The Basel Committee on Banking Supervision

The New Basel Capital Accord

Response to Consultative Documents dated January 2001

30 May 2001

KPMG

This report contains 41 pages

Appendices contain 2 pages

Contents

Glossary

The following abbreviations have been used in this document:

The Committee	The Basel Committee on Banking Supervision
CD	Main Consultative Document
SA	Standardised Approach
IRB	Internal Ratings Based Approach
LGD	Loss Given Default
EL	Expected Loss
PD	Probability of Default
EAD	Exposure of Default
The New Accord	Consultative Document – The New Basel Capital Accord, January 2001
IRBA	Consultative Document: The Internal Ratings – Based Approach
SACR	Consultative Document: The Standardised Approach to Credit Risk
CD Pillar 3	Consultative Document: Pillar 3 (Market Discipline)
EU	Commission Services Second Consultative Document on Review of Regulatory Capital for Credit Institutions and Investment Firms

1 Introduction

1.1 Why is KPMG responding?

KPMG is one of the leading global professional services firms, offering a range of audit, advisory and consultancy services. We have been providing services to a wide range of financial sector clients for over 100 years. Our banking audit clients represent approximately 25% of the world's largest banks, and range from the largest international banks and financial services groups to some of the smallest regional banks.

Globally, KPMG employs many risk management professionals and financial sector regulatory specialists, including a large number of former regulators. A group of these risk management and regulatory professionals from KPMG's offices around the world have contributed to this report. Their understanding of both the global and local issues affecting our clients' operations has allowed us to present a detailed global response.

External professional advisors are playing an increasingly significant role in advising and assisting firms to achieve compliance with regulatory requirements and standards. This is in addition to the significant role such advisors have played in the banking supervisory process in many countries by providing a source of independent verification from which regulators are able to take significant comfort. In this way, they have clearly contributed to the strengthening of the supervisory process and have helped regulators to achieve a greater degree of consistency of standards across banks. As the Committee's proposed approach will place greater reliance on banks' own internal processes and systems, we believe that there will be an even greater need for independent validation by external professional advisors, not to mention the need for advice and assistance in preparing to meet the new requirements. We believe that we are well placed to play an important role in helping banks and regulators to implement the revised capital adequacy framework. On an ongoing basis, we continue to provide independent validation and advice.

We also note that the implementation of the Committee's proposals will pose significant challenges for regulators around the world. From our discussions with regulators in a number of countries, it is clear that many regulatory bodies do not have enough staff with the types of specialised skills needed. Advisory firms such as KPMG are well placed to provide support and assistance to regulators in this important area.

This said, we are concerned to note that despite the open and transparent consultation process encouraged by the Committee following the release of its first consultative paper on the New Capital Accord, future consultation is intended to have a much narrower focus on industry groups. These groups are, however, not fully representative of the industry. Many institutions, and also advisory firms, are excluded.

We would strongly urge the Committee to widen the scope of its consultation so that it is able to benefit from a wider range of input. We would welcome the opportunity to meet with representatives of the Committee to discuss aspects of our response in greater detail.

Our reply follows the general outline of the Consultative Document. Mindful of the number of likely commentators on this topic, we have intentionally kept our response to what we consider to be the key issues.

In preparing our response, we have, of course, consulted a number of our more internationally active banking clients. However, the views expressed in this response are those of KPMG alone and may not in all instances accord with the views of our clients.

2 Executive Summary

Our main observations are summarised below. Paragraph references are to the location of more detailed discussion on these points in the main sections of this document.

2.1 Developments from the discussion paper 'Proposals for a new capital adequacy framework'

KPMG welcomes the Committee's more detailed proposals following the earlier consultation process based on the paper released in June 1999. We particularly welcome the inclusion in this latest paper of many of the credit risk proposals made by ourselves and other industry participants in response to the first paper.

We believe that the general approach based on three pillars, and on use of bank's internal systems is the right one to take. Nevertheless, along with many banks and other financial intermediaries who will be subject to these proposals by virtue of their regulation by EU based supervisors, we have substantial misgivings about some of the treatments proposed. These concerns relate to the practicality of implementing some of the new proposals, the cost/benefit to the industry, obvious omissions and the participants in the market who will inevitably be disadvantaged by a standardised framework. We welcome comments publicly made by Committee members that you are already taking industry feedback seriously and that you are prepared to compromise on some of the more contentious proposals.

2.2 Transparency and consistency of application [paras 3.1 and 6.3]

We consider that it is important not to lose sight of the benefits afforded by the comparability and simplicity of the existing Accord. The New Accord will introduce both greater complexity, and a significant amount of supervisory discretion into an institution's capital adequacy calculations. With this comes greater potential for inconsistent application that does nothing to assist the aim of achieving a level playing field.

We would encourage the Committee to take a more active role where possible, in either producing or facilitating the production of detailed guidance on definitional and implementation aspects and in setting standards that national supervisors should adhere to for all areas where national supervisory discretion exists, thereby reducing substantially the potential for inconsistent interpretation and implementation.

2.3 Pillar 1 – Credit Risk

2.3.1 Reliance of External Credit Assessment Institutions (ECAI's) [para 5.1.2]

We are pleased to see that the Committee has specified a set of criteria for the recognition of ECAI's. However, we are concerned that the criteria are largely subjective and general in nature and will therefore be open to a wide variety of interpretations by national supervisors. We are particularly concerned about this given the fact that ECAI's will, under the proposed approach, have the potential to exert a strong influence on banks'

capital calculations. The consistency and integrity of their approach will therefore need to be ensured.

2.3.2 Use of Portfolio Credit Risk Models [para 5.1.3]

We note that the Committee has decided that it is still too early to allow recognition of banks portfolio credit risk modelling. While we accept that the current state of development of portfolio credit models is not sufficient to support their use in capital calculations at this moment in time, and agree that the introduction of the IRB approach is a move in the right direction (subject to the specific points we have made on the IRB approach), we firmly believe that the longer term aim of sophisticated firms should be to move to such models. Given the lead-time for implementation of the New Accord, we believe that the Committee should provide encouragement to sophisticated firms to be moving in this direction.

This process could begin by recognising the benefits in using portfolio models (better understanding of the interaction of different counterparties and exposures in a portfolio, changes in portfolio risk through the addition/removal of a credit exposure, etc) through Pillar 2. Recognising the qualitative benefits to banks in using credit portfolio models through Pillar 2 would encourage banks to use these models to take advantage of their eventual use for calculating capital requirements under Pillar 1.

2.3.3 Practical difficulties in implementing the IRB Approaches across all books and locations [para 5.1.9.2]

KPMG has concerns about the ability of banks to move completely towards IRB recognition in all activities. This is particularly so in the case of the Advanced IRB approach where the practical issues associated with full implementation are significant. In particular, the difficulties of obtaining sufficient data in some locations and for some books for LGD estimation will be a major constraint to Advanced IRB implementation in the early stages. Going forward, there will be difficulties when new products come on stream. In some portfolio segments it will be almost impossible to build a statistically validated model based on 5 to 7 years' internal/external data.

From our experience in assisting banks to implement credit rating systems, we believe that even those internationally active banks with the most sophisticated credit risk management systems will struggle to achieve coverage on all books within "a reasonably short period of time" as proposed by the Committee. In particular, we do not support the implicit assumption in the proposals that every credit risk can be modelled <u>and</u> statistically validated.

We are concerned that the Committee may have underestimated the significance of these issues. Specifically, we recommend the following:

- Articulation of what is meant by "a reasonably short period of time", (we recommend 3 years).
- We consider that partial application of the IRB approach should be permitted, subject to the institution being able to put forward a robust argument supporting the claim that it is not cherry picking. We recommend that criteria are developed and incorporated into Pillar 1 enabling supervisors to carry out reviews as part of the supervisory

recognition process and ongoing Pillar 2 work to ensure that an institution is not cherry picking the approach to take.

In addition, we note that the proposals are silent on what rating approaches would be allowable for IRB recognition; eg:

- external rating agency predictor,
- default predictor,
- contingent claims,
- risk neutral,
- expert based,
- cash flow deterministic.

Given the imperfections of credit grading systems and difficulty in achieving full book coverage, KPMG recommends that all of the above rating approaches be permitted under the IRB approaches. However, the Committee will need to be clear about the standards of performance they expect internal rating systems to meet. Without this key information it will be difficult for banks to prepare for implementation.

2.3.4 Model performance and data limitations [para 5.1.9.3]

KPMG's experience in building rating tools shows that rating model performance varies across industry, segment and product groups. As stated above, lack of data is a constraint on model performance, and complexity and facility specific features make it challenging to rate emerging market as well as project, structured and acquisition finance transactions.

A solution for lack of data could be to expand rating agency coverage, allow scope for expert based rating approaches, and encourage the market to pool data using consistent definitions of default and LGD.

Another methodology, which KPMG has successfully used in the past, is to:

- Allow banks to sample part of their portfolio to rate against an external benchmark, such as one of the ECAIs
- Have the same ECAI rate the same sample in isolation
- Compare the two results

Once the bank is getting a good fit to the ECAI results, it should continue using the methodology over a period of time (for example, 3-5 years) so as to develop a pool of internally rated counterparties large enough for independent rating purposes.

2.3.5 Collateral recognition [paras 5.1.5, 5.1.6 and 5.1.7]

While we appreciate the Committee's attempts to give wider recognition to collateral under all approaches, KPMG views the proposals as still being too simplistic given that collateral structures represent a key component of bank credit risk mitigation techniques.

In particular, in relation the Advanced IRB approach, LGD should be derived from recoverable collateral values (which are transaction specific) *and* an assessment of remaining unsecured claims on a counterparty. LGD components are a function of:

- seniority,
- product,
- jurisdiction and country,
- counterparty issuer rating/intrinsic balance sheet strength,
- asset volatility,
- economic conditions,
- realisation cost and
- persistence of default

but none of these factors has been recognised within the proposed framework.

Also, the framework could be more expansive on the many forms of collateral that are taken by banks under the following categories:

- Financial collateral such as guarantees and insurance contracts
- Physical collateral such as ships, aircraft, real estate, rolling stock, commodities, goods in transit etc
- Liquid collateral such as cash, bonds, equities etc

KPMG believes that a highly granular framework of collateral categorisation is required for Standardised, Foundation and Advanced approaches.

2.3.6 Country risk [para 5.1.12]

While the proposals explicitly address the treatment of sovereign risk with the IRB approaches, Country risk, which is a major consideration for internationally active banks, is not addressed. This may lead to underestimations of capital requirements. Also, many organisations confuse sovereign and Country risk and this could result in double counting of risk in internal models and specific country risk provisions. KPMG would be pleased to discuss specific country risk measures with the Committee.

2.4 Pillar 1 – Operational Risk

2.4.1 The proposed approaches to operational risk [para 5.2]

Whilst we understand the reasoning behind the Committee's proposed approaches to determining an operational risk capital charge, KPMG wishes to stress to the Committee the distinct limitations of these approaches.

The Committee's stated aim is to encourage firms to develop risk management practice, by providing appropriate incentives. However, the Basic Indicator and Standardised Approaches are not risk sensitive. In particular, they fail to recognise risk reduction/mitigation which results from the quality of risk management and the control

environment. It seems likely that most institutions will adopt one of these two more basic approaches, with few progressing to the most advanced methodology. There is, therefore, a danger that institutions will focus on the (non-risk sensitive) calculation methodologies, with little attention given to the continuous development of operational risk management.

The advanced Internal Measurement Approach put forward by the Committee is only one of the many methodologies for operational risk available to banks, and represents only a part of a comprehensive operational risk management approach. Whilst we recognise that the Committee favours loss measurement as a methodology which delivers a quantifiable, comparable analysis, given that operational risk management practices in most institutions are still developing, there is a danger that the industry is encouraged into this one approach. To this extent, the proposals may discourage innovation in risk management.

We note that the Committee's chosen definition of operational risk (with which we are in broad agreement) is a causal definition yet the proposed advanced approaches are loss-driven.

We have specific concerns about the proposed advanced approaches with regard to allocation and calibration of losses and categorisation of losses and risks. These concerns are articulated at section 5.2 of our response

2.4.2 Calibration of the operational risk charge [para 5.2.4]

We suspect that many firms will find it difficult to respond to the proposals for an operational risk charge as, in the absence of calibration by the Committee of the capital factors, it is not possible to calculate the impact that the proposals will have on capital charges. Without calibration, institutions will struggle to put together a business case for the expenditure required to develop operational risk management practices. We recommend that the Committee engages in full and open discussion with the industry as work progresses to calibrate the operational risk charge.

2.5 Pillar 3: Market Discipline

2.5.1 Involvement of the International Accounting Standards Board [para 7.1]

While we agree with the general principle that market discipline is needed to support the supervisory process, we do not believe that this principle can be used as a basis for requiring the provision of a higher level of disclosure to market participants than that which is provided to shareholders and their representatives. It is also important that the information provided to shareholders should be relevant to their decision making requirements, and not be hidden within a large volume of other information provided to meet the interests of other users of financial statements. When there are already established bodies involved in setting standards for financial statement disclosure we are strongly of the view that such standard setting bodies should have the primary role in determining which disclosures are necessary for market discipline purposes.

We therefore believe that primary responsibility for determining the final set of disclosure requirements to support Pillar 3 should be given to the International Accounting Standards Board (IASB), and in particular the IAS 30 Steering Committee.

2.5.2 Volume of proposed disclosure [para 7.2]

We have a general concern about the sheer volume of proposed disclosure which appears excessive. In particular, we consider that the extent of the proposed disclosures in some areas is out of proportion to the power of disclosures to act as a stimulant for market discipline.

2.5.3 Location of disclosures and nature of audit assurance [para 7.2]

The proposals do not make it clear as to whether the proposed disclosures should be made in the annual report. While we believe that it would be logical for them to be incorporated within mainstream financial reporting, the frequency and type of audit assurance to be provided in respect of these disclosures requires further and careful consideration.

2.5.4 Fair value accounting [para 7.4]

The draft Accord does not appear to address the impact of the extension of fair value accounting under IAS 39. It is likely that the impact of extending fair value accounting to some of the financial instruments held in the banking book would be wide ranging and would have an impact on asset valuations and reported capital, as well as on disclosures in the financial statements. It would therefore need to be considered in relation to Pillar 1 and 2, as well as Pillar 3.

3 General Points

3.1 Transparency and consistency of application

We consider that it is important not to lose sight of the benefits afforded by the comparability and simplicity of the existing Accord. The New Accord will introduce both greater complexity, and a significant amount of supervisory discretion into an institution's capital adequacy calculations. With this comes greater potential for inconsistent application that does nothing to assist the aim of achieving a level playing field.

The increased complexity will place an increased burden on institutions as they seek to comply with the New Accord, particularly those that wish to calculate minimum capital requirements under the more advanced approaches.

In addition, the New Accord places significant burdens on national supervisors. For example, supervisors will have to exercise judgement in the areas of:

- Giving approval to the use of more advanced approaches; and
- The application of Pillar 2.

We consider that it is essential that the Committee promotes consistent and transparent application of the New Accord, including by either producing or facilitating the production of detailed guidance on the definitional and implementation aspects of the New Accord. An added benefit of this is that it would assist non-BIS member countries, particularly those where supervisory resources are limited, in adopting the proposals.

We also note that there are a number of areas where the CD uses words that are vague or unclear such as "meaningful", "reasonably" or "relatively". We would encourage the Committee to take a more active role in providing more explicit definitions where possible and in setting standards that national supervisors should adhere to for all areas where national supervisory discretion exists, thereby reducing substantially the potential for inconsistent interpretation and implementation.

There remains, though, the question of 'who supervises the supervisors' and we wonder whether some form of peer review or quality standard could be introduced to encourage supervisors to achieve consistency and to reach certain standards.

3.2 Timetable for consultation and implementation

We consider that the proposed timetable for consultation with the industry on the New Accord and subsequent production of a final Accord by the end of 2001 with implementation set for 2004 is highly ambitious. Also, as noted in our introduction, we understand that no further public consultation is proposed, including in relation to the areas where the Committee acknowledges that significant work is still required, for example:

- Calibration of the operational risk charges; and
- Development of approaches for project finance and equity exposures.

We understand that any additional consultation subsequent to 31 May 2001, in the period when the Committee seeks to finalise the Accord, will be undertaken directly with certain industry groups. As noted in our introduction, we are extremely concerned by this shift from an open and transparent consultation process to a much narrower one. Informed industry groups are not representative of the industry as a whole. Even if consultation includes industry trade bodies these are generally loose affiliations of industry participants, not fully representative of the entire industry. In addition, advisory firms such as ourselves would be excluded despite being in the rare position of having a perspective which cuts across the entire financial sector, ie a range of firms potentially impacted by the New Accord.

We would therefore urge the Committee not to narrow its consultation process. However, if such a narrowing cannot be avoided, then it should be done in a very open manner. For example, we recommend that meeting minutes and subsequent drafts of the Accord, or relevant sections of the Accord, be published in a manner that will keep all industry participants aware of the direction of the discussions and give them the opportunity to respond where appropriate.

In addition, we share the concerns of those institutions that will be required to hold additional capital following the introduction of the New Accord that insufficient time will be available for those institutions to efficiently raise that additional capital. We recommend that the Committee encourages supervisors to allow firms a certain amount of time (say 12 months) following calculation of the new capital requirements in which to raise additional capital to avoid undue capital markets pressures.

3.3 Capital incentives to adopt more advanced techniques

Whilst the Committee has presented the different approaches for the calculation of capital charges as a menu of options, it is clear that national regulators (if not the market via the proposed disclosures) will expect the more sophisticated banks to adopt the more advanced approaches as quickly as possible. There is industry concern that for credit risk, the capital incentives available for adopting the more advanced approaches are not sufficient in themselves to encourage an institution to adopt the more advanced risk management techniques.

With regard to operational risk which is not yet calibrated, there may be insufficient incentive to adopt the internal measurement approach as the benefits of this approach will be limited by a regulatory implied “floor” the impact of which is not yet known. The impact of the floor will need to be reviewed when considering the business case (costs vs benefits) for the more advanced approaches.

In addition, the proposals are light on explanation as to how the operation of Pillar 2 will interact with the calculation of minimum capital requirements. For example, if a bank is reluctant to move from the Standardised Approach to the Foundation IRB Approach due to higher capital charges under the IRB approach (even if operational requirements/risk management processes are adequate to move to the IRB approach), it is not clear whether supervisors will require that bank to hold additional capital under the powers provided by Pillar 2.

Whilst we support the Committee’s intentions to encourage sophisticated banks to adopt good practice in the areas of risk management, and to reward those that do so by

permitting them to use the more advanced approaches for calculating capital charges, we recommend that the Committee should reconsider the calibrations such that real capital incentives do exist and that Pillar 2 will be robust enough to support adoption of more advanced approaches.

3.4 Ability of national supervisors to implement the proposals consistently

As noted earlier, the resources of national supervisors may act as a constraint to the effective implementation of the New Accord. There could, for example, be delays or incorrect assessment of the appropriateness of a particular capital treatment for a bank.

The resources in demand from supervisors will also be in demand from institutions implementing the Accord. We recommend that national supervisors should be encouraged to assess their own resources at the earliest opportunity, and draw up plans including recruitment from the market on a permanent or secondment basis as well as consideration of other solutions such as use of professional advisers.

4 Scope of application

4.1 Practicalities of consolidation

The proposals do not address the practicalities of consolidation in an environment where supervisory recognition is needed for the approach adopted. For example, where a large international banking group has subsidiaries world-wide, what happens if the supervisor in one country decides to offer only the basic methods in their jurisdiction? Does the subsidiary have to do two separate calculations, one according to the group supervisors rules, and one according to local supervisory rules as, clearly, this situation would be highly undesirable. It would both increase the cost of meeting supervisory requirements and create possible conflicts in the treatment of the same risk by two different supervisors. Another possible situation we foresee is where a local supervisor allows a subsidiary to use the IRB approach but the consolidated supervisor is not happy with use of the approach for consolidated reporting purposes. Again a two-tiered reporting process would appear necessary, though may not be desirable.

In the case of market risk, this problem was overcome in some countries by accepting local supervisors' judgements and requirements, and aggregating the resultant capital requirements via the "aggregation plus" technique. We accept, however, that in the case of market risk, apart from Hong Kong, Singapore, and Australia, the supervisory jurisdictions affected were all members of the Committee, where it was easier to exchange views and simpler to reach any compromise. In the case of credit risk, the population of supervisors to be consulted and negotiated with will be considerably greater, and lines of communication may not be as well established as they were for those involved in market risk.

We believe that it will be necessary for supervisors internationally to reach agreement on how they will deal with situations of this nature, for example, memoranda of understanding between countries may be required. Also, we believe it is essential that accommodation be reached between all supervisors (or at least G10 supervisors) such that no bank or banking group is required to calculate its capital ratio twice over according to different supervisory rules.

4.2 Distribution of capital around a group in accordance with risk

The proposals are silent on the treatment of intra-group balances in the context of the individual firm's (unconsolidated) capital calculation. This is an important area, which has the potential to significantly impact the distribution of capital around the group.

We believe that capital should be distributed around the group such that each subsidiary's capital base provides support for the risks that subsidiary is taking. However, we also believe that there should be a general bias in favour of holding some capital, and particularly surplus capital, centrally. This is because it is nearly always easier and quicker in times of crises to down stream capital to a subsidiary compared with up streaming it back to a parent, or sister subsidiary. If intra-group balances are weighted in the same way as loans placed outside the group, then this will discourage central pooling of resources, and capital will gravitate towards subsidiaries.

One possible approach would be to weight intra-group exposures at zero and then apply other forms of controls and restrictions. These would include the supervisory treatments under Pillar 2 of the Accord, and quantitative large exposure limits or other forms of capital ring-fencing. This, we believe, is the "most neutral" way of treating intra group exposures for supervisory purposes in as much as it does not build into the system a conflict between unconsolidated and consolidated capital ratios.

There is also a view which we have heard expressed by some supervisors that loans by a subsidiary back to a parent should be treated as a deduction from the subsidiary's capital based on the grounds that they represent a de facto repayment of capital. While we accept that any loans back to a parent which are treated as parent capital should be deducted in order to avoid double gearing, we do not accept that deductions will be appropriate in all cases. Rather, it should be possible to make a clear distinction between permanent or semi-permanent transfers of funds in the form of capital, and short term liquid exposures within a banking group. To treat a subsidiary's deposit of surplus funds with its parent as a repayment of capital would, we believe, create damaging inflexibilities within the banking system, which would run counter to sound banking practice.

5 Pillar 1 – Minimum Capital Requirements

5.1 Credit risk

5.1.1 Introduction

In commenting on the credit risk proposals under Pillar 1, we have confined ourselves to those areas that give us the greatest cause for concern. More minor points have not been included in this document.

5.1.2 Reliance on external credit assessment institutions ('ECAIs') in the Standardised Approach

We are pleased to see that the Committee has specified a set of criteria for the recognition of ECAI's. However, we note that only one criteria (objectivity) is a 'must' while all of the other criteria are 'shoulds' and are fairly general in nature, leaving it open to national supervisors' discretion as to how the criteria are applied in practice. In other words, variable standards could be applied across supervisory jurisdictions. We recommend that the Committee establishes a more prescriptive framework for rating agency recognition.

This will be particularly important given that ECAI's will, under the proposed approach have the potential to exert a strong influence on banks' capital calculations. The consistency and integrity of their approach will therefore need to be ensured.

5.1.3 Use of Portfolio Credit Risk Models (IRBA 7)

We note that the Committee has decided that it is still too early to allow recognition of banks portfolio credit risk modelling. While we accept that the current state of development of portfolio credit models is not sufficient to support their use in capital calculations at this moment in time, and agree that the introduction of the IRB approach is a move in the right direction (subject to the specific points we have made on the IRB approach), we firmly believe that the longer term aim of sophisticated firms should be to move to such models. Given the lead-time for implementation of the New Accord, we believe that the Committee should provide encouragement to sophisticated firms to be moving in this direction.

This process could begin by recognising the benefits in using portfolio models (better understanding of the interaction of different counterparties and exposures in a portfolio, changes in portfolio risk through the addition/removal of a credit exposure) through Pillar 2. Recognising the qualitative benefits to banks in using credit portfolio models through Pillar 2 would encourage banks to use these models to take advantage of their eventual use for calculating capital requirements under Pillar 1.

5.1.4 The limitation of concentrations to 30% of a rating band (CD242)

We share the EU Commission Services' view [EU67] that the proposed limitation penalises small and medium sized (regional) banks. While we recognise that the Committee is only recommending these proposals for "internationally active banks", the reality is that, as with the 1988 proposals, these are likely to be applied to most banks in over 100 countries.

As per the EU document, while it is necessary for large banks to ensure "meaningful risk differentiation" there may be a significant number of small and medium sized financial institutions focussing their business on specified borrower segments who happen to be in the same rating category. From a practical point of view, KPMG believes that the rules should be relaxed for lenders who do not have the ability to originate across the rating spectrum.

5.1.5 Credit Risk Mitigation (Standardised and IRB approaches)

While Credit Risk Mitigation covers the areas of Collateral, On-Balance sheet netting, Guarantees and Credit Derivatives, we have focussed on collateral in our response as this is where we believe there is the greatest potential for confusion.

While we appreciate the Committee's attempts to give wider recognition to collateral, KPMG views the proposals as still being too simplistic given that collateral structures represent a key component of bank credit risk mitigation techniques.

5.1.5.1 *We make the following observations:*

- Eligible collateral (CD76) under the Standardised Approach is too narrow, whereas the Advanced IRB Approach leaves too much scope for inconsistency across the market. We suggest, therefore, that tighter definitions are required, a point that we will cover later in this response – see para 5.1.6 below
- KPMG recommends that more collateral categories should be included in the Standardised Approach and that a highly granular framework for evaluating components of LGD should be specified in the IRB approach. Specifically, the framework could be more expansive on the many forms of collateral which are taken by banks under the following categories:
    - Financial collateral such as guarantees and insurance contracts
    - Physical collateral such as ships, aircraft, real estate, rolling stock, commodities, goods in transit etc
    - Liquid collateral such as cash, bonds, equities etc , even when this collateral is held on deposit with another bank, subject to appropriate documentation pledging the security.
- Under the IRB approach we believe that a more granular definition of LGD is required so that banks can calibrate LGD factors to collateral recovery risks and counterparty recovery risk arising from claims on residual or clean exposures.
- We recommend that LGD should be broken down into recoverable collateral estimates and unsecured claim estimates (which are counterparty dependant). LGD factors can be derived from these components that will make the reporting/justification of internal LGD factors more transparent. In particular, LGD needs to be derived from recoverable collateral values (which are transaction specific) *and* an assessment of remaining unsecured claims on a counterparty. LGD components are a function of:
    - seniority,

- product,
- jurisdiction and country,
- counterparty issuer rating/intrinsic balance sheet strength,
- asset volatility,
- economic conditions,
- realisation cost and
- persistence of default

However, none of these factors have been recognised within the proposed framework.

5.1.5.2 *Different legal frameworks for pledging collateral*

We suggest that the concept of "first claim" in CD 320 needs to be clarified to take account of very different legal frameworks, for example, pledging real estate as collateral between different jurisdictions. The wording of CD 320 is mainly relevant to Anglo-Saxon countries and in order for the supervisors in different countries to issue more specific guidelines they will need to be able to map their different legal frameworks to a clear definition of what constitutes a "first claim". One solution might be to focus on the concept of the "loan-to- value" ratio rather than "first claim" as we believe this would make it easier to achieve a level playing field across jurisdictions with different legal frameworks.

5.1.6 Collateral issues under the Standardised Approach

Eligible Collateral (CD76)

With the exception of gold, physical asset collateral is not recognised in the Standardised Approach. We recommend that the range of physical collateral is extended to at least cover residential and commercial real estate (RRE and CRE). We consider that the risk weight for RRE of 50% is too simplistic as this approach does not take into account the impact of loan to value ratios that vary between mortgage loans. Instead of a flat 50% risk weighting for RRE, we recommend that mortgage loans with lower loan-to-value ratios should benefit from a lower capital charge in line with our general proposals on the treatment of collateral.

Commodity Trade Finance (CD77)

The provision for "equities not included in….but traded on a recognised exchange are eligible…" does not explicitly cover commodity warrants, hedged and traded on the LME, LIFFE, Comex and other major exchanges, and taken by banks as collateral for financing commodities. We recommend those commodities are explicitly included for the following reasons:

- In the case of commodity financing, where a bank is using the Standardised Approach, the bank's title to physical assets such as oil, metals and soft (natural resources) as evidenced by exchange traded warrants or convertible into deliverable warrants, or saleable warrants in the terminal markets, does not count as collateral (other than in the case of gold).

- Hence, all commodity trade finance banks using the Standardised Approach will be seriously disadvantaged over those who build Advanced IRB models to show lower LGD.
- Yet many smaller natural resource financing houses in Europe will be "forced" to adopt SA due to skill constraints, budget constraints & IRBA qualifying requirements.
- The proposals recognise collateral "with reliable market price and sufficient liquidity". These LME/LIFFE grade commodity stocks evidenced by warrants or warehouse receipts have both attributes and yet are not recognised under the Standardised Approach.

Unless all relevant banks are able to comply with the Advanced IRB approach for commodities and natural resource financing, these physical collateral should be given recognition in the Standardised Approach through a simplified haircut methodology. KPMG has developed such methodologies and we would be happy to discuss the general principles of these with the Committee.

5.1.7 Collateral issues under the IRB Approach

5.1.7.1 *Treatment of collateral & LGD (IRBA-58,81-84,99,238)*

Paraphrasing from IRBA, in the Advanced IRB approach to LGD "*there is no limit on types of collateral, ..nor is a specific technique for recognition set out…*". In view of the inadequacy of LGD data, "the Committee does not believe that it is appropriate for all those using the IRB approaches to use their own estimates of LGD…". Only those banks who can demonstrate that their LGD estimates are robust should be permitted to use these estimates. In the Foundation Approach, collateral is as per the Standardised Approach (only financial, RRE and CRE). "The Committee does *not feel that any specific additional collateral types are capable of meeting the test* for recognition, ie, that they provide for a meaningful, consistent and reliable reduction in losses…"

We comment as follows specifically on the italics:

(a) Most banks are unlikely to use the Advanced LGD method and yet very many types of collateral are disallowed under the Standardised and Foundation approaches.

(b) Having restricted collateral under the Foundation Approach, we suggest that it may also be inappropriate to leave the Advanced IRB LGD methodology so wide open with "no limit on collateral and no technique set…." Our experience also shows a wide range of methods (some wrong) are used by banks to compute final LGD with collateral.

In summary, the two options appear to us to be unbalanced with severe restrictions under the Standardised and the Foundation approaches to LGD and yet full freedom under the Advanced IRB approach to LGD.

We would recommend an approach where Realisable Collateral Values (RCV) are removed from LGD, combined with greater clarity as to the specific risk factors affecting collateral values in the event of default. The LGD should be measured through three components: (i) impact of RCV through haircuts (ii) additional severity of country risk impact on all recoveries affected by transfer risk and (iii) recovery rate on residual unsecured claim on the borrowers.

The problem of non-recognition of collateral can be resolved by (a) allowing a wider range of physical collateral in the Standardised Approach and (b) creating a standard framework for advanced measurement of collateral values for LGD under IRB rather than leaving it to the national supervisors to validate methodology.

5.1.8 The Standardised Approach

5.1.8.1 *'Past due' assets (CD39 & 40)*

We are concerned that the requirement to assign a 150% risk weight to assets 'past due' beyond 90 days could create perverse incentives resulting in under estimates of capital, for example, the restructuring of term loans as one year "guaranteed roll over" short term loans. Since assets 'past dues' 90 days attract a 150% risk weight, a bank may be tempted to construct due date definitions so as to avoid the application of a 150% risk weight. For example, in some banks in Europe, no facility letters are issued formally to borrowers indicating an Expiry (of last drawdown/avaliability) and Facility END date (END= Exposure Nil Date).

We suggest that the Committee needs to define exactly what is meant by "past due" in order to avoid inconsistent treatments of "past due assets". This point is also relevant in relation to Pillar 3 (see our para 7.5.3.1).

5.1.9 The IRB Approach

5.1.9.1 *Inconsistencies in risk weightings under the Standardised and IRB approach*

The more advanced approaches allow banks who invest in risk management systems to report risk capital, at the expense of greater disclosure, based on the results of internal models and supporting data. Banks who are able to present a risk sensitive picture of their portfolios will find themselves disadvantaged in relation to those who cannot. For example, under the Standardised Approach, credits with a BB - rating and below would have a maximum weight of 150%. However, under the IRB approach, a 3 yr BB - would have a capital weight of 482% calculated as follows: BB - for 3 yrs has a Cumulative PD of 8.2% which equates to a BRWc of 482% (the linear average of the BRWc corresponding to PD's of 5% and 10%). Assuming an LGD of 50%, the Rwc is 482%, over three times the % under the Standardised Approach. (note: we have used a 3 year cumulative default probability from an ECAI as 3 years in the benchmark used by the Committee – refer to IRBA177, table 4.)

KPMG believes that the framework should provide banks with a clear regulatory incentive to improve the sensitivity of their risk management systems. To achieve this, we believe that the BRWc under the IRB approach should be recalibrated to better align the Standardised Approach and the IRB approach. Without an alignment it may be difficult to persuade banks to move onto the more advanced approaches.

5.1.9.2 *Practical difficulties of implementing the IRB approach (CD159)*

The Committee proposes that a banking group that has met the requisite minimum requirements and is using the IRB approach (whether Foundation or Advanced) for some of its exposures must adopt that same IRB approach across all exposure groups and across all significant business units within a reasonably short period of time. Some

exposures in non-significant business units that are immaterial in terms of size and perceived risk profile may be exempt from the above rule, subject to national discretion.

KPMG has concerns about the ability of banks to move towards IRB recognition. This is particularly so in the case of the Advanced IRB Approach where the practical issues associated with full implementation are significant. In particular, the difficulties of obtaining sufficient data in some locations and for some books for LGD estimation will be a major constraint in the early stages of implementation. In some portfolio segments it will be almost impossible to build a statistically validated model based on 5 to 7 years' internal/external data. Going forward, there will be difficulties when new products are being developed or the bank wants to venture into new geographical areas. (see section 5.1.9.3 for a possible solution).

There is the particular problem for firms whose business is primarily retail but who have material corporate business. As there is currently no provision for a Foundation Retail approach under IRB, these groups are penalised by having to wait until all their material businesses are on the Advanced IRB Approach before applying for permission to use the Advanced IRB Approach. Below, we provide an outline for a suggested Foundation Retail approach that will prevent such groups being penalised (section 5.1.9.8)

From our experience in assisting banks to implement credit rating systems, we believe that even those internationally active banks with the most sophisticated of credit risk management systems will struggle to achieve coverage on all books within "a reasonably short period of time" as proposed by the Committee. In particular, we do not support the implicit assumption in the proposals that every credit risk can be modelled and statistically validated.

We are concerned that the Committee may have underestimated the significance of these issues. Specifically, we recommend the following:

- Articulation on what is meant by "a reasonably short period of time," (we recommend 3 years).
- We consider that partial application of the IRB approach should be permitted, subject to the institution being able to put forward a robust argument supporting the claim that it is not cherry picking. We recommend that criteria are developed and incorporated into Pillar 1 enabling supervisors to carry out reviews as part of the supervisory recognition process and ongoing Pillar 2 work to ensure that an institution is not cherry picking the approach to take.

In addition, we note that the proposals are silent on what rating approaches would be allowable for IRB recognition; eg:

- external rating agency predictor,
- default predictor,
- contingent claims,
- risk neutral,
- expert based,
- cash flow deterministic.

Given the imperfections of credit grading systems (see the section below on model performance and data limitations) and the difficulty in achieving full book coverage, KPMG recommends that all of the above rating approaches be permitted under the IRB approaches. However, the Committee will need to be clear about the standards of performance they expect internal rating systems to meet. Without this key information it will be difficult for banks to prepare for implementation.

5.1.9.3 *Model performance (CD66 & 267) and data limitations*

KPMG's experience in building rating tools shows that rating model performance varies across industry, segment and product groups. In some instances lack of data is a constraint on model performance, and complexity and deal specific features make it challenging to rate emerging market as well as project, structured and acquisition finance transactions.

We understand from market commentators that the proposals include a standard buffer for model risk or rating uncertainty of about.1.5 times. This 'one size fits all' factor does not address the fact that model variance is not a constant. It may therefore penalize robust models and underestimate the error in others.

We suggest that standards for model performance need to be determined within the framework. Banks who are investing in rating systems have not received, to date, information on the performance standards that will be required under the IRB approaches. While data requirements have been discussed, there is no guidance on the model performance standards required to achieve IRB recognition. Such standards could be defined in terms of hit rates or regression statistics but care would need to be taken to ensure that hurdles set by the Committee are not too difficult to achieve. In order to strike the right balance, KPMG recommends that more work should be done in conjunction with leading practitioners in key market segments to build up a series of model performance benchmarks

Data Limitations

KPMG also finds it difficult to understand why 5 to 7 years' data is necessary for Advanced IRB recognition. The last economic cycle would not be covered by this time-span and therefore the rationale for requirement is difficult to follow.

A suggested solution where data is scarce could be to:

- Expand rating agency coverage,
- Allow scope for expert based rating approaches, and
- Encourage the market to pool data using consistent definitions of default and LGD.

Another methodology, which KPMG has successfully used in the past, is to:

- Allow banks to sample part of their portfolio to rate against an external benchmark, such as one of the ECAIs
- Have the same ECAI rate the same sample in isolation
- Compare the two results

Once the bank is getting a good fit to the ECAI results, it should continue using the methodology over a period of time (for example, 3-5 years) so as to develop a pool of internally rated counterparties large enough for independent rating purposes.

5.1.9.4 *Maturity adjustments (IRBA 125 and 126)*

The Committee has explicitly requested comment on the assumption of the average 3-year maturity under the Foundation IRB Approach. Our experience does not support the cut-off point of 3 years for loan maturity adjustments. Rather, our experience tends to suggest that very short, (for example, trade finance) exposures of 30 to 60 days have a much lower risk profile than 1-3 year maturities. Under the current proposal, a 30 day BBB bank risk and 3 year BBB - bank risk would have the same capital weight which appears to us to be counter intuitive.

A brief analysis of economic capital requirement in relation to maturity by KPMG showed that a single cut-off point for maturity is too blunt. Our analysis suggests an increasing trend which tails off once maturities exceed 5 years.

We recommend that maturity adjustments should be revised into a more granular set of maturity buckets; for example 0-1month; 1-3 months; 3-6 months; 6 months – 1 year; 1-3 years; 3–5 years 5 years and beyond. If this is deemed to be too complex for the Foundation Approach, then consideration should be given to shortening the cut-off point to 1 year.

5.1.9.5 *Reference definition of default (CD271)*

The definition set out in the proposals appears to be a definition of impairment rather than default. We foresee potential problems with the collection of "default data", especially in respect of impaired loans which subsequently become good. Inclusion of an "impairment" element could give some banks an incentive not to identify such exposures or provide against them. We recommend that the default definition should follow those definitions used by the established credit rating agencies such as Standard & Poors, Moody's or Fitch IBCA which all refer to payment defaults with a certain remedy period. Furthermore, clarification is required on whether the definition refers to counterparty default, transaction default or both. For example, a counterparty may default on a bilateral facility with a bank but not on a public issued bond – how is default treated in this case?

5.1.9.6 *Retail exposures – Reference definition of default (CD466)*

In our experience, the reference definition of default for retail exposures needs to take into account the following:

- Some credit providers call default earlier than others as a counterparty relationship begins to deteriorate meaning that the PD is higher, but the LGD is lower, than the average. Conversely, those credit modellers that allow a relationship to deteriorate longer will have a low PD history but higher LGDs. So the arguments that were considered by the Committee in IRBA144 for corporate exposures should also be applied to retail exposures.

- Some credit providers target low quality/high margin business that is very profitable if managed properly. The PD definition should be flexible enough not to penalise these credit providers.
- The consumer credit industry is strongly regulated in many countries for the protection of consumers. The Committee should ensure, to the extent possible, that the definition of default is compatible with that provided by these regulations.

5.1.9.7 *Retail exposures – Minimum requirements for segmentation (CD443)*

We note that segmentation by product type and borrower risk are proposed as "musts" while segmentation by vintage and delinquency are merely "expected". In our view segmentation by vintage and delinquency should also be required, ie should not be optional.

5.1.9.8 *Retail exposures – Lack of a Foundation IRB approach*

While there is uncertainty among banks on the correct way to proceed for the retail book, from our discussions with bankers, as noted above, we believe that the proposed jump from Standardised Approach to Advanced IRB Approach is too great and that there should be a Foundation retail approach as follows:

From a business viewpoint, we can assume that most banks have at least basic portfolio information (eg PD, LGD, EL), or should be able to calculate those parameters at portfolio level. Based on this assumption, it is our opinion that the risk weight calculation could be divided into a Foundation and an Advanced Approach.

The Advanced Approach would be the one developed in the current retail exposure framework. The Foundation Approach could be a simplified approach using simpler and broader product based segmentation. The bank could estimate each key parameter by the relevant segmentation category on a historical basis and apply the corresponding weights for the relevant segmentation category.

This approach should be supported by:

- a larger population stability in the retail portfolio due to the higher customer base
- a greater risk dispersion leading to a reduced parametric volatility
- consistency of parameters used in the banking sector

It is important that a clear distinction is made between the Foundation and Advanced approaches.

5.1.10 Oversight of the Rating System: Internal and External Audit (CD253-254)

The proposals state that Internal Audit must review a bank's rating system annually and that some national supervisors may also require an external audit of a bank's rating assignment process and estimates of loss characteristics.

We note that the Commission Services (EU 71) propose two deviations from this requirement, subject to national discretion: that the annual review could be conducted by External rather than Internal Audit and, second, that institutions pooling their data to estimate PDs could share an Internal Audit function.

With the respect to the first deviation, we agree that there might be cases where a bank would, in effect, want to 'outsource' this aspect of Internal Audit to a firm of external auditors, for example, where it did not feel it had sufficient expertise within its internal audit function. We would ask the Committee to consider allowing for this possibility, subject to national supervisory discretion.

5.1.11 Project Finance exposures (CD157)

The Committee has asked respondents for recommendations as to a proposed treatment for project finance (IRBA 421). KPMG has worked with clients in this area and, based on our experience, we have provided some background information and outlined our recommendations at Appendix 1.

5.1.12 Country Risk (CD479 – 494)

Though the proposals include rules on sovereign exposures, they are silent on the methodology to be used for incorporating the additional severity of transfer and political risks on recoveries. This is an important LGD contributor for "internationally active banks" with cross-border assets (in the region of $20bn to $60bn each). One bank may include a fixed shock rate via devaluation and asset value decline caused by country risk while another bank may ignore it if the Committee's proposals remain silent on this issue. Those banks which use a more granular and rigorous method incorporating country specific, variable country risk loss rates, would therefore, in effect, be penalised.

Under the Standardised Approach, haircuts cover H_E , H_C , H_{FX} and W = 0.15 covers "remaining risk" mainly to reflect obligor credit quality. There is no adequate provision for additional loss on recoveries and collateral realisable values due to country risk severity/transfer risk impact. The w=0.15 and the FX haircut of 8% may not represent the full impacts of country risk. In the Advanced IRB the country risk impact will/should be included to increase LGD. Until this is done, Standardised Approach may be preferred by banks with exposure to emerging markets, to avoid the impact of country risk. The extra haircut w=0.15 is said to ensure that "capital requirement remains a function of the credit quality of the borrower". However, we believe that capital requirements, under any method, should also be a function of the economic and external debt service ability of the country which may affect borrower's ability to repay via country/transfer risks. The H_{FX} of 8% relates to exchange rate/ market risk and not to Country/Transfer Risk.

KPMG recommends that a standard methodology for LGD estimation of country risk severity is considered by the Committee in order to provide a standard method and resolve issues such as whether country risk should be reflected via borrower rating/PD or via LGD impact or what should be the country risk loss rate for use?

The Committee proposes that the ECAI ratings of countries should be used. As the ECAIs also use fairly robust methods for country risk LGD, it is recommended that the loss given country defaults methodology used by the ECAIs is used as a basis. It is suggested that, after an analytical exercise, a simple methodology for country risk severity under the Standardised Approach could be designed (or at least used to check if w = 0.15 can cover country risk).

5.1.13 Sovereign rating (CD479 – 494)

The proposals require banks to design their own internal models for sovereign ratings and LGD by using the same inputs as those for corporate estimations, leading to mappable gradings.

IRBA377 requires banks with significant material exposure to sovereigns to design and use their internal models instead of relying on external ratings. This will require many banks to design internal models they do not currently use. Also it is not clear whether a bank with no sovereign loans (to sovereign bodies) but with material exposure to country risk via commercial loans and securities would be caught by this rule. In our experience, sovereign risk analysis is not identical to country risk analysis, although the activity of the sovereign is a strong influence on the country rating.

We recommended that a section is provided in the New Accord outlining the basic parameters and standards to be adopted for country risk measurements and sovereign rating approaches. We also recommended that the sovereign loss rates estimated by the major ECAs on the basis of the World Bank classification of countries and the empirical study of sovereign defaults and Paris Club rescheduling be used as a basis for country specific, variable loss rates. These recommendations should cover the following deficiencies in the current proposals:

- IRBA 367-369 states that inputs for sovereign exposure rating will be the same as those for corporate exposures, and that LGD estimation requirements will also be the same as for corporate exposures. However, from our practical experience, we note that parameters for assessing sovereign risk and country risks and LGD estimatation methodologies are different from those for corporates (different parameters and considerations). CD494 also requires banks to assess loss rates for sovereigns yet no methodological basis has been outlined.
- IRBA 368 makes corporate and sovereign rating grades to be the same/mappable. Corporate ratings have a relevant range of 0.03% to 20%+ PD. However, we note that the method of sovereign ratings and PD used by the ECAIs, as well as some econometric models, show a wider PD range.
- IRBA 365 and 366 imply that there are no suitable methods available for sovereign PD, rating and LGD factors. Yet some of the major ECAs, as mentioned above, use very sound and sophisticated systems for sovereign/country risk rating, PD, transition.

5.2 Operational risk

5.2.1 Definition of operational risk charge (CD547)

We support the Committee’s proposed definition for operational risk, namely "the risk of direct and indirect loss resulting from inadequate or failed internal processes, people and systems or from external events". This definition is the most widely adopted in the industry and focuses on the cause of loss.

Reputational, business and strategic risks are excluded from the Committee’s definition of operational risk. If not defined, these risks could be introduced into the operational risk capital charge through incorrect categorisation of losses. Clear boundaries and

definitions are needed between risk types to minimise the inclusion of these "opportunity type" risks which are exempt from the regulatory capital requirements.

5.2.2 The principal of an operational risk charge

KPMG believes that operational risk is an important category of risk for banks and we therefore agree in principal that there should be an operational risk charge provided that this charge can be consistently applied. We also agree with the concept of a “continuum of increasing sophistication and risk sensitivity” for operational risk capital assessment. We consider that a charge under Pillar I is the most appropriate way of reflecting operational risk within capital as it should provide incentives for financial institutions to better control this risk.

However, the most simplistic (Basic Indicator and Standardised) approaches are insensitive to risk and would not lead to improvements in controls being reflected in a reduction in capital charges. These insensitive approaches may cultivate perverse individual and organisational behaviour and discourage the taking of protective and effective risk management. Capital should not be seen as a replacement for the application of sound risk management practice in banks. Indeed, unless it is closely linked to these practices, it will not achieve the desired long term benefits.

5.2.3 Loss driven versus causal approaches

Though the definition chosen by the Committee is a causal definition, the Committee’s focus has clearly been on developing loss driven quantitative approaches which use a bank's historical performance as the measure for its future effectiveness. Loss driven approaches do not provide forward looking measures but, rather, depend on past performance. The allocation and categorisation of loss driven approaches is extremely difficult and will need to be resolved before implementation of the Accord. Causality is the key to understanding and predicting controllable operational risks. However, at this time, causal approaches to quantifying operational risk are relatively new and, as yet, unproven.

5.2.4 Calibration of the operational risk charge (CD553 & 554)

We suspect that many firms will find it difficult to respond to the proposals for an operational risk charge as, in the absence of calibration by the Committee of the capital factors, it is not possible to calculate the impact that the proposals will have on capital charges. Without calibration, institutions will struggle to put together a business case for the expenditure required to develop operational risk management practices. We recommend that the Committee engages in full and open discussion with the industry as work progresses to calibrate the operational risk charge.

5.2.5 Categorisation of operational risks

KPMG is concerned that the introduction of a capital charge for operational risk in Pillar 1 may lead to the double counting of certain risks in an institution’s capital requirements. In addition, we note that the introduction of a Pillar 1 charge for operational risk is causing significant concern within the banking industry. Specifically, we have concerns about double counting in the following areas:

- The capital charges for market risks in the trading book set out in the existing Accord include a buffer for operational risks, for example by the use of a VaR multiplier. The proposed operational risk charge will cover an institution's entire business. Whilst the credit risk rules are being made more risk sensitive in the New Accord, the existing proposals do not allow for significant changes to the existing market risk rules to take account of potential double counting;
- We understand that the proposed calibration of the IRB approach to credit risk also includes buffers for model risk and unexpected loss;
- It is not clear whether there is a distinction between the operational risks associated with certain guarantees and credit derivatives, and the remaining risks that are to be covered by setting the proposed w factor applicable to the secured portion of these transactions at 0.15;

Several industry initiatives are underway to categorise operational risk losses in order to develop suitable databases. In practice, operational risks can be easily allocated to one of several loss categories. However, without an applicable standard there may be no consistency in application by the industry. In addition, market and credit risk losses can readily arise from operational risk events leading to substantial potential for overlaps between risk categories and therefore to the risk of double counting of these impacts.

Ideally, under the Internal Measurement Approach, all losses should be allocated to independent (mutually exclusive) loss categories but at present there is no prescribed industry standard or model which achieves this. In fact, the current suggested models provide greater detail and result in more complexity and overlap between loss categories.

Without an approved standard to account for losses there is the potential for overlap between loss categories and therefore the potential for "double counting" of operational risks. In the absence of a prescribed standard, the development, usage and maintenance of loss databases should be treated with caution as there is the potential for inconsistency in application. Although loss categorisation enables management to determine the loss amounts for a particular operational loss category, it will not provide an understanding of the causes, nor the assignment, of operational risks.

5.2.6 Accounting for operational provisions and losses

The Committee has recognised the differences between countries' accounting rules for provisions and losses. Given the wide range of treatments which are adopted in respect of recognising operational losses and provisions, further investigation is needed to assess the implications of such diversity of approaches before the implementation of the Accord

5.2.7 Qualitative standards

As noted above, the three proposed approaches for calculating the operational risk capital charge do not take account of the quality of management and controls. Yet this is an essential element in minimising and reducing an organisation's operational risk exposure, as well as differentiating an organisation's overall operational risk profile.

Measuring and managing the quality of management and controls acts as an incentive to good operational risk management. However, the measurement poses difficulties for capital charge quantification as these qualitative factors are typically assessed on a

subjective basis and therefore this assessment is most readily catered for under Pillar II requirements, subject to the need for consistent and transparent application.

We believe that consideration should be given to the development of an industry standard methodology and benchmarks relying on a set of qualitative and quantitative risk factors which span the management and the controls environment (for example, the management and monitoring of key risk indicators, early warning indicators and management scorecards).

The use of a diagnostic approach to interrogate the quality of the management and controls environment, would consider a number of high level aspects when reviewing and measuring the quality of management and controls environment, for example:

- Controls in place to manage and mitigate operational risks;
- Extent to which operational risk is transferred, for example. insurance, alternative risk transfer and outsourcing;
- Management control, for example comparisons with control frameworks such as COSO and COCO;
- Quality of human resource management; and
- Process quality.

The diagnostic may be further enhanced to focus upon detailed quantitative operational factors. Examples of these factors could include the following metrics:

- Volatility of income;
- Transaction volumes and amounts;
- Number of accounts;
- Down time for processing systems;
- Error rates in relation to processing; and
- Failure rates on settlements.

We propose a quality control environment adjustment factor based on a control environment checklist or indices that would need to be approved/supervised by regulators and potentially implemented by external/internal audit.

5.2.8 Validation of the operational risk capital charge

The previously successful introduction and implementation for market risk capital requirements was in part due to the required use of back testing procedures that measure a bank's ability to manage its market risk. We note that while the Committee's proposals contain general statements about the need for regular validation, no rigorous validation technique is proposed. We assume such a technique has been omitted because the Committee recognises that historical data is needed.

Clearly, historical data is needed for the validation of the Internal Measurement Approach and only through the process of data gathering and analysis can the capital measurement levels be verified. Back testing can occur only with a reasonable history file of operational loss events and costs.

5.2.9 Basic Indicator Approach (CD561)

We understand that there needs to be a simple capital assessment approach for many banks. However, as noted above, we are concerned that this approach is insensitive to risk. We believe that it is of little analytical value as it is based on unclear relationships between high level variable and loss and bears no or little relationship to a firm's operational risk profile. Although simple and easy to use, the proposed approach does not encourage proactive and effective operational risk management.

5.2.10 Standardised Approach

Under this approach, the lines of business, relevant indicators and the beta factor are set by the regulator. However there is little opportunity for the management of an institution to take action to reduce the Pillar I capital charge.

As noted above, this approach does not provide any indication of the quality of the control environment per business line and provides an arbitrary beta factor not representative of, or tailored to, a specific organisational line of business. We realise that the Committee is undertaking a regulatory study and analysis to calibrate further the beta factors and the minimum regulatory capital used in this approach. However, structural or product mix changes are not presently recognised or catered for in this approach.

We agree with the qualifying criteria required to be able to adopt this approach, as these should increase operational risk management effectiveness. However, as noted earlier, there is minimal linkage between operational risk management improvement and a reduction in capital charge.

We suggest that greater clarity is required on the comment that "banks will have to develop specific, documented criteria for mapping business lines and activities into the standardised framework". In addition to the qualifying criteria provided, it may be pertinent for periodic audits from regulators/auditors to verify the data integrity of the management systems and the reported financial measures.

5.2.11 Internal Measurement Approach (CD556)

Although this approach enables banks to provide their own internal data, the Committee has recognised that the majority of this data currently does not exist. KPMG believes that the losses by category and business line will not be stable over time and a large historic time period will be required to determine a relatively stable probability of loss event (PE) and loss given that event (LGE) which will cause forecasting/budgeting difficulties.

The Accord seeks to reward those who deploy sophisticated internal measurement and analytical tools with likely reductions in capital charges. However, management will need to be able to develop a clear business case, highlighting the costs and benefits of adhering to the more sophisticated approach.

We believe that there is currently insufficient detail specified in the proposals for an organisation to be able to implement or use internal models to calculate the operational risk charge that would apply under this approach.

This said, KPMG supports the Committee's willingness to consider developing methodologies which are more risk sensitive.

5.2.12 Risk Transfer and mitigation

The Committee has expressed interest in risk transfer / mitigation and insurance but clearly still has concerns over merely transferring risk to another business sector. This is still a developing area and it will be fundamental to ensure what risks are actually transferred and what, if any, new risks are created. Reservations have been expressed about counterparty risk, the timeliness of payment and robustness of transfer for operational risk insurance products.

Our own experience of alternative risk transfer (ART) solutions leads us to believe that ART can provide an effective insurance solution with the potential to reduce risk for some low frequency, high severity, exposures.

5.2.13 Interdependencies

The Committee’s prescribed lines of business and proposed approaches do not adequately deal with the contagion effect (ie an event in one business unit that can trigger events in other areas of the bank, for example, human failure in one business unit leads to process breakdowns in other business units). There are many interdependencies between lines of business in a bank which tend to increase the financial impact of operational loss. For example, a bank typically has shared IT resources and the risks associated with these resources may impact all business lines. This effect potentially exposes organisations to greater operational risks which are not currently catered for in the proposed approaches through the adoption of prescribed lines of business.

5.2.14 Operational risk management reporting

The regulator-prescribed lines of business requirements pose many banks with significant organisational, management reporting and system challenges. In addition, different geographies have different lines of business to those proposed by the Committee and this creates confusion, for example, in Switzerland, private banks are a common industry category yet these business units have been arbitrarily allocated to Retail banking with an unresolved allocation to the asset management business line. There needs to be greater clarity about the prescribed lines of business to ensure that they reflect geographic industry practice.

Management reporting for operational risk may be geographic rather than product specific. This therefore requires potential huge changes to management information reporting, data collection and systems.

5.2.15 Near miss reporting

The Committee comments that there may be other types of losses or events such as near misses, latent or contingent losses, etc, which should be reflected in the capital charge. The Committee will need to provide definitions and applicability criteria for these events to be used in the future so as to minimise the potential for ambiguity and confusion. Incidents or near misses can provide management with invaluable information and key learning points. However, there are organisational and behavioural implications if near miss events are to be formally disclosed and included within a capital charge. We do not believe that public disclosure would assist the development of effective operational risk

management but, rather, incidents or near misses should be used for internal measurement and management purposes only.

5.2.16 Change Management

The rapidly changing pace of banking has a huge impact on the risk profile of financial institutions. The operational risk profile will change constantly with the acquisition of new business/new products and divestment of traditional business. The proposals do not appear to address the issue of how these changes should be catered for.

Although the Committee mentions that regular reviews are needed to update the operational risk capital charge, no criteria are provided to indicate the frequency and triggers to initiate a review. Large changes to the business will have huge implications for loss history and the approach adopted for quantifying operational risk. With any new businesses there will be no data or information available and we recommend that the Committee should specify a way forward or criteria dealing with this type of scenario.

5.3 Trading book counterparty risk

We sympathise with the objective of reforming the Accord in manageable stages and note that the Committee intends to address the question of counterparty risk in the trading book in due course. However, we consider it would be an error to omit the treatment of counterparty risk on derivative positions, repo and reverse repo and stock borrowing and lending transactions from the process at this stage, particularly as counterparty risk on these transactions in the banking book is to be addressed.

Whilst the boundary between the banking and trading book is reasonably well defined in most jurisdictions, we believe that a potential difference in the treatment of counterparty risk between banking and trading books will open up arbitrage opportunities, which should be avoided if possible. We would therefore encourage the Committee to reconsider treatment of counterparty credit risk in the banking and trading books to avoid the possibility of regulatory arbitrage. We believe also that there would be additional costs for banks in operating dual systems for what is essentially the same risk.

6 Pillar 2 – Supervisory Review Process

6.1 Principle of Pillar 2

We fully support the principle of the supervisory review process as an integral part of the New Accord as we do not believe that any quantitative system will, on its own, adequately cover all the risk inherent in every banking business. Some elements of supervisory "over-ride" to a purely quantitative system will always be necessary and desirable. The challenge, though, is to ensure an appropriate degree of openness, transparency and international consistency in the exercise of supervisory review. In addition, it will be important to ensure that Pillar 1 and Pillar 2 can operate together in a complementary, rather than overlapping, manner.

6.2 Supervisory resources

We believe that the switch to a system that is more judgementally based will be a major change for many supervisors particularly given that many supervisors currently apply a heavily quantitative approach.

We also note that, if the proposed system is to operate efficiently at the consolidated level, all supervisors world-wide will need to offer to locally incorporated institutions the full range of possible systems for quantifying credit and operational risk. This merely adds to the implementation hurdle that many supervisors will face.

We commented earlier on resource requirements for supervisory recognition of capital calculations. Pillar 2 will add a further dimension to resource needs.

6.3 Transparency and consistency of application

As noted earlier, we believe that the Committee has a critical role to play in publishing clear criteria for use by supervisors. In those areas where local criteria are needed, the Committee should encourage national supervisors to produce this, preferably by providing them with guidance on the nature of criteria required in each area.

We also suggest that the Committee should consider a more structured approach to the analysis of risks being captured by the supervisory review process. For example, some risks are internal to a bank (such as reputational risk, legal risk and management quality) whilst others are largely external (such as the economic environment, the threat of competition or the quality of local supervision). We think that analytical tools which facilitate a more consistent, transparent and systematic approach should be developed internationally as they would provide a valuable supervisory structure for Pillar 2 assessments.

7 Pillar 3 – Market Discipline

7.1 Involvement of the International Accounting Standards Board (IASB)

We agree with the general principle that market discipline should support the supervisory process. We also support the notion that regulators have a role in ensuring that depositors and other market participants are provided with an appropriate level of financial disclosures. Nevertheless, we are concerned that the Committee's proposals include detailed disclosure provision which , whilst there is a stated intention in the CD to work with the IASB, are currently outside the established framework for setting disclosure standards. The main (but not only) focus of the established framework is on the needs of shareholders. Since shareholders stand below depositors and other creditors in terms of security, it seems unlikely that accounts prepared for their purposes would not contain all the information (and more) than a depositor could require. Consequently, we see a high degree of alignment between the objectives of the IASB and of the regulator, insofar as the exercise of market discipline by accounting disclosure is concerned.

We believe that the Committee should hand over its disclosure suggestions to the IASB, to be taken forward within the context of financial statement disclosure standards generally. The IASB can be expected to take the suggestions seriously. Nevertheless, it should ultimately be a matter for the IASB (in consultation with the Committee) to decide how they should be implemented, including whether some suggestions go beyond the needs of users of financial statements, and should not be implemented at all.

If the Capital Accord were to contain broad disclosure principles, agreed with the IASB, and a requirement to comply with International Accounting Standards, we believe that this approach would have the following benefits:-

- The IASB has a wealth of experience in setting accounting standards – based on articulated principles and firm but where appropriate, flexible application – designed to cope appropriately with development and innovation.
- In order to be effective, disclosure requirements will need to continually adapt to developments in financial reporting generally and to the needs of the market as well as the increasing sophistication of risk review and reporting techniques within banks. Given that the opportunities for revising the Basel framework are generally limited, there must be a danger that if the New Accord were to contain detailed disclosure requirements that it may not achieve its objectives regarding transparency and market discipline in the future. Within the context of International Accounting Standards, disclosure requirements could more easily be kept up to date.
- Standards produced by the IASB can be subject to interpretation by its Standards Interpretations Committee which will also help achieve consistency and relevance.
- There is a danger that if regulators are seen as taking responsibility for setting financial statement disclosures that they become exposed to a "moral hazard" in the event that the disclosures prove to be inadequate.
- The IASB is already considering disclosure requirements, through the IAS 30 review.

We believe that the New Accord would be significantly undermined were it to require financial disclosures which were of a different level and nature from those arising as a result of the IAS 30 review.

In addition, we urge the Basel Committee to discuss the audit and assurance requirements with the International Federation of Accountants not only in the context of the disclosure requirements but also with regard to the procedures to be adopted in respect of providing audit assurance in respect of internal risk models.

We set out below a number of general and specific concerns regarding the current proposals which we consider should be best addressed through the proposed involvement of the IASB.

7.2 General concerns about the proposals

We have a general concerned about the sheer volume of the proposed disclosure. In particular, we consider that the extent of the proposed disclosures is possibly out of proportion to the power of proposed ex post quantitative disclosures, comparing actual performance with projections made by internal models, to act as a stimulant for market discipline. Where models are used, given their complexity, it is unrealistic to rely on market discipline as a mechanism for ensuring that they are used appropriately. The onus for this should remain with the supervisors given the difficulty in interpreting causality when problems occur.

We are concerned that in some areas, and particularly in the area of credit risk, the proposals attempt to put the reader in the position of being able to "second-guess" the decisions of management or banking supervisors. This cannot be the function of published financial information - to do so would require so much detail so as to put decisions in context as to be impossible to compile or use effectively.

The current proposals do not make it clear as to whether the proposed disclosures should be made in the annual report. We believe it would be logical for them to be incorporated within the mainstream financial reporting, particularly as they are likely to contain price sensitive information and the relevant exchanges will, in any event, insist that the additional information is given to shareholders.

The frequency and type of audit assurance that can be provided on the disclosures requires further consideration. 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 could be interpreted in many different ways as to the extent of audit assurance required. It should also be noted that many of the proposed disclosures, in particular those in respect of credit and market risk models, are inherently complex and that careful consideration will need to be given to achieving a proper balance between the degree of audit assurance required and the resources required to provide such assurance.

7.3 The practicalities of the disclosures

7.3.1 Frequency of Disclosure

We consider that the recommendation that "internationally active banks" should make quarterly disclosures is not sustainable given that, outside the US, many such banks still

report on a semi-annual cycle or even annually in some cases. We do not consider it appropriate for the proposed disclosures to be made with a greater frequency than is the case for the income statement and balance sheet and, in fact, to report the former without the latter may well give a misleading picture.

A more simple and realistic approach would, we believe 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 distinguish between disclosures of relatively static information, for example, the structure of the risk management function and other information such as risk profiles which warrant more frequent disclosure, rather than requiring the full set of disclosures at each reporting date. "Market discipline" will be a strong factor in encouraging more frequent reporting where this is desirable.

7.3.2 Use of supplementary disclosures

We believe it would be most effective for the IAS 30 Steering Committee to assist the Basel Committee to develop practical means of determining the extent of supplementary information which is required by "sophisticated internationally active banks". Rather than trying to define this term it may be more practical 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, or which undertake certain types of operations in excess of defined volumes, to make supplementary disclosures.

7.3.3 Disclosures on a geographical or business line level

Where disclosures are required on a geographical or a business line basis, the level of aggregation proposed is generally much less than that which is provided for segmental reporting in financial statements at present. This is also an area where issues of commercial sensitivities can be of significance, particularly where the bank is offering a single product in a particular geographical area or business line and, as a result, details of individual product pricing may become available to competitors.

Current accounting requirements usually take into account issues such as materiality and commercial sensitivity and we suggest that the final Accord contain a statement that geographical and business line analyses required by the disclosure standards should be at the same level of aggregation as required for segmental reporting in 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.

7.3.4 Differences in Consolidated Grouping

If the disclosures are to be made in the context of the financial statements then consideration needs to be given to how the financial and regulatory consolidated bases can be better aligned so that information given is inherently consistent - otherwise it will be costly for the preparer and overly complex for the reader. 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 capital should not undermine the basis of the preparation of the consolidated financial statements.

7.3.5 Supervisory involvement in approving market disclosures

Given our view that the IASB should have the primary role in determining disclosure requirements for financial statements, we do not support the proposal to make market disclosure a prerequisite to supervisory approval for the use of internal methodologies. We do however believe that it would be appropriate for the IAS 30 Review Committee to determine the manner in which the disclosures required by IAS 30 may be varied to reflect the differing use of internal methodologies, as is currently the case in many accounting frameworks when market risk models are used. We believe that the approach of relying on defined accounting standards, supported by suasion from the Supervisor to ensure that statements are prepared in accordance with an appropriate accounting framework is preferable to the proposed alternative which could lead to the supervisors direct involvement in approving accounts disclosures before financial statements are issued and subject to audit.

7.4 Fair value accounting

The draft Accord does not appear to address the impact of the extension of fair value accounting under IAS 39 and possible future standards. The impact of extending fair value accounting to some of the financial instruments held in the banking book is likely to be wide ranging and will have an impact on asset valuations and reported capital, as well as on disclosures in the financial statements, and will therefore need to be considered in relation to Pillar 1 and 2 as well as Pillar 3.

We set out below some of the effects of IAS39 which will need specific consideration:

- The change in the basis of valuation of some banking book financial instruments (eg securities available for sale, loans and receivables not originated by the bank and hedging derivatives) will have a direct impact on capital requirements and the disclosure of any such amounts eg the ability to distinguish and disclose the components of any movements between periods may in some cases be restricted.
- The ability to maintain and regulate the division between the banking and trading books for regulatory capital purposes may be weakened if a substantial part of the banking book is to be valued on a similar basis.
- It is not clear how the amounts which are directly taken to reserves (rather than being credited/charged to the income statements) in respect of available for sale securities and cash flow hedges under IAS 39 should be treated for qualifying capital purposes.
- The increased use of fair values is likely to lead to an increase in the volatility of reported qualifying capital – how will this be reflected in determining capital requirements?

It should also be noted that the Joint Working Group (JWG) is currently consulting on a proposed full fair value standard proposal. This goes a good deal further than IAS 39 – potentially requiring nearly all financial instruments to be accounted for on a fair value basis. The implications would accordingly be even more significant than IAS 39. While we do not wish to pre-judge the outcome of the JWG's consultations and any standard which may emerge, the JWG's current proposals raise a number of issues which would have a significant impact on the working of the new Accord. This suggests that the Committee should work closely with the IASB. As already noted, we see a fundamental alignment between your two objectives; we believe that the issue of accounting

measurement and disclosure, while naturally the province of the standard setters, can be made to serve your purposes as well. For example:

- Asset valuations and reported capital reserves in the financial statements would reflect adjustments in respect of the level of expected losses, given that this element of such adjustments will also be reflected in capital requirements when using credit risk models, there is a danger that capital will in effect be provided twice (once as a reduction in retained earnings and once through capital requirements in respect of the asset).
- Would disclosures and capital requirements under Pillar 2 in respect of interest rate risk in the banking book be relevant, when the impact of any interest rate mismatches will be reflected in the valuation of banking book assets and liabilities?
- Nearly all financial instruments in the banking and trading books would be valued on a fair value basis which may make it much more difficult for regulators to ensure that an appropriate division is maintained for capital purposes.
- Many components of regulatory capital, for example, subordinated debt, most preference shares and innovative Tier 1 capital may be subject to fair valuation which together with the impact of retained earnings of the change in valuation basis would lead to an increase in the volatility of reported qualifying capital as well as the split of its components between Tier 1 and Tier 2 capital.

7.5 Specific disclosure proposals

We have the following comments in respect of the specific proposals detailed in the Appendices:

7.5.1 Scope of application

The thrust of these disclosures appears to be aimed at the consolidated position of the Group. We believe that market counterparties are generally most interested in the position of the specific legal entity (which will presumably make its own disclosures) with which they are trading rather than any consolidated (or sub-consolidated position). Nevertheless, the focus of International Accounting Standards is generally group level. We would recommend that the IASB be asked to give consideration as to how the differing interests of shareholders and market counterparties may effectively be reconciled in this regard.

The position of sub-groups per se could result in extremely voluminous disclosure for large multi-national groups and it is difficult to see how it would be used. Similarly, the proposed disclosure of entities not included in the consolidated approach and how they are dealt with (including any surplus capital) should be restricted to "major" entities only.

The requirement that there should be additional disclosure where the treatment of non-consolidated entities is not based on the deduction method is likely to lead to confusion as to which is the correct approach. If different approaches are permitted under certain circumstances under the Accord, then they should all be considered acceptable, without any further disclosure.

The supplementary disclosure of any entities that do not meet their regulatory requirements should be extended to any entities not simply those excluded from the "consolidation" (presumably this means the supervisory consolidated approach?).

7.5.2 Capital

The core disclosures are non-contentious as are most of the supplementary disclosures. It may however be helpful to set a materiality threshold regarding those capital issues for which the terms and conditions are to be disclosed, otherwise the disclosures may be of excessive length in some cases. We recommend that the IASB be asked to consider whether any guidance is required in respect of the materiality of the disclosures so that they do not become inappropriately voluminous.

The disclosure required for SPV's needs further development as it is not clear what is intended.

We note that the disclosure within upper tier 2 capital of "undisclosed reserves" would appear to be somewhat contradictory (surely once disclosed, the reserves are “disclosed”?).

7.5.3 Credit risk

7.5.3.1 *Definition of past due/Impaired loans*

As noted in para 5.1.8.1 above, more guidance is required as to the definition of past due/impaired loans as, in practice, the definition varies widely between different regimes (overdrafts are a particular problem). One possible solution might be to make the disclosure consistent with that contained in paragraph 48 of the current IAS 30 which requires disclosure of all loans and advances on which interest is currently not being recognised in the income statement. However, this could be somewhat circular and further consideration needs to be given to this.

7.5.3.2 *Supplementary disclosure in respect of type of exposure*

The detailed breakdown of types of exposure given in Appendix 3 of CD Pillar 3 appears to be incomplete. For example, it should include settlement balances.

7.5.3.3 *“Lumpiness of the portfolio”*

The reference to “lumpiness of the portfolio” should either be left out or clearly defined - it is difficult to see how it differs from disclosing significant concentrations.

7.5.3.4 *Distinction between general and specific provisions*

The distinction between general and specific provisions for credit losses will probably at some stage require addressing by the standard setters. In particular, there is a need for greater clarity as to what constitutes general 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 really only the case for the poorer performing elements. The quantitative disclosures could usefully distinguish between these elements.

7.5.3.5 *Templates*

Disclosure templates

Although disclosure templates are only suggested there is a danger that they become the norm. In particular, we believe that it should be emphasised that disclosures will need to be modified to reflect banks' risk management polices and, ideally, should reflect information used for internal management purposes eg for some businesses it may be appropriate to separate disclosures in respect of commitments and non derivative off-balance items where this represents a distinct part of the bank's business

We have the following comments on specific templates [CD Pillar3]:

- Template 3.I.6 - Allowance for credit losses - is it the intention only to show the profit and loss account charge in respect of general provisions as opposed to the balance sheet amounts? If the intention is both then the columns of the table should be split between specific, general and total provisions.
- 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 unduly lengthy disclosures in any reasonable sized institution.
- It is difficult to see why Templates 3.III.1, 3.III.2 and 3.III.3 contain the granularity adjustment given its application to the whole portfolio. Template 3.III.3 also suggests combining nominal exposures for very different types of exposure; eg loan draw downs and forward FX transactions. It is difficult to see that the result would be meaningful. Perhaps this could be limited to EAD numbers only?
- Template 3.III.4 implies that all external ratings are conformed or is it seriously expected that different tables be produced for each agency? In addition is this just to cover loans as it implies or should other sources of exposure also be included? One other way of giving this information would perhaps be to indicate in the qualitative disclosure how the internal and external ratings correlate and quantitative information could then be limited to the exceptions.

We suggest that market disclosures should be confined to a comparison of actual credit losses with those predicted by the models, rather than providing details of many of the model inputs as at present. Such an analysis should ideally 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. In particular, we note that 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.

7.5.4 **Market Risk**

We believe that the proposed disclosure of detailed back test results in respect of each day's trading during the reporting period as envisaged in Template 4.3 is excessive, given that with only two distinct portfolios it would lead to the disclosure of 3,750 numerical

amounts, and would in practice be difficult to analyse. There is further potential for confusion in that total real and hypothetical profits are unlikely to reconcile to total trading profits as disclosed in the accounts.

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 reliability. One aspect that might benefit from further exploration is that many banks currently adopting this form of disclosure show consistent real profits greater than VAR due to the "retail" spread built into the former - this distorts any meaningful analysis.

7.5.5 Operational risk

The chance of any bank taking up the option to disclose operating losses is likely to be remote, unless they are of such a size as to warrant disclosure anyway.

7.5.6 Interest rate risk in the banking book

The proposed disclosures naturally do not take any account of the Joint Working Group's proposals in respect of fair value. However they also ignore the fact that many banks do monitor their risk in this area using value-at-risk models (particularly for actively traded short term treasury accruals books). We recommend that the quantitative disclosures should allow for this.

8 Appendix 1 – Project Finance exposures

8.1 Project Finance

Brief description of issue:

Unique characteristics of project finance:

- Higher correlations between PD, LGD and EAD compared to other asset classes.
- Since the borrower by definition is a special purpose vehicle no historic data is available. Banks, therefore, build cash flow models to understand future cash flows and possible default. In other words, there is useful data available for one project but this data refers to the (uncertain) future and not to the (fixed) past.

Limited availability of data:

- Banks do not have sufficient in-house default and loss data available because a portfolio contains - relative to other asset classes - only a few (and large) transactions.
- Specific project-based lending needs to distinguish the various industries, since power plants, communication projects, mining projects, oil & gas upstream (as well as downstream) and infrastructure projects such as toll roads, tunnels, bridges etc. have little in common. Therefore, it is not possible to use the data of one industry to assess a transaction in a different industry.
- There are still not sufficient externally rated project bonds in the market to develop a credit rating based on regression analysis where such external data could be used.

For these reasons, a specific bottom-up credit rating approach is needed.

We believe that project finance should be defined as pure, specific, project-based lending (such as power plants, infrastructure projects etc.). Raw land should be excluded since raw land by definition does not generate any substantial cash flow.

To assess the credit risk associated with a project finance transaction, lenders need to assess all risks that can impair the ability of the project to generate sufficient cash flows to pay debt service. After all, project finance has worked well since the various risk groups have been allocated to the party that has the best understanding of it (eg risks associated with the building of a power plant are allocated to the EPC contractor through a turnkey, fixed price contract including liquidated damages). As a result, a large degree of expert knowledge is needed in various dimensions such as industry, country and regional markets. Given the data constraints set out above, there is no simple approach to allocate a credit rating to project finance transactions.

The model produces the PD factor (EAD according to repayment schedule; LGD is industry-specific) over the life of a project financing from a structured auditable process around a predetermined risk register as follows:

1 Identification of relevant risks from risk register

2. Gross impact assessment of each relevant risk on cash flow
3. Net impact of risk on cash flow, after specific risk mitigation is taken into account
4. Probability of occurrence estimate for each risk
5. The impacts of all possible combinations of risks (known as risk states) because a single risk may not cause default on its own but may do so in combination with other risk events.
6. Identification of risk states which meet breach of a default condition eg debt service coverage ratio < 1
7. Assumption on whether risks can occur together or are deemed to be mutually exclusive.

At this stage the approach requires expert input but could, through time, be supported by historical databases and analyses of risk event probabilities and impacts. This approach converges on some of the methodologies used in operational risk and could be adapted as a measurement tool for expected losses arising from operational risk.