The Loan Market Association

Submission to Basel Committee on Banking Supervision in relation to its consultative document on the New Basel Capital Accord

The LMA has reviewed the Basel Committee on Banking Supervision's (the "**Committee**") consultative document on the New Basel Capital Accord (the "**New Framework")** which addresses many of the Committee's proposals of June 1999, (on which the LMA commented on 1 March 2000).

The LMA is aware that a number of trade associations are submitting comments on all or parts of the New Framework. With the LMA's specific interest in the syndicated loan market and in the trading of loans on the secondary market, it has decided to use the Committee's request for consultation to address issues of particular interest to our members in these two areas of the financial markets.

Liquidity and Equality of Treatment

Amongst the core objectives of the LMA are:

- The promotion of a liquid loan market in both the primary and secondary sectors.
- Developing equality of treatment, both for loan instruments relative to other forms of debt instruments and also between loan market participants located in different jurisdictions.

The LMA believes that liquidity in the loan market is not only a desirable outcome in itself but also contributes to a stable banking system. By enabling efficient syndication and loan transfer processes, liquidity is a key facilitator in the management of risk both within banks and within the banking system. Banks that can access deep, liquid loan markets are better able to manage their portfolios dynamically and therefore optimise their risk management techniques. The same is also true for the markets for credit risk transfer instruments. Portfolio management can be conducted more efficiently using liquid instruments than illiquid ones. This contributes to a virtuous circle: liquid markets enable efficient risk transfer to those institutions best able to manage that risk and increased use of those markets by participants enhances liquidity.

Equality of treatment is a core component of liquid loan and risk transfer markets. The LMA believes that the general principle in applying capital rules should be the doctrine of equal treatment for all instruments which achieve equivalent economic effects for the relevant bank. If this is not observed, banks will tend to concentrate their activities in those categories of instruments which give the most favourable regulatory capital treatment. This leads to lack of liquidity in some markets and potentially inappropriate asset allocation by banks - whilst the playing field is made uneven in relation to the relative level of attractiveness of certain types of assets. In turn this may result in banks incurring higher levels of risk due to concentrated exposure to some types of asset class. Equally, it is important that institutions are treated equally in relation to the capital requirements imposed on them irrespective of their geographic location - this will also assist in levelling the playing field internationally whilst

also avoiding the possibility that banks in regions where more favourable treatment is given to certain assets become exposed to excessive concentrations of risk in relation to those types of asset.

The LMA therefore urges the Committee to continue to ensure that its efforts in regulatory capital reform are directed at promoting liquidity in the loan and risk transfer markets and ensuring equality of treatment both of loan instruments and market participants.

Convergence between the New Framework and the European Union's Proposed Revised Capital Directive

Historically, the LMA has been concerned that differences between the Basel Capital Accord of 1988 (as amended) and the EU's Capital Adequacy Directive (93/6/EEC) place banks regulated by a regulator in the EU at a potential disadvantage to banks in other states. In particular, as a result of the definition within the Capital Adequacy Directive of financial instruments which are eligible for inclusion within the trading book, it has to date been impossible for EU banks to obtain trading book treatment for their actively traded loan portfolio. This has been the case even where an EU bank trades loans as actively as its bond portfolio and constituent elements of each portfolio have equivalent levels of liquidity and result in equivalent economic exposures for the bank. The LMA therefore welcomes the proposed broadening by the EU of its definition of financial instruments for this purpose - opening the door to the possibility of actively traded loans qualifying for trading book treatment and equality of treatment between actively traded bonds and loans.

The LMA also welcomes the prospect of the Committee's implementation timetable for the New Framework accommodating national rulemaking procedures. The LMA urges the Committee and the EU to collaborate closely in order to ensure a parallel implementation timetable in the EU and other states so that banks which have their capital regulated by a regulator in the EU are not placed at a competitive advantage or disadvantage by any mismatch in the implementation timetables between the two regimes. This is a particular concern in the context of any amending or new Directives that may need to be produced within the EU.

Overall Capital Levels

The LMA applauds the Committee's primary goal to deliver a more risk sensitive standardised approach that, on average, neither raises nor lowers the regulatory capital requirement for internationally active banks. The LMA is, however, concerned that certain elements of the proposed regime may well result in increased capital charges, either under individual elements of the New Framework or incrementally, without any corresponding increase in the risks to which banks may be exposed or which may subsist within the banking system. For example, proposals such as the one to introduce a charge for residual risks (the "w" factor), either alone or in conjunction with one or more of the other proposals in the New Framework (e.g. those for asset securitisations) hold out the prospect of an overall increase in the capital held within the banking system. The LMA is particularly concerned that the New Framework currently proposes to impose increased capital charges on the usage of credit risk transfer techniques by banks, relative to those which subsist under the current regime. This is likely to be a significant disincentive to banks contemplating transferring credit risk and will discourage the location of credit risk with those institutions that have both the appetite and the economic and technical resources to assume and manage it.

Accordingly, the LMA looks forward to a recalibration of the capital charges contained in the New Framework so that there is no increase in the capital to be held by banks as a result of the prudent management of their loan portfolios or trading activities.

The LMA would encourage the Committee to ensure that any revisions to risk weightings for market, credit or particular financing techniques (e.g. securitisation) do not produce distortions in the lending markets or an overall increase in the capital requirements of banks which engage in these particular sectors, either predominantly or exclusively. In addition, the LMA is keen to see that the addition of risks for which capital is to be allocated under the New Framework, such as operational risk, does not increase the capital charge within the banking system.

Credit Risk Mitigation Techniques

The LMA considers that prudent portfolio management is an essential element in the stability of the international banking system. Accordingly, it believes that loan portfolio managers should have the widest array of credit risk mitigation techniques available to them in order to optimise portfolio management. The LMA asks that the Committee facilitate this choice and promote the development of sound portfolio management techniques by (i) recognising as broad a range of credit risk mitigation techniques as possible, (ii) allowing the regulatory capital relief afforded such instruments to reflect the economic impact to a bank in terms of the reduction of risk and (iii) ensuring equality of regulatory capital treatment between the different techniques. In this way, the LMA believes that portfolio managers will have the greatest choice of robust credit risk mitigation techniques available to them, without artificially distorting their selection of the best technique for a particular portfolio or management purpose.

In this regard, the LMA believes that, used appropriately, the following techniques all constitute effective and prudent credit risk mitigation techniques. Therefore, their use should be encouraged as part of the efficient portfolio management process and to the fullest extent practicable should be subject to equality of capital treatment:

- Collateral;
- Guarantees;
- Credit derivatives;
- Netting;
- Asset securitisations;
- Synthetic securitisations;
- Participations; and
- Credit insurance[1].

[1] The LMA recognises that the Committee's focus rests within the banking system. However, the LMA is of the view that not only is credit insurance an established and valid risk transference tool, enabling banks to add another instrument to their array of credit risk mitigation techniques, but it also allows banks to avail themselves of another source of liquidity. In addition, it offers the benefit of transferring risk outside the confines of the banking system whilst ensuring that it remains with undertakings that are experienced in, and equipped to, manage such risks.

Accordingly, the LMA asks that the Committee develop the New Framework to ensure the minimum asymmetry of regulatory capital treatment between these credit risk mitigation techniques and to recognise their beneficial contribution to prudent risk management equally.

Whilst the LMA welcomes the Committee's proposal to provide a choice of approaches and balances between simplicity and sensitivity, the LMA believes that the focus on economic substance and risk treatment should result in a more homogenous treatment of credit risk mitigation techniques than exists in the current proposal. The LMA considers that excessive demarcation between the form of mitigation used is inimical to the desirable focus of the New Framework on economic substance and risk.

Credit Derivatives and Guarantees

Given that the Committee prescribes specific conditions for the recognition of guarantees and credit derivatives, it seems to the LMA inappropriate to distinguish between types of guarantor/protection providers and then seek to add a further hurdle in the form of the "w" factor.

Diversification

The LMA is of the view that diversification is a vital component of prudent portfolio management and notes with regret that the New Framework does not give due recognition to the manifestly beneficial effects of diversification. Whilst the New Framework proposes disincentives for excessive risk concentrations under the rules on granularity and/or sanctions imposed under Pillar 2, the LMA had hoped to see a greater use of positive incentivisation for banks to diversify their risk profiles. Whilst the consultation document discusses this in the context of guarantees and credit derivatives, the LMA believes that the inhibiting effect of the development of credit risk models is a significant shortcoming in the current version of the New Framework. Accordingly, the LMA would encourage the Committee to allow the recognition of diversification to be included in the New Framework so that banks may continue to work with regulators to explore ways to recognise the beneficial effect of diversification and double default correlation on the banking system.

In particular, the LMA regrets the absence of recognition of "double default correlation" and believes that the resultant charges will be excessive for the risks incurred. Whilst the LMA appreciates the difficulties associated with producing an approach that is both prudent and simple, it is of the view that the lack of recognition of double default effect is a major disincentive for banks to develop efficient portfolio credit risk models. The LMA also recognises that it may be premature to include credit risk modelling as an integral part of the regulatory capital regime. However, it believes that the New Framework should offer sufficient inducements and flexibility to encourage banks to develop the requisite degree of sophistication and consistency in their credit risk models to enable them to be employed in the future.

Residual risks

The LMA recognises the concern expressed by the Committee over residual risks. However, the LMA is of the view that it is inappropriate to require banks to hold regulatory capital specifically against these residual risks. The LMA is concerned that to do so would result in an excessive degree of "double counting", in that the credit risk and operational risk charges

already address these residual risks adequately. Therefore, to impose a further residual risk charge will result in excessive amounts of capital being held in respect of the same risks under different categories of regulatory charges.

To the extent that banking supervisors may not feel that the operational and credit risk charges cover fully those risks considered to be "residual risks", the LMA believes that the New Framework offers them two tools. The first is the supervisory process contained in Pillar 2 (and, to a lesser extent, Pillar 3) in that the supervisory process will act as an efficient mechanism to ensure that banks are addressing these residual risks appropriately. The LMA notes with approval that the Committee anticipates that risks other than credit risk, market risk and operational risk are to be captured through the supervisory process and believes this to be the most consistent approach.

The LMA considers that, to the extent the Committee is concerned that residual risk may not be dealt with adequately by the combined use of operational/credit risk charges and the supervisory process, it is key that the detail and nature of these concerns are communicated to banks. Accordingly, the LMA believes that the New Framework should set out these "residual concerns" and provide criteria by which banks can be judged to have addressed them. For example, the LMA notes that, in the New Framework, some steps have been taken to specify minimum criteria that have to be met in respect of guarantees and credit derivatives. Such an approach could be expanded to articulate all the supervisory concerns that are currently embodied in the generic term "residual risk".

In articulating these concerns, banks will be able to understand them. They will also be incentivised to address them by meeting the minimum criteria as the condition for the regulatory recognition of the relevant instruments. The LMA is of the view that a significant shortcoming of the current proposals for the regulatory treatment of residual risks is that banks are unable to ascertain their precise nature and are not incentivised to develop techniques, policies and procedures to address or manage them. Therefore, at best, the current proposal can only seek to contain these residual risks rather than create a regulatory environment in which banks develop processes to eradicate them.

The use of the "w" factor to address residual risks is, in the LMA's opinion, a case in point. The risks that it seeks to address are not articulated in the New Framework. These risks differ in their nature and extent between different credit risk mitigation techniques, yet they are swept under a blanket "w" which operates as a floor on the regulatory charge. There is no incentive or mechanism for banks to address them.

To seek to differentiate between those instruments that are perceived as possessing residual risks and those that do not will skew banks' use of credit risk mitigators in favour of those which do not attract a residual risk charge. Similarly, to implement different charges for differing types of residual risk or to impose similar charges for residual risks of differing severity will result in certain credit risk mitigation techniques being preferred for risk management purposes, relative to the other credit risk mitigation techniques. Indeed, to the extent that the imposition of regulatory capital charges for residual risk inherent in the use of credit risk mitigation results in increases to the regulatory capital to be held by banks, there is a latent risk that the regulatory capital cost will discourage the use of credit risk mitigation. The LMA is concerned that the use of residual risk charges, instead of reducing systemic risk, will contribute to it by

disincentivising banks to use credit risk mitigants. For example, differing treatment of certain guarantees relative to credit derivatives and securitisations will artificially stimulate the acquisition of "qualifying" guarantees by banks. The LMA is concerned that, should this result occur, it will lead to distortions in the use of certain techniques over others and colour the choice of portfolio managers when selecting the most appropriate risk mitigation technique.

As described above, in order for portfolio managers to have a full and balanced choice of credit risk mitigation techniques, the LMA is of the view that distortions should not be generated by the use of differentiating residual risk charges. To the extent that the operational, market and credit risk charges do not address the regulatory concerns, the LMA believes that the New Framework should specify minimum criteria that must be met in order for a particular credit risk mitigation technique to be recognised as reducing the regulatory capital charge. The New Framework makes some steps towards this and these are welcomed by the LMA.

Disclosure

The LMA is concerned that the disclosure requirements put forth in the New Framework as pre-requisites for the recognition of internal methodologies may render banks vulnerable to breaches of legal or moral obligations to their customers or other market participants in seeking to meet these requirements.

In addition to the concerns reflected in the New Framework, regarding litigation and competitive implications of disclosure of confidential information for legal proceedings, the LMA is mindful of the obligations of confidentiality and discretion that banks may owe to third parties, whether legally or ethically. Such obligations may be owed to different parties (e.g. customers, depositors, principals, syndicate members etc.) under differing regimes (e.g. codes of practice, protocols, civil codes, criminal statutes, in laws of contract and tort) and assume differing degrees of importance in differing jurisdictions.

Clearly, it would not be prudent for the New Framework to incentivise banks to breach or infringe such obligations or act so that they are perceived to be doing so. However, if recognition is given to the mosaic of differing regimes and jurisdictions in which banks operate in order to tailor disclosure to a particular bank's circumstances, the question would arise as to whether any meaningful comparisons could be drawn from examining data in respect of different banks. Further questions would arise in respect of the consistency of consolidated disclosure and the impact of national or regime specific restrictions on disclosures.

Capital Buffers

Whilst the LMA recognises that many banks do hold buffers of capital in excess of minimum regulatory requirements and that this affects the impact of minimum capital requirements on lending, it nevertheless considers that the utilisation of regulatory capital is an integral variable in the lending decision making process. Therefore, any inconsistencies in the regulatory capital framework will have a significant impact on banks' lending decisions and activities, notwithstanding the existence of capital buffers.

On Balance Sheet Netting

The LMA is of the view that the beneficial effects of netting as a credit risk mitigation technique are such that it is not helpful to circumscribe on balance sheet netting from off

balance sheet netting. Accordingly, the LMA would ask the Committee that it works with banks in order to develop a mechanism for adequately recognising netting across both on balance sheet and off balance sheet instruments.

Maturity Mismatches

Whilst the LMA recognises the difficulties associated with developing a framework which is both simple and prudent in its treatment of maturity mismatches, the LMA is concerned that the New Framework provides inadequate incentives for banks to undertake hedging when there is not an exact maturity match. The LMA would therefore encourage the Committee to continue to work with the banking community to produce an appropriate framework for maturity mismatches which could conceivably involve a combination of both Pillar I and Pillar II.

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