31 May 2001

MEMORANDUM OF COMMENT TO
THE BASEL COMMITTEE ON BANKING SUPERVISION:
A NEW CAPITAL ADEQUACY FRAMEWORK

Memorandum submitted in May 2001 by the Banking Committee of the Institute of Chartered Accountants in England and Wales to the Basel Committee on Banking Supervision in response to a second consultative document, issued in January 2001, seeking views on its proposed new capital adequacy framework to replace the 1988 Accord, 'International Convergence of Capital Measurement and Capital Standards.'

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Introduction

1. The Banking Committee of the Institute of Chartered Accountants in England and Wales has reviewed the consultative papers issued by the Basel Committee on Banking Supervision in January 2001. The Banking Committee represents Chartered Accountants working in practice and in the banking industry. Therefore, our comments focus on the accounting and auditing issues raised by the consultative paper, in particular those relevant to the third pillar, market discipline, which aims to encourage high disclosure standards.

2. In accordance with our usual practice in relation to documents of this nature, we are sending a copy of this memorandum to the UK Accounting Standards Board and to the International Accounting Standards Board. In view of the subject matter, we are also sending a copy to the Financial Services Authority.

General comments

3. We support the Basel Committee's efforts to promote safety and soundness in the financial system and to improve standards throughout the world. We therefore welcome the consultative paper and support the framework of the New Accord, with three complementary pillars to banking supervision which seek to balance capital regulation, supervisory review and market discipline.

4. In particular, we agree that market discipline has the potential to reinforce capital regulation and other supervisory efforts. The use of published information has, of course, been used for many years in many jurisdictions for the protection of creditors and the information of shareholders and potential shareholders of companies, as well as other stakeholders. In many individual markets, and internationally, a sophisticated system of the production of general purpose financial reports has grown up. The framework for the production of such financial statements which is increasingly gaining international acceptance is that defined by the use of International Accounting Standards (IAS). By failing to base their disclosure requirements on these Standards, the Basel Committee risks adding needlessly to the costs of banks, in requiring them to accommodate more than one system of accounting and disclosure. Besides this fundamental dis-economy, the Committee do not appear to have taken the following matters into account in framing their disclosure requirements:

   - shareholders and their representatives require similar information as trading partners - for the proper operation of markets, disclosure requirements should be framed to accommodate the needs of both;

   - information required should not be so comprehensive as to risk breaching legitimate commercial confidentiality or to encourage users of financial statements to attempt to second-guess the decisions of management or banking supervisors;

- the disclosure of excessively detailed information is impossible to analyse and use effectively in the context of a trading relationship, as it is when making investment decisions; and

- The need for disclosures to be made would be better assessed in terms of relevance or materiality to the users of financial statements rather than in terms of undefined and possibly diverse categories, such as "sophisticated international banks".

5. In particular, we have the following serious concerns with the proposals as drafted:

- Their relationship to the current financial reporting framework is not clear. In practical terms, since the disclosures are likely to contain price sensitive material, listed banks will be required to ensure that the disclosures are available to shareholders. Therefore, they should be included with other published financial information in, for example, the annual report. In order to achieve their objectives, they must fit within this context.

- The frequency and type of audit assurance that can be provided on the disclosures has not been fully considered. The reference to "information being subject to a suitable verification process on at least an annual basis in the context of the annual report" in paragraph 22 is subject to different interpretations.

- The requirement to provide supplementary disclosures on a more frequent basis has implications that have not been fully considered. It is not clear which banks would be considered to be “sophisticated international banks”. It is also not clear how more frequent disclosure would be possible in the absence of a framework such as that in the US for quarterly reporting. We consider that the disclosures must be made within the context of the bank’s results and financial position or they are likely to be misleading. Electronic reporting is still relatively unsophisticated and until it becomes more widespread and accepted, it seems inappropriate to rely on it for market discipline.

- The different classes of risk to which a bank is subject may be inter-related, with consequent effects on the disclosures required. For example, an increase in interest rates is likely to have a consequent effect on credit risk. These inter-relationships should be discussed in the paper, to address the issue of the possible double counting of risk exposures. This is particularly the case with operational risk, where an administrative error could lead to credit, interest rate, or a number of other types of losses. Together with the likelihood that the

disclosure of operational risk would be commercially sensitive, we suggest that the proposed recommended disclosure of operational losses is rethought.

6. We believe that these concerns can best be addressed by the involvement of the accounting standard setters and the auditing profession in the development of the final proposals. Therefore we strongly support the involvement of the International Accounting Standards Board, and in particular the IAS 30 Steering Committee, in reaching a final set of disclosure requirements. The New Accord would be undermined if the revised IAS 30 or other international accounting standards contained disclosure requirements that differed from or were incompatible with those set out in the Accord. Consistency with IAS would not only directly help enforcement in countries where the use of IAS is required, but would also assist supervisors in using persuasion to encourage banks or local standard setters to adopt disclosure requirements that are at least equivalent to IAS. The Accord would be significantly undermined were the IAS 30 review to result in a level of disclosure less than that required by the Accord.

7. In order to be effective, the disclosure requirements will need to be able to readily adapt to developments in financial reporting generally and to the needs of the market as well as the developing sophistication of risk control and reporting techniques within banks. Unless the Basel Committee will be able to continually review and update the disclosure requirements, the New Accord may not achieve its objectives in the future. Therefore, it would be preferable for the Accord to contain broad disclosure principles and a requirement to comply with IAS or an equivalent disclosure standard. This will ensure that the disclosure requirements can be kept up to date. Standards produced by the IASB can be subject to interpretation by the SIC which will also help achieve consistency and relevance.

8. Discussions with the IAS 30 Steering Committee should help the Basel Committee develop practical means to address the issue of the need for more frequent reporting by “sophisticated international banks”. Rather than trying to define this term, it may be necessary to consider matters such as materiality and the information needs of users. It may also be more helpful to require banks with a certain level of total assets or total own funds to make additional disclosures. This could achieve greater international consistency. A more simple and realistic approach to the issue of more frequent disclosures would be to require banks to make the proposed disclosures with the same frequency as that with which they report their financial results. It should also be possible to differentiate relatively static information, such as the structure of the risk management function, from information, such as risk profiles, which would benefit from more frequent reporting. The requirements of the markets will be a strong factor in encouraging more frequent reporting where this is desirable.

9. We believe that concerns about the disclosure of proprietary information can best be addressed within the context of accounting standards, which take into account issues such as materiality and commercial sensitivity. For example, the proposals

currently require disclosure on a geographical or a business line basis to be made at a level of aggregation that is generally much less than that which is generally provided for segmental reporting in the financial statements. This has the potential to impact on commercial sensitivities, particularly where the bank is offering a single product in a particular geographical area or business line and the disclosure could result in details of individual product pricing becoming available to competitors. It would be helpful for the final Accord to contain a statement that the geographical and business line analyses should be at the same level of aggregation as required for segmental reporting in the financial statements. If there is a concern about the level of segmental reporting in certain reporting frameworks, then this could be addressed by requiring the level of segmental reporting to be at least equivalent to that required by IAS 14 Segment Reporting.

10. We urge the Basel Committee to discuss the audit and assurance requirements with IFAC not only in the context of the disclosure requirements but also with regard to the review of the procedures to be adopted in respect of the internal risk models that will require evaluation.

11. Although disclosure templates are only illustrative suggestions, there is a danger that they become seen as standardised requirements. It should be emphasised that the disclosures made should reflect the bank's risk management polices and the information used for internal management purposes.

Scope of application

12. The disclosures relating to the scope of application appear to be aimed at the consolidated position of the Group for regulatory purposes. Whilst we agree that the group should explain the basis of consolidation for prudential supervision and the effect of unconsolidated entities on regulatory capital, the relevance of detailed information about sub-consolidated entities to market counter-parties is not explained. We are also concerned that, since the entities included in the consolidation for determining regulatory capital may be different to those controlled by the group, the disclosures about regulatory requirements should not undermine the basis of the preparation of the consolidated financial statements.

13. We are concerned that these disclosures could be voluminous for large multi-national groups. Parent companies are already required to disclose information about significant subsidiaries, associates, joint ventures and investments in their annual report, including the percentage interests. However, not all such investments need be included in the annual report if this results in a list of excessive length. The disclosure in Appendix 1 should be reviewed in the context of the existing requirements to ensure that the additional information will not be of excessive length or serve to undermine the description of the group for financial reporting purposes. Similarly disclosure of entities not included in the consolidated approach and how they are dealt with (including any surplus capital) should be restricted to significant entities.

14. The requirement that there should be additional disclosure where non-consolidated entities use a method other than the deduction method could confuse users about which approach is appropriate. If the New Accord permits different approaches in certain circumstances, then the approaches should be acceptable without further disclosure.

Capital

15. We believe that the core and most of the supplementary disclosures with respect to capital are appropriate. However, it may be helpful to set a materiality threshold with regard to those capital issues for which the terms and conditions are disclosed to avoid disclosure of excessive length. A possible approach could be to adopt similar approach to that used for subordinated debt under the EU Bank Accounts Directive where specific disclosures are only required for those issues which exceed 10% of the total balance for subordinated debt, with only a summary being required for smaller issues.

16. The consistency of accounting principles between years is a fundamental accounting concept addressed in accounting standards with specific disclosure requirements for accounting policies and changes to accounting policies. Therefore it is not necessary to address this issue solely in the context of regulatory capital. Similarly, it is not clear why deferred tax should require separate disclosure. We consider that the New Accord should rely on existing practice as much as possible and only require additional disclosure where this is considered necessary to implement Pillar 3.

17. While we support the same annual report being used for reporting to shareholders as well as for regulatory purposes, it should be recognised that financial accounting requirements and regulatory requirements may not be identical. The disclosures should include provision for the statutory reserves to be reconciled to the regulatory capital.

18. In addition, the disclosure required for SPVs needs further development, as it is not clear what is intended. The disclosure within upper tier 2 capital of "undisclosed reserves" does not seem sensible.

Credit risk disclosures

19. Since the definition of past due and impaired loans varies in between particular regimes, we consider that more guidance in this area is required. Consistency would be better assured by making the disclosure consistent with paragraph 48 of IAS 30 which requires disclosure of all loans and advances on which interest is currently not being recognised in the income statement. However, since this is a circular definition, further consideration needs to be given to this area in the context of the review of IAS 30.

20. The reference in the supplementary disclosures to the "lumpiness of the portfolio" should either be left out or properly defined. It is not clear how this differs from disclosing significant concentrations.

21. Standard setters will need to consider the distinction between general and specific provisions. At present there are effectively three ways of establishing provisions - individual loan specific, formulaic provisions for whole portfolios of small value homogeneous credits and general (which are also increasingly formulaic). The middle method is often classified as specific, but it could be argued this is only true for the poorer performing elements. The quantitative disclosures could usefully distinguish between these elements.

22. It is not clear whether the intention of the disclosure in Template 3.I.6, Allowance for credit losses, is to show the profit and loss account charge in respect of general provisions or both the profit and loss account charge and balance sheet amounts. If the intention is to show both then the columns of the table should be split between specific, general and total provisions.

23. Where information is required on a portfolio basis for the IRB approach, it should be made clear that banks are allowed to aggregate information to a level where it is not giving price sensitive information in respect of individual products. Indeed to do otherwise would lead to disclosures of an inordinate length in any bank of a reasonable size.

24. It is difficult to see why Templates 3.III.1, 3.III.2 and 3.III.3 contain the granularity adjustment since this is applied to each portfolio as a whole. Template 3.III.3 also suggests combining nominal exposures for very different types of exposure, for example loan drawdowns and forward FX transactions. It is difficult to see that the result would be meaningful. It may be better to limit the disclosure to EAD numbers only.

25. Template 3.III.4 either implies that all external ratings are conformed or it implies that different tables are produced for each agency. In the second case, this seems an excessive burden. It is also not clear whether the table is expected to just deal with loans. A different way of giving this information would be to indicate in the qualitative disclosure how the internal and external ratings correlate and limit quantitative information to the exceptions. The power of ex post quantitative disclosures to act as a stimulant for market discipline may be out of proportion to the extent of the proposed disclosures. Because of the complexity of the models used, it is unrealistic to rely on market discipline as a mechanism for ensuring that internal models are used appropriately. The onus for this should remain with the supervisors given the difficulty in interpreting causality when problems occur. The market disclosures could be confined to a comparison of actual credit losses with those predicted by the models, rather than providing details of the model inputs. It would be helpful for this analysis to cover not just a single period, but

several years so that readers can form a view of the reliability of the models over the economic cycle. The detailed format of the analysis should not be specified as it should be consistent with information used for internal management purposes, which in practice is likely to vary widely. It would also be helpful if details were provided of the amounts of expected and actual costs which are reflected in accounting provisions at each period end. The present disclosures in respect of numbers of defaults by grade/segment, as opposed to the values of credits concerned, are unlikely to be of much practical use to any market participants.

Market risk

26. We consider that the proposed disclosure of daily back test results envisaged in Template 4.3 is excessive and could prove difficult to analyse in practice. In addition, we are concerned that users could be confused because total real and hypothetical profits are unlikely to reconcile to total trading profits as disclosed in the financial statements. It may be more appropriate simply to summarise the disclosures the highest, lowest and average daily VARs during the period, together with details as to the number of days and the amounts by which real profit and loss was outside the VAR limits. The qualitative disclosure on acceptance by the supervisors of the models will give adequate early warning if they are disallowed because of concerns about their reliability. It might be useful to consider further why some banks adopting this form of disclosure show consistent real profits greater than VAR due to the "retail" spread built into the real profits. This distorts meaningful analysis.

Operational risk

27. In our view, it is unlikely that banks will wish to take up the option of disclosing operational losses, unless the losses of are such a magnitude that they require disclosure under the current financial reporting frameworks, for reasons of commercial confidentiality. We suggest that the recommendations in this section of the accord are reviewed very critically, to be limited to a more realistic disclosure recommendation, more likely to contribute directly to developing best practice.

28. In addition, the definition of operational losses requires thought, to clarify the treatment of the effects of administrative or operational errors which lead to an increase in credit, interest rate, or other losses.

Interest rate risk in the banking book

29. We note that the proposed disclosures do not take any account of the Joint Working Group's (JWG) draft standard on financial instruments. We have a number of issues we have raised with the JWG. Nevertheless, we believe that the principle of consistency between the requirements of IAS and regulatory requirements is of primary importance, and would urge the Basel Committee to

follow the requirements of the eventual standard issued by the IASB, when one has been finalised.

30. The proposed disclosures do not take into account the fact that many banks monitor their interest rate risk using VAR models. This is particularly the case with respect to actively traded short-term treasury accrual books. The quantitative disclosures should allow for this possibility.

31. By contrast, it is not our experience that banks monitor their risk by the use of economic values, and so we do not consider this basis of valuation to necessarily be an appropriate basis for the disclosure of interest rate risk.

32. As noted above, a change in interest rates will have an effect on credit risk. In our experience, banks will assess the risk of interest rate changes across the entire organisation. This should be taken into account in setting the requirements in relation to the disclosure of risk, to avoid double counting or inconsistency in the disclosures given, leading to a lack of comparability between banks.

FJB/T:2408-1