believes that the banking industry would severely suffer compared to other industries if issues raised by Regulators in their usual Control duties should be publicly disclosed to the market.

4.1.2 Criteria to assess implicit support should be clearly stated at the industry level, and not left to the appreciation of national Regulators: the current wording of the consultative document is too broad and vague. Notably, substitution as such should not be set as a criteria for implicit support. Banks need substitution features to optimise the diversification and efficiency of their structures throughout their lives. Only the misuse of substitution (for example, substituting a defaulted asset with a performing one) may be considered as triggering the implicit support.

4.1.3 No ex ante capital charge should be applied to cover potential implicit recourse**,** as this would apply to all banks, irrespectively of their actual policies and practices. This could only weaken the incentive for banks to engage in real risk transfer as they would be charged in capital anyway.

4.2 Early amortisation features:

The early amortisation clause is not a credit enhancement and consequently should not generate capital charge as much. The liquidity risk that a bank may face if one or more of its securitisation vehicle enter into early amortisation may vary according to (i) the kind of securitised assets and (ii) the part of securitisation in the funding sources of the originated bank:

4.2.1 The kind of securitised assets: *for short term assets* (credit cards or receivables), a deterioration of the credit quality of the portfolio may lead to an decrease in the quality of the new drawings on credit cards facilities because the debtors are the same. Indeed, newly originated assets can be drawings on existing facilities from existing debtors. In this matter, the early amortisation triggers provision can be broadly considered as an economic trigger. *For long term assets* (residential loans), the fact that an early amortisation has been triggered does not means that newly generated assets have suffered from bad credit performances.

Indeed the deterioration of the credit quality can be linked to the decreasing credit quality of the oldest assets. In this case the sponsor is not bearing any additional risk by funding on balance sheet newly originated assets which credit quality can be better than the ones previously securitised.

4.2.2 The liquidity risk is only material for banks that rely massively on securitisation as their primary source of funding. A low diversification of funding sources does not modify assets quality and therefore does not concern Credit Risks. Specific liquidity risks incurred by those banks should be addressed under Pillar 2, which provides National Regulators with enough room to adjust the capital requirements for such institutions. Liquidity risks potentially incurred following early amortisation should be explicitly excluded from Pillar 1, as no other source for liquidity risk is quantified in the New Accord.

5. Originating banks and third party investing banks should be applied the same capital treatment

Considering that the capital charge should be representative of credit risk only, the French Banking Federation believes it should be recognised that the Credit Risk of a given tranche is the same, irrespective of the status of the holder of this tranche.

5.1 The French Banking Federation expresses the concern that a more favourable treatment for investing banks than for originating banks may lead to inappropriate arbitrage, and will weaken the competitive position of banks that are structurally issuing banks (large retail and corporate lending banks) compared to investment banks and insurance companies.

5.2 The French Banking Federation recognises that for practical reasons, some rules may not be applicable by third party investors as they may have less information on the underlying portfolio. Still, the conceptual framework should be similar and based on the investor’s reporting that are produced by originating banks, investing banks should normally be in a position to model the risk on the underlying portfolio, which they need to do anyway for their internal risk monitoring practices or hedge requirements.

6. The framework should be defined on the basis that securitising a pool of assets does not create additional Credit Risk, but rather reallocates the pre-existing Credit Risk among the various tranches and investors

The French Banking Federation strongly believes that recognising this feature should be the corner stone of the formulaic approach to the capital treatment of securitisation. The reallocation of the pre existing Credit Risk to the various tranches, depending on their seniority, is the essence of the Portfolio Credit Risk Transfer Techniques in all forms (Cash and Synthetic Securitisation, Basket Default Swaps). Grounding the new framework on this conceptual basis would allow for the New Accord to be more flexible to incorporate new techniques as they will undoubtedly develop through the expected life of the New Accord. It would also give banks a clear incentive to increase the risk transfer obtained from securitisation, as this risk transfer would be fully recognised from a regulatory capital perspective.

Therefore, **the total capital charge potentially applied to all tranches of a given securitisation should be equal to the capital charge that would have been allocated to the pool of securitised assets.** This is a direct consequence of the reallocation of risk described in

the previous paragraph. Conceptually, this rule should apply not only on the tranches that the originating bank might retain (typically, the first loss and possibly the supersenior), but also take into account all tranches whether they have been sold to banks or other institutions that are not subject to the Capital Accord. This implies that, in the case of an equity piece which size is equal or larger to the capital that would be allocated to the underlying pool of assets, and if other tranches have been sold, the capital allocated to the first loss piece may be less than the dollar-for-dollar capital reduction. Those tranches do attract some risks, which means that the risk supported by the equity should be lower than the initial capital charge.

7. The framework should follow as closely as possible the framework developed for the underlying assets

The French Banking Federation believes that maximum consistency between the securitisation capital framework and the various options offered for the capital treatment of the underlying assets (Standardised, Foundation IRB, Advanced IRB) is the best way to avoid capital arbitrage and promote real risk transfer. The French Banking Federation has attempted below to propose a gradual framework which we believe would adequately serve this need.

8. Deduction from the equity: Definition of the first loss/equity piece

Under all approaches (Standardised, IRB foundation or Advanced), banks would be required to deduct the equity piece.

The French Banking Federation would like to propose to set following definition of first and second loss: a tranche would be characterised as a second loss if either

- it is rated at least BB (included) or
- if it benefits from a prior loss protection in an amount equal or greater to the capital charge of the underlying assets if they were held on balance sheet. Any other junior tranche would be characterised as a first loss.

9. Standardised approach: full consistency with the Standardised approach for Corporates

The French Banking Federation broadly supports the Committee's proposal of treating each rated tranche as a single exposure, but would like to add the following amendments:

9.1. Unrated tranches: use of the look through approach. Our view is that banks without a sophisticated internal rating system should have access to the look through approach.

9.2. No reason to differentiate the risk weights compared to corporate ratings: The French Banking Federation, considering the methodology developed by rating agencies to rate securitisation tranches, sees no reason why the risk weights to be applied should be higher for a securitisation tranche than for a corporate of the similar rating. More specifically, the risk of potential losses is by construction equal in both cases. Rather, it could valuably be argued that, while the Expected Loss of a securitisation tranche is deemed to be equal to the Expected Loss of a corporate with similar rating, its volatility is significantly lower, as its rating is based on the behaviour of a diversified pool of assets, instead than on the specific risk of a given corporate. This fact is supported by all recent studies by rating agencies which show that the migration probability of securitisation tranches has been significantly below the migration pattern observed for corporates. Therefore, we recommend that the risk weight of a

BB tranche and below (whether it is held by the originating bank or a third party investor) should have the same risk weight as will finally be proposed for corporates (see § 27 of Consultative Document).

9.3. Treatment of the second loss: The French Banking Federation believes that the portion of the proposal which suggests that the second loss piece may or may not be deducted from capital, according to whether the "implied" rating of the second loss tranche is investment grade or not, may be quite difficult to implement in practice by national regulators. Implying a rating would involve heavy modelling work that is unlikely to be available for an unrated tranche held by a bank which has no IRB system validated. The look through approach seems to us to be the only practical method.

10. Foundation IRB approach

As an answer to the Committee's request for ideas as to how develop a more risk-sensitive framework for the IRB method, the French Banking Federation has defined a gradual approach with allows for differentiation between foundation and advanced IRB approaches. The framework we recommend for the Foundation approach is to consider each tranche as a single credit exposure and apply to this asset the PD/LGD model as for the corporate portfolio.

10.1. As suggested by the Committee, **the PD should be the PD associated to the internal rating of the originating or investing bank**. This internal rating may either be derived from the external rating assigned to that tranche if any, or from an internal rating assessed according to the Bank's internal rating policy.

10.2. Super senior tranches should be risk-weighted below AAA tranches: The French Banking Federation believes that, for the specific case of securitisation tranches, tranches that are more senior than a AAA tranche should not have a PD floor of 3bp as set for AAA corporate exposures, as they are undoubtedly less risky than the AAA tranche which has the 3bp default probability below them. Differentiating the capital charge for AAA and super AAA exposures would be, in our view, another incentive for originating banks to transfer the AAA risk to third party investors, while keeping only the risk associated with the super senior tranche.

10.3 The LGD should not be set at 100%, but at 50% like for corporate exposures: In fact, the rating assigned to a securitisation tranche by the rating agencies is not an "issuer rating", but an "issue rating" (indeed various ratings are assigned to various notes issued by the same SPV, according to their seniority). As per the rating agencies methodology, this "issue rating" is set as a function of the Expected Loss of the tranche, not its PD. To convert an "issue rating" into a PD/LGD framework as required in the New Accord, the following very simple rule can be applied:

$$EL_{\text{securitisation tranche}} = EL_{\text{corporate unsecured exposure of the same rating}}$$

which translates into:

$$PD_{\text{sec. tr.}} * LGD_{\text{sec. tr.}} = PD_{\text{corporate rating}} * LGD_{\text{unsecured corporate exposure}}$$

As the PD to be applied to the securitisation tranche is the same as that of a corporate exposure with the same rating, this implies that the LGD to be applied to the securitisation tranche should also be equal to the LGD defined for unsecured corporate exposure.

The French Banking Federation strongly believes that the 100% LGD suggested by the Committee is therefore not acceptable, as it would roughly double the capital charge required for all securitisation tranches. This would also create a significant bias in the conceptual framework, as well as penalising the IRB method compared to the standardised approach, where no explicit LGD assessment is required.

The French Banking Federation wonders whether the final document should not leave the door open for an EL-based framework, as some banks may have internal rating models for securitisation tranches that may not split the EL into a PD/LGD framework.

10.4. The maturity should be taken into account: as most securitisation transactions have an initial maturity of more than the 3-year underlying assumption set for the Foundation IRB corporate exposures, the French Banking Federation believes that the maturity should explicitly be taken into account in the Foundation IRB approach, consistently with the FBF proposal to differentiate maturity for all corporate exposures in the Foundation IRB approach.

11. The Advanced IRB approach

The French Banking Federation believes that while most of the conceptual framework to measure the capital charge of securitisation tranches is defined above in our proposal for the Foundation IRB approach, there are a few areas where the Advanced IRB could provide more flexible treatment, subject to the Bank meeting operational requirements that must be defined. Areas where a more risk sensitive framework than the Foundation IRB include:

11.1. Treatment of first loss tranches: the deduction of equity on a dollar-for-dollar basis could be replaced by a deduction of equity based on the difference between the capital charge corresponding to the underlying assets and the capital charge corresponding to the mezzanine and senior tranches. It should be noted that this feature is a necessity for any bank that will want to be active in the Basket Default Swap growing market. The French Banking Federation wonders whether, depending on the final criteria to qualify for the Advanced IRB approach, this could not be extended to Foundation IRB as well.

11.2. The LGD assumption may vary according to the structure and the tranche. It could be derived from the full loss distribution of the securitised portfolio.

11.3. Maturity needs to be taken into account. The French Banking Federation draws the Committee's attention to the fact that if the maturity dimension is not factored into the Foundation IRB approach, then the Advanced IRB may end up being more conservative because of the longer maturities of most securitisation deals.

12. Conduits

The French Banking Federation believes that the treatment of the facilities granted by banks to ABCP conduits should be based on the same guiding principles as those used for ABS which are already outlined in this document. In particular:

- The treatment of ABCP conduits should ensure consistency with the treatment of any other form of credit risk transfer techniques,
- The benefit of credit risk transfer to third parties should be granted even if the ABCP conduit is consolidated for accounting purposes,
- The capital treatment of any facility should be independent from the role played by the bank in the structure and be the same for a sponsoring bank, a bank only providing a liquidity line or a credit enhancement or for an originating bank that sells assets to the conduit,
- The definition of a first loss for an ABCP conduit and its capital treatment should be consistent with the capital treatment of first losses for ABS.

12.1. Treatment of first losses :

The French Banking Federation appreciates the recognition by the Committee that first losses are generally borne by the sellers and that the sponsoring bank is generally placed in an investment grade position (paragraphs 39 to 42 of the Consultative Paper). The French Banking Federation would like to stress that a similar analysis should prevail when the assets of an ABCP conduit are ABS that already benefit from a first loss or a credit enhancement at the level of the SPV from which these ABS have been issued.

A credit support granted by a bank to an ABCP conduit should be characterised as a first loss or as a credit enhancement depending (i) on the amount of any first loss protection brought by any third party and (ii) on its rating when available. To that effect, the rules applicable to ABCP conduits should be the same as those applicable to ABS.

12.1.1. Under Standardised Approach and Foundation IRB Approach
First losses should be deducted from capital subject to a cap equal to the greater of (i) the nominal amount of the first loss multiplied by the average risk weighting of the conduit's assets and (ii) the capital charge of the conduit's assets as calculated by the bank.

12.1.2. Under Advanced IRB Approach
As proposed for ABS under paragraph 9 (Foundation IRB approach), the deduction from capital would be equal to the amount of capital charge for the conduit's assets minus the capital charge of any more senior tranche or facility issued by or granted to the conduit.

12.2 Treatment of second losses:

Any form of credit support that would not be treated as a first loss would be treated as a second loss. The capital charge would be similar to the capital charge of an ABS tranche and be based on its external rating under Standardised approach and its internal rating under IRB approach. Under Standardised approach an unrated second loss position would benefit from the look through approach.

12.3 Treatment of liquidity lines

12.3.1. Under Standardised Approach
The French Banking Federation is looking for a confirmation that the capital charge for a liquidity line would be based on its "conversion factor" and its credit risk weighting according to the following formula:
Capital charge = nominal amount of the liquidity line * conversion factor * credit risk weighting
* percentage of capital required

The French Banking Federation believes that liquidity lines granted to ABCP conduits should attract a lower conversion factor than similar liquidity lines granted to corporate because of (i) their low probability of drawing and (ii) the large number of structural features that generally mitigate their credit risk :

- Transactions generally provide for a monthly surveillance report on the assets and revolving deals are generally forced into liquidation when credit risk indicators hit certain triggers usually set well below the first losses protection;
- Drawings under liquidity lines are subject to an asset quality test that prevent drawings in situations where credit risk has materialised. This is a very strong improvement in comparison with liquidity lines to corporates that, under certain legislations, can be drawn by the administrator of a bankrupt borrower;
- The drawings under the liquidity lines subsequently benefit from the first loss protection granted by the sellers and from the program wide credit enhancement granted by the sponsor.

The French Banking Federation believes that a less than one year liquidity line to an ABCP conduit should attract a conversion factor of 10% and have a credit risk weighting based on its external rating or, if not rated, equal to the average of the weightings of the assets held by the conduits. The liquidity lines dedicated to one single asset or one single sub-portfolio of assets and that, when drawn, would be reimbursed only from the collections related to that asset or sub-portfolio of asset, would have the same credit risk weighting as the underlying asset.

12.3.2. Under the IRB approach

The capital charge for a liquidity line would be similar to the capital charge of an ABS tranche and be based on its internal rating as detailed in paragraphs 8 (Standardised approach) and 9 (Foundation IRB approach).

In addition to the treatment under the Standardised and IRB approach the French Banking Federation would welcome a confirmation, in the final document, that commitments that are unconditionally cancellable would not attract any capital charge as suggested in paragraph 46 of the Consultative Document.

12.4. Disclosure

While the French Banking Federation recognises that the information to be disclosed by an SPV is very similar to the information already disclosed in the current form of the ABS offering circulars, the French Banking Federation would like to stress that such disclosure requirements may be inappropriate for ABCP conduits:

Sellers of assets to ABCP conduits are usually very sensitive confidentiality and their names should not be disclosed. An information about the number of sellers, their amount sold, their industry and/or country can be disclosed,

The triggers for each of the sub-portfolios is a too detailed information that can be difficult to analyse. The French Banking Federation believes that a disclosure of the three-month average of the default rate (both at each sub-portfolio level and at the program wide level) and its comparison to each seller first loss and to the program wide LC is more appropriate.

13. Grandfathering transitory period

The French Banking Federation 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 Capital Accord. This would avoid banks to enter into significant unwinding costs in case call options are not built into the existing structures.

E - PILLAR I - OPERATIONAL RISK

One of the most important changes introduced with the Capital Accord review process is the proposed operational risk charge.

As an opening remark, *FBF would like to underline that with this new charge there is a risk of distorting competition*[11] *between regulated institutions and those that are either unregulated or regulated*[12] *with no capital charge for operational risk.*

FBF appreciates that the Basel Committee consultative document follows industry proposals as to the definition itself of operational risk and the choice of a spectrum measurement approach with four (4) options designed to satisfy varying degrees of sophistication.

In as much as FBF recognises the good of this overall framework, it wishes nonetheless to raise some questions in reference to how this framework translates into functional processes, namely:

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.

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 FBF to believe that the Basel Committee has submitted itself and the industry to an unrealistic time constraint with its intent to release its final recommendations by year-end 2001.

However, should the Basel Committee feel compelled to stick with its initial objective, given the necessary time needed for amending regulations, namely those of the European Community, *FBF suggests to the Committee, firstly, that the final wording of its recommendations be flexible enough to accommodate for future developments in operational risk issues (measurement, modelling, data, etc.) and, secondly, that a formal and thorough review process of the impact of the new rules be implemented within its recommendations, along with the formal possibility for corrective actions and interim papers, should they prove necessary.*

Fully in line with the concern expressed by the Basel Committee within 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.

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[11]Its implementation in the European Community will have a significant impact on investment firms, small institutions and specialised firms.
[12] Though regulated, insurance companies -they compete heavily with banks in asset management- are currently exempted of any operational risk capital requirement.

1. Overall calibration of the operational risk charge

Although FBF agrees with the general consensus that operational risk is somewhat costlier to firms than market risk and much less than credit risk, FBF calls into question how the Basel Committee came up with a level of 20% of total regulatory capital for the majority of banks.

As a matter of fact, not only just a few banks[13] reported to the Committee that they 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. Besides, at the time these figures were quoted to the Committee, no unique definition of operational risk was then used by institutions, not to mention the wide differences in measurement techniques. Furthermore, one should not forget the reducing impact of the diversification among credit, market and operational risks, even if techniques (convolution of loss distributions for instance) for measuring such an allowance are still to be proven.

FBF therefore thinks that the proposed 20% is an inflated number, that only with the inclusion of expected loss would such a level be credible since it is widely thought within the industry that the level for unexpected loss is most likely below 10%.

FBF wishes that the charge component that relates to expected losses be expressed in an explicit format allowing for its prompt removal (if and when ex-ante risk provisioning becomes reality), notwithstanding the fact that already some existing provisions[14] should be recognised immediately and allowed for deduction from the minimum capital requirement.

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

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

By and large FBF welcomes the definition[15] of operational risk as proposed by the Committee since it reflects the industry position and specifically excludes strategic and reputational risks.

Though it is the perception of FBF that business risk is also implicitly excluded, it would be best addressed if it were clearly mentioned along with strategic and reputational risks as being "… not included … for the purpose of a minimum regulatory operational risk capital charge ".

Since there is a strong potential for double-counting of capital charges, FBF wishes that *clear boundaries be set up in a pragmatic 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 instance, whenever a loss originates primarily from a default, this loss is most often categorised as a loss related to a credit risk event though there may be a possible impact

[13] See § 21 on page 5 of the document "Operational Risk" from the Basel Committee (January 2001).
[14] Model risk provision for instance.
[15] See § 6 on page 2 of the document "Operational Risk" from the Basel Committee (January 2001).

of an added amount to the loss itself due to a 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 and that 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.

On the "w" concept, FBF would like to offer the following remarks: there is a fundamental difference between market/credit risks and operational risk which is that market/credit risks are willingly taken by firms while on the other hand operational risk is unwillingly taken and only because taking market/credit risks necessitates such unpleasant taking, whether from external events or internal fails. As presented to the industry, all risks that are meant to be covered by the "w" factor are of this nature, i.e. unwillingly taken in the course of business. In a nutshell, *the "w" factor has nothing to do with credit/market risks, but only with operational risk.*

Regarding market risk losses, FBF would like to remind the Basel Committee that the multiplier of 3 is intended to cover operational risk losses such as model risk. Herewith is another possibility for double-counting.

Finally, *as to the proposed inclusion*[16] *of certain indirect losses* (as nebulous as "near-misses" or "latent"), *FBF argues that this should not be done* given the impossibility of assessing if not defining such losses, not to mention measuring them.

3. Capital charge gradient

To move from option to option, there are relatively stringent criteria pertaining to effective risk managements, controls, measurement and validation: therefore, *one would expect that the gradient of capital changes across the spectrum of approaches be quite steep and this is not the case at this stage.*

Contrasting with the willingness expressed by the Committee in favour of incentives geared towards prompting banks to choose the more sophisticated option, this does not seem to be the case: for instance, two members of FBF ran a comparison between option 1 -known as the Basic Indicator Approach (BAI)- and option 2 -known as the Standardised Approach (SA)- and found that, based upon the current definition of indicators and calibration[17] of the α and β factors to be used in options 1 and 2, the operational risk capital charge for certain activities could be between 15 and 20% higher in option 2 than in option 1. This result has been confirmed through an IIF study.

To explain such inconsistency the FBF believes that the relative weightings of the business lines as presented by the committee [18] are to be questioned since the calculation is not based solely on a level of operational risk embedded in each business line but on an unexplained combination of size and risk.

[16] See § 7 on page 2 of the document "Operational Risk" from the Basel Committee (January 2001).
[17] See Appendix VIII: "A case in point: the β factor proposed for the 'asset management' business line" .
[18] See Appendix 3 of the document "operational risk" from the Basel Committee (January 2001)

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. *FBF would suggest that results of any proposed calibration for option 2 through QIS2 be compared to such a risk profile* or another profile denied satisfactory (see attached Appendix IX).

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*[19], α *and* β *values to be used in options 1 and 2 should only be regarded as a basis for discussion's sake* (see attached Appendix VIII).

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 for more risk management sophistication. *FBF thinks that there is no need for a floor*.

4. 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 though there is no evidence of a linear link between operational risk exposure and size or volume. To the contrary, research currently conducted within the industry, notably ISDA, tends to demonstrate a non-linear functional form[20] 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 though within an identical context many reasons exist for a large institution to experience a proportionately smaller amount of loss than a less large institution.

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

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

5. Flexibility in mapping business lines

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, FBF does not believe that there is a "fit-to-all" canvas of business lines as it is the case, were the 8 categories that make up the level 1 mapping[21] proposed by the Basel Committee be implemented without sufficient discrimination. A recent industry survey, conducted through the IIF, has shown a strong preference for a more granular set of business

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19 With its Appendix X, FBF wishes to comment on the proposed risk indicators with a view to drawing the Committee attention to possible adverse.

20 Losses Y relate to size indicator X according to: $Y = X^{0.25} - 0.5$

21 See Appendix 2 of the document "Operational Risk" from the Basel Committee (January 2001).

lines (similar to level 2 without however endorsing any specific one) than the proposed level 1.

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

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

Should the Basel Committee decide not to allow for flexibility, then FBF wishes that level 1 mapping be more granular: at the minimum, FBF strongly supports the set-up of an "Agency Services" business line that risk-wise must stand at the same level as "Payments & Settlements" (see attached Appendix IX).

6. 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).

Notwithstanding this statement, *FBF thinks that, contrary to IMA, 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.*

Building upon option 2 (SA) with its business lines and indicators, option 3 (IMA) takes into account the so-called "effect" categorisation of non-overlapping and comprehensive operational loss types.

Besides its comments on the choice of indicators and the mapping of business lines (see above), *FBF thinks that commenting on option 3 -as it stands now- is not possible to the exception of the highly improbable linearity*[22] *of the γ factor over time and across firms.*

However, FBF 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, etc), i.e. a P&L loss,
2. event (criminal, sales malpractices, transaction processing, unauthorised activities, etc), i.e. a single incident that leads directly to one or more effects,

[22] FBF has noted that the typical UL to EL ratio varies from 3 to 1 (theoretical and observed) for transaction processing to 10 to 1 (theoretical) and 50 to 1 or higher (observed) for the more volatile operational risk categories.

3. cause (improper segregation of duties, miscommunication, poor supervision, inadequate documentation, etc), i.e. one or several “risk factors” that increase the probability that an operational risk event will occur.

FBF 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 like figuring the single most important causal factor through a necessarily subjective exercise, etc.

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

With 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. FBF wishes to offer some comments on one of them, i.e. the data observation period.

If on one hand 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, 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: if the collection period is too long then it might contain losses that recent changes in internal environment would certainly make much less likely. Within a given firm, its data collection period needs to picture its most current status of internal controls.

One can think about some form of weighting[23] 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.

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

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

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23 Another instance where some weighting may be warranted: if a bank has gone through a major merger in those 5 years, they may have suffered more losses than one which did not have a merger. Should a bank be penalised for merger losses when they may not merge again, whereas the one which has not merged (but may have a higher probability of merging in the future) does not have to allocate any operational risk capital to such losses because they have no such experience and no events in the 5-year database ?.

7. Qualitative factors

Operational risk management in financial firms is akin to Total Quality Management in industrial or commercial firms and thus is more directly linked to straight good management than with risk management itself. 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 quantified. Subjective judgement 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.

Along with the industry[24], *FBF believes 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.*

With respect to option 1 (BIA) and option 2 (SA), FBF is willing to offer for the Committee's consideration the following suggestion: for a given institution, α or β factors could be weighted down through its realised capital expenditures whenever those expenditures (systems, back-up sites, internal controls, etc.) are undertaken for the sake of reducing operational risk.

FBF would also like to draw the attention of the Committee to the importance of self-assessment procedures designed by banks to assess their internal control environments along with the usage of sets of "scorecard" questions. Answers to such questions could also be used to adjust the capital requirement produced using the currently proposed quantitative methodologies in options 1 and 2. One could object that control self-assessment scorecards may suffer from lack of objectivity and ease of manipulation: key performance indicators can be used as a proxy.

Under option 3 (IMA), FBF wishes to see the use of self-assessment and scorecards as a modifier to the Risk Profile Index (RPI) as FBF thinks that qualitative adjustments find their place within RPI.

8. Risk mitigation

While the Basel Committee conceptually -as a general principle- agrees that risk mitigation should be reflected in the operational risk capital charge, thus in line with the approach to credit risk, a reduction of capital is not yet allowed.

While acknowledging that operational risk mitigation is still very much under development, FBF also recognises that insurance programs of large banks already address operational risk in part (general and professional liabilities, fraud, etc.), even if several issues (deductibles, inconsistent wording, various exclusions, different policy periods, etc.) remain today inherent to current structures and preclude considering insurance as capital.

Nonetheless, any insurance has 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.

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24 See ISDA Discussion Paper "Operational Risk Regulatory Approach" (September 2000).

FBF believes that the Basel Committee should move forward and in a prescriptive way and set up standards for risk mitigation purposes, at least with insurance policies.

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

F - PILLAR III – MARKET DISCIPLINE

I - GENERAL COMMENTS

1.1 THE FBF'S PROPOSALS ARE BASED ON THE OBJECTIVES OF THE BASLE COMMITTEE

The FBF is in full agreement with the Basle Committee on the introduction of a link between the new capital ratio and the disclosure of financial information on the risks borne by the banks. The proposals made below are based on the FBF's wish of implementing market discipline.

1.2. SUPERVISORY AUTHORITIES AND MARKET PARTICIPANTS : DIFFERING REQUIREMENTS

Within the Basle Committee framework, we must clearly define and distinguish :

- the respective aims of regulatory reporting and disclosure to market participants,
- the outline and the components of such information to the market.

Prudential information used in connection with the capital adequacy ratio computation is sent to the relevant regulatory authorities to enable them to fulfil their supervisory duties over lending institutions, including the follow-up of their implementation of sound management practices, and also to help them on their monitoring of systemic risk.
Such a mission is performed in particular through the monitoring of the ratio computation and, more generally, through the checking of the implementation by banks of prudential and management standards and regulations. Within such a framework , the FBF is convinced that the supervisory authorities must have access to the most precise information, to be able to perform its duties under optimal conditions.
At the same time, financial information is disclosed to the market in order to meet other requirements :

- investment decisions from individual or companies,
- risk control and management, mostly performed by financial intermediaries.

Such requirements must be met by banks through their disclosure of quality financial information, consistent with the elements passed on to the supervisory authorities, but in line with their needs. It must also respect the proprietary character of some of the data, in order to avoid distorting free competition between market actors. Finally, it must also be conforming with the principle of privacy of customer information :

- a level of aggregation of disclosed data enabling the user to get a clear picture of the condition of a bank (business, type and global magnitude of risks per large category, capital available to meet them),
- profitability of bank and of projected or performed investment (shares, bonds...).

Amongst this, prudentiel ratios and the quality of the monitoring of the data and the calculations of the banks by the supervisory authorities represent the main guarantee for

the market. Further, the supervisory authorities participation makes it possible to protect the proprietary character of bank information whilst giving the market comfort about its quality.

This distinction made, the FBF fully agrees with the Basle Committee's proposals aiming at a greater clarity of information on risks, and its consistency with regulatory-based calculations.
The FBF wishes to allocate information within two large categories :

- those which disclosure contributes the quality of financial analysis, and thus the market discipline objective,
- those which support the accuracy and reliability of regulation-based prudential ratios, which are useful to the regulatory authorities.

1.3. THE BANKS WILL HAVE TO DEVELOP A PRUDENTIAL INFORMATION SYSTEM

The FBF established that the meeting of the new regulatory requirements on disclosure will lead banks to establish a prudentially-based information system, quite separated from the current accounts-based one. The implementation of disclosure constraints will thus require significant efforts by banks, hence extra expenditure.
Furthermore, a significant part of the information requested by the Basle Committee is not even asked for by the ratings agencies, which does not seem to prevent them from rating bonds and other debt securities. Nevertheless, the Basle Committee considers such ratings sufficiently reliable to propose that they are used as a reference in the weighting of credit risk.

This said, the FBF is obviously not opposed to the transmission of the requested information to the supervisory authorities.

The FBF also noted that financial disclosure will also be affected by the changes in accounting practice, in particular within the scope of the work by IASC to re-write norm IAS 39. The FBF wishes that that financial disclosure under « Pillar 3 » is based on requirements consistent with the ones imposed by IASC, and do not lead to an increase in the number of separate required standards of reporting and disclosure.

1.4. THE RECOGNITION OF THE EXISTENCE OF PROPRIETARY INFORMATION MUST BE TRANSLATED IN THE BASLE COMMITTEE'S REQUIREMENTS

In paragraph 21 of « Pillar 3 », the Committee acknowledges the existence of proprietary information and the need to protect it. Unfortunately, the proposals made under « Pillar 3 » do not seem to be based on this statement of principles. This is the case with the requirements on credit risk, interest-rate risk of the banking portfolio, description of the methodology used for stress-test scenarios, and the description of the system of allocating economic capital.

This situation seems to result from the difficulty probably experienced by the Committee in its trying to ascertain the exact boundaries of market discipline, with references to the aforementioned objectives.

II- REMARKS AND PROPOSALS ON THE COMMITTEE'S RECOMMANDATIONS

For the ease of the study, the remarks and proposals follow the Committee's presentation of the appendixes to the « Pillar 3 ».

2.1. SCOPE OF APPLICATION (ANNEX XI)

In a « market discipline » perspective, the compulsory disclosure requirement, which do not seem appropriate are the following :

- the prudential treatment of entities not consolidated for prudential purposes, and connected matters (*differential impact of methods used other than deduction, surplus capital coming from such companies, and impact on group's capital adequacy*),
- deductions from Tier 1 and Tier 2 for all entities prudentially consolidated or not, considered for the ratio calculation.

Such elements are appreciated by the regulators in their determining the ways of calculating the ratio. It must be thus assumed that the ratio is a reliable representation of each bank, in prudential terms.

With respect to « supplementary disclosure » the FBF considers that it is not useful to disclose eventual insufficiencies of unconsolidated entities : either they are not meaningful for the FBF as a whole, or the supervisor took the necessary measures to make them disappear or include them in the FBF's capital requirements.

PROPOSAL
DECISIONS ON THE DISCLOSURE AT THE UNCONSOLIDATED LEVEL SHOULD BE MADE BY TOP ENTITY OF EACH BANKING GROUP, ACCORDING TO THE ACCESS TO THE MARKET OF EACH SUCH ENTITY, AND A MATERIALITY THRESHOLD TO BE DEFINED FOR EACH GROUP BY THE SUPERVISOR.

2.2. APPENDIX 2 : CAPITAL (ANNEX XII)

The FBF considers that the proposal made by the Committee on core disclosures, which amount to a synthetic presentation of the main components of capital, is a relevant implementation of the market discipline objective.

At the same time, the FBF thinks that the disclosure to the public of supplementary elements raises many issues. In particular, the Committee requests for each item part of the core disclosures, and for each capital instrument part of Tier 2 and Tier 3 a description of contractual features, maturity ; level of seniority, step-up and dividend features, use of SPV, and fair-value of embedded derivatives.

Nevertheless it must be emphasised that some of this information is of an interpretative character. It is difficult to determine the appropriate scope, form, and level of precision of the contractual provisions which must be disclosed, unless all contracts are wholly disclosed. It seems to the FBF that banks which would implement such a requirement would face a definite operational risk (*against which the Committee requires them to*

specifically allocate capital). In some circumstances, investors or lenders could bring an action against a bank arguing they were misled in their choice by inaccurate disclosure.

PROPOSAL
Disclosure on capital should be restricted to the compulsory elements.

2.3. APPENDIX 3 : CREDIT RISK DISCLOSURES (ANNEX XIII)

This appendix describes in its first section disclosure applicable to all banks, whichever method of measurement of the credit risk they use. The other sections deal in succession with the disclosure under the various approaches, and with respect to the eligible risk reduction techniques.

2.3.1. PART 1 : DISCLOSURES APPLICABLE TO ALL INSTITUTIONS

The FBF made the following proposals :

a) the maturity breakdown of the whole portfolio (core disclosure) appears only reasonable if performed with a certain level of aggregation, and not at a very detailed level (supplementary disclosure),
b) the description of the scoring tools seem somewhat excessive, as their features are part of the competitive advantages which each institution considers to be endowed with. The FBF agrees that a synthetic presentation of the scoring method used and of its objectives is possible, but the results of its use are proprietary information (supplementary disclosure).
c) reference to a concept of only « non performing loans » and not doubtful loans under the meaning of French banking regulations does not correspond to the situation of French banks. It should lead banks to alter their information system. The Committee's project should speak of « non performing loans or doubtful ones according to the regulations of each relevant country ».
d) Information on risks transferred through Special Purpose Vehicles or credit derivatives (supplementary disclosure) should be disclosed only at a highly aggregated level. Either these elements are accurately integrated in the ratio computation, and there is no reason to disclose a detailed description of them, or they are not, which is primarily a problem for the relevant supervisory authority.
e) The multiple level at which information must be disclosed (gross, before and after « risk reduction », and weighted, for loans, or total commitments) will be a burden for the banks. The disclosure of information which will not be based on the accounts will be difficult. The banks should be left with the option of making more selective disclosures.

2.3.2. PART 2 : CREDIT RISK DISCLOSURES UNDER THE STANDARDISED APPROACH

This section mostly deals with the use of ratings agencies, both in terms of selecting them, and using them.

The FBF observed that the major part of the data which the Basle Committee wants to be disclosed under the IRB method is not used by the ratings agencies in their work. At the same time, these institutions are able, based on much more limited information, to extend ratings accepted by the Committee in its standardised approach of credit risk. Moreover, ratings agencies apply a clear distinction between information received from

their customers, for analytical purposes, and their disclosure on them, which respects confidentiality requirements. What obviously matters to the market is their ratings, not the data used for determining their level.

It is also indicated that banks must prepare a whole set of procedures to be able to use, in credit assessment, the ratings of securities extended by ratings agencies. Such a method looks somewhat cumbersome.

Finally, for retail banks, the use of ratings agencies is of limited interest. This feature is increased, for co-operative banks, by their de-centralised structure, which makes the setting-up of an IRB-based information system more difficult.

PROPOSAL
The Basle Committee should clarify and simplify the requirements associated with the use of ratings agencies, especially through stating that long term ratings of senior debt and issuers ratings covering the same type of risks, are eligible reference in the standardised approach, and that they can be used for disclosure with respect to credit risk.

2.3.3. ***PARTS 3 AND 4 : CREDIT RISK DISCLOSURES FOR THE IRB APPROACH AND CREDIT RISK MITIGATION*** (ANNEX XIV AND ANNEX XV)

The FBF considers that the major part of the information request by the Basle Committee is confidential, and that its disclosure, due to its complexity, would not really help market discipline.

It is requested (most requirements already apply to the foundation approach),
at the qualitative level,

- to describe the methods used for model-building and operation (*essentially, per portfolio estimation of PD, LGD, EAD, required data for the estimation of the model, explanations on internal ratings and links with external ones, inclusion of mitigating techniques, definition of PD*),

at the quantitative level

- for each portfolio, inter alia, to give the assumption for each element (PD and LGD assumptions related to each PD and LGD grade, for each PD-LGD bucket, or by segment in the retail portfolio, nominal exposure before and after risk mitigation,
- for each portfolio, a comprehensive set of information on default, type of borrowers, their distribution per level of internal rating,
- disclosure based on economic capital.
  With respect to the credit risk mitigating techniques, the FBF notes that :
- some of the requests for disclosure are legitimate, with reference to market discipline (*total exposure, collateralised exposure, exposure mitigated by netting arrangements, method of prudential calculation applied*),
- unfortunately, at the same time, the Committee requests the disclosure of confidential information (*policies and process for the management of collateral, suppliers of guarantees and of credit derivatives*).

Proposals

a) ***with respect to IRB, information should be disclosed at aggregate and synthetic level (per broad instrument) which safeguards the confidentiality of each institution and is consistent with the objective of market discipline pursued by the Committee in its project. Assumptions should not be disclosed with precision.***
b) ***collateralisation policies, as well as information on providers of guarantees and counterparties in credit derivatives are proprietary and should not be disclosed.***

2.4. APPENDIX 4 : MARKET RISK (ANNEX XVI)

2.4.1. VAR OR STRESS-TESTS ? THE LEAST INAPPROPRIATE INDICATOR

VaR is an interesting piece of information for an investor, for the assessment of profitability. Nevertheless, it gives little knowledge of the real market risk of a bank.
In such circumstances, it would seem that, considering that the objective of the disclosure is to make it possible to determine the capability of a bank not to default, it is preferable to favour stress-tests rather than VaR.

Nevertheless, there are no universal stress-tests, meaningful for all banks. Each institution has specific positions, and is sensitive to individual stress situations. Disclosure based on stress-tests would lead to confusion, not make comparisons possible.

This leads us back to the Value at Risk, which is a rather stable concept, but knowing that is not the really appropriate piece of information in the Committee's approach, and that disclosure on VaR should be made only at aggregate level, for instance :

- foreign exchange,
- interest rate,
- derivatives.

The aim of such a reporting should be to allow the assessment of the profitability and the level of risk of each individual business, but to appraise the main components of a bank, to determine its capability of not defaulting (objective of market discipline).

2.4.2. REGULATORY APPROACHES WHICH CAN INCREASE THE PERCEPTION OF RISK COMPARED TO REALITY

There are also problems caused by a differing treatment between internal models and the Value at Risk approved by the regulator. For instance, an institution can have an approved VaR for most of its market activities with a few exceptions, (such as exotic products). Separate reporting is made for each approach, which leads to an increase in the level of the disclosed risk. The FBF wishes that all institutions be allowed to report only using the VaR, when the majority of its market risk is eligible to this method.
The text is also ambiguous (paragraph 58, section 7.3.1., p.15). It states that « the market risks covered are ....currency risk and commodity risk **for the whole bank** ». It is not possible that this sentence refers to regulatory disclosure requirements, as they must be based on the approved VaR ; and supervisory authorities can only approve the trading VaR and not the global one.

2.4.3. DOES A DETAILED DISCLOSURE REALLY CONTRIBUTES MARKET DISCIPLINE ?

The FBF also recalled that ratings agencies do not request much information on market risk , as they rate credit risk and do not consider market risk to be a major one. Market risk only interests them insofar as it is a component of the global default risk of an institution. In this context, the meaning of daily income statements is somewhat limited.

If one considers the objective of the disclosure, it does not seem necessary to disclose information at the level of the regulatory portfolio, but at an aggregated level.

The FBF also proposes that the activities for which the VaR was approved by the regulator is made part of the disclosure. The disclosure of stress-tests may also be made compulsory, if no framework is imposed to banks, as the meaning of comparisons between institutions is somewhat limited. In such circumstances, banks would be compelled to provide as much detail as possible to make it possible to draw meaningful comparisons.

The FBF also wondered whether a detailed disclosure on market activities as proposed by the Committee was consistent with the objective of market discipline. There is no straightforward answer to that as, although there is a risk of confusing the user, sufficient information must be disclosed to enable market participants to establish a clear picture of the analysed institution.

PROPOSALS

a) due to difficulties in making stress-tests comparisons, the FBF proposes to emphasise the use of VaR as a basis for disclosure on market risks.
b) The scope of reference for this information should not be the elementary portfolio but grouping of major risks (such as forex, interest rate...).

2.5. APPENDIX 5. OPERATIONAL RISK

The operational risk was considered by banks and regulators only at a very recent stage. As a result, the regulatory framework is still somewhat imprecise, and this situation reflects in the difficulty for the Basle Committee to give precise definitions for it.

The consultative document requests that banks describe their system for the monitoring of operational risk. The Committee also suggests that operational losses be disclosed, and that, over the longer term, the disclosure on operational risk, in the context of a better and more comprehensive measurement, will be made part of the criteria which must be met by a bank to be allowed to use internal models.

The disclosure of qualitative information seems normal to the group (method for analysing the risk and computing the capital requirements, framework for managing the operational risk).

On the contrary, the request for quantitative disclosure raise some issues : there is no track-record with respect to disclosure on operational risk. On the one hand, the Basle Committee is not yet able to supply banks with a typology of operational risks, but is working on it. On the other hand, the disclosure of operational losses would be premature, as there is identity of methods used for the collection of information between institutions. Further, as this is all novelty for external analysts, the risk of misinterpreting data exists.

In this context, the system could penalise the « good pupils », those would make the biggest efforts to identify and check operational risk.

The FBF finally discussed the eventuality of taking insurance cover into account when measuring operational risk. It is, nevertheless, a problem of measurement of operational risk rather than a disclosure issue.

PROPOSAL
The FBF proposes to postpone any quantitative disclosure on operational risk till the Committee publishes a precise grid of events clearly pertaining to operational risk, and defining techniques for the assessment of potential connected losses.

2.6. APPENDIX 6 : INTEREST RATE RISK IN THE BANKING BOOK (ANNEX XVII)

This is a consistency issue in the work of the Basle Committee. The Committee decided to make this matter part of « Pillar 2 », in recognition of the fact that it was not possible, at this stage, to harmonise the analytical methods and the concepts used by the various supervisory authorities and banks. The FBF therefore does not understand the Committee's proposal to submit banks to homogenous disclosure based on a detailed framework.

The proposed method (upward or downward impact of an interest rate stress) does not solve this difficulty :

- identical results may be obtained using different methods or in different situations,
- the approach of the Committee is very general, but its refining would be too complex to undertake,
- there is no consistency between the scenarios retained in the fields of market risk and of interest rate risk in the banking book,
- some information might be inappropriate, or inaccurate, such as economic values which are only meaningful over a few years horizon, as they are increasingly dependent, with time, upon each bank's individual assumptions about the level of future profits. Furthermore, the management of the interest rate risk of the banking book is based on the going concern assumption, whereas the economic value must correspond to a close-out valuation.

The meaning of the results is strongly dependent upon the assumptions. These are very variable in type and quality. In this way, for most components of the banking book, there is no market in the sense of the meeting of supply and demand.

In the area of the interest rate of the banking book too, there is also a potential for generating an operational risk through the disclosure of assumptions or calculations of an interpretative character, which could be used by investors as a pretext for litigation with the bank.

It must also be stressed here too, that some assumptions, conventions, or methods used are proprietary, and that their disclosure could damage the competitive position of the disclosing institutions.

Finally, it can be noted that some large banks already disclose a significant number of elements on the matter.

PROPOSALS

a) ***disclose requested qualitative information, at a level of aggregation enabling the protection of proprietary and confidential information of banks, without disclosing quantitative information, even with respect to assumptions,***
b) ***disclose requested quantitative data only to supervisory authorities. Avoid disclosure of information not even requested in the area of market risk, such as internal limits or information of limited significance (notional amount of credit derivatives),***
c) ***use a Gap approach for clearly specified scenarios, which fully correspond to the operational practice of banks, is not distorted by the level of future profits assumed, and makes it possible to control, in a transparent fashion, the assumptions made in the models. It would be possible to calculate a sensitivity, from the Gaps, as a number and a percentage of regulatory capital,***
d) ***the supervisory authorities, within the Basle Committee, should continue their discussions to proceed towards greater harmonisation of their respective points of view, in particular in the area of stress-tests.***

2.7. APPENDIX 7 : CAPITAL ADEQUACY

This section/appendix defines the disclosure requirements linked to the capital requirements and the computation of the capital adequacy ratio :

- requirements linked to credit risk,
- requirements linked to market risk,
- requirements linked to operational risk.

This section/appendix subsequently deals with the regulatory ratio, computed on a consolidated basis, which must be disclosed (core disclosure). The project of the Basle Committee differs on the matter from the European Union one, which considers that the disclosure of the ratio would be inappropriate.

The Basle project specifies as well (par. 82) that banks should also make available to the public an analysis of factors influencing its capital adequacy, and the consequences on the ratios.
Such a disclosure would not raise difficulties.

On the contrary, in a second part, the Committee requests, based on « Pillar 2 » requirements, that institutions disclose the method they use for capital allocation, i.e. economic capital allocation, and the result of its implementation. It must be stressed though that « economic capital » is the expression of the internal policies of each bank, for the use of its capital, and reflects upon their strategic priorities. At the same time, the systems of allocation used by each of them might be proprietary. The disclosure of economic capital does not appear to be an indispensable prerequisite of market discipline. Due to the aforementioned elements, it should be optional, and its format should be left to the banks to decide.

Appendix 7 also includes two templates :

- in the first one which discloses the ratio calculation, the presentation of market risks is too detailed, and the FBF proposes to group its components in three broad categories, such as interest rates, foreign exchange, and other ;
- the second template discloses the economic capital, which was already commented upon.

PROPOSALS

a) group together the market risk disclosed for the purpose of the measurement of capital adequacy in three broad categories : interest rate, foreign exchange, and other,

b) give an optional character to the disclosure of economic capital, due to the difficulty to define proprietary information and disclosable one through the issuing of regulations.