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17 May 2001

Mr Guy Eastwood
Australian Prudential Regulation Authority
GPO Box 9836
Sydney NSW 2001

Dear Guy

The New Basel Capital Accord

following our meeting of 4 May 2001, I summarise below our comments on the Basel proposals.

1. *Forward sale and bought put option contracts in the banking book*

   Forward sale and bought put option contracts are not allowable collateral in the banking book under current capital adequacy rules, although they are able to be fully taken into account in measuring market risk in the trading book.

   The New Accord perpetuates this anomaly by still not including forward sales and bought put options as allowable collateral in the banking book.

   These contracts have been in use in financial markets for many, many years now and their legal enforceability is undoubted. This is one of the reasons why they are fully recognised in the trading books and why <u>sold</u> put options and forward <u>purchases</u> require capital support in the banking book.

   This lack of recognition leads to another anomaly in the capital rules for the banking book, in that a securities position held under repo is risk weighted in accordance with the repo borrower's risk weight, but a securities position held and divested (or protected) by entering into a forward sale or a bought put option contract is to be risk weighted in accordance with the risk weight of the securities themselves.

   We believe that the New Accord is a good opportunity to remedy these anomalies.

2. *Netting of balance sheet and market related contracts exposures*

The New Accord still does not allow the netting of an on balance sheet receivable with a payable arising under market related contracts with the same counterparty.

The reverse however is allowable – that is, where a receivable under a MRC can be netted against a deposit held on balance sheet.

There seems to be no reason why the former should not work where a qualifying netting agreement covers both exposures.

3. *Collateral floor of 0.15 applies to cash collateral*

The collateral floor factor “w” of 0.15 applies to all collateral, including cash. This seems completely unwarranted. If it is supposed to cover the risk that collateral documentation is not enforceable, this would appear to be double counting, as that risk is an operational risk which is covered by the new proposed operational risk charge.

4. *Treatment of subordination under Foundation IRB*

Under the IRB approach, subordinated exposures are assigned a higher risk weight than an equivalent senior exposure. The upscaling is around 1.5 times. This requirement makes no attempt to differentiate between different degrees of subordination.

For example, a second mortgage on a residential property, whether the first mortgage has a loan to valuation ratio of 10% or 90%, will suffer the same penalty.

We suggest that an attempt should be made in the proposed rules for Foundation IRB, to differentiate between different depths of subordination.

5. *Subordination under standardised approach*

The New Accord makes no provision for increased risk weights for subordinated exposures under the standardised approach. This is a much more lenient treatment than that proposed under the IRB approach (see above).

We believe that this capital arbitrage may provide some incentive for banks not to move to the IRB approach.

6. *Risk weights under IRB approach*

The New Accord paper does not publish equivalent risk weights for different ratings under the IRB approach. We have however seen a couple of studies, one of them by William Treacy of the Federal Reserve Board, which show that the probable risk weights for internal ratings equivalent to ratings agencies’ ratings of BB and below are extremely punitive. The risk weight for BB is estimated at 150% and those for lower ratings go up to 900%.

These risk weights appear excessive and are likely to result in either of two outcomes:

- banks will not go to the IRB approach, or
- banks will bunch their internal ratings towards the top of the ladder, which will probably cause regulators to intervene, which will cause banks to go back to the standardised approach.

It must be borne in mind that an unrated counterparty under the standardised approach attracts a risk weight of 100% - ie a status quo with current rules.

We believe that the calibration built into the Basel formulae is too harsh and that Basel must review its approach and formulae for lower ratings under IRB.

7. *Interest rate risk in banking book*

The New Accord does not require capital to be held against interest rate risk in the banking book. Instead, Pillar 2 has a feeble requirement for regulators to only monitor this risk, with little guidance as to how to determine whether it is too large or not, or as to what to do about it.

The exemption from capital support of interest rate risk in the banking book was a major lacking of the market risk capital rules when they were introduced a few years ago.

We believe that it is unacceptable that Basel is once again ignoring this risk, which is substantial for most banks, in what is a major revamp of the capital rules.

8. *Requirement to have economic / internal capital requirement*

The New Accord makes it mandatory for banks to have their own internal capital adequacy model and measurement process.

We believe that this requirement is redundant, given that banks must hold the Basel prescribed minimum capital requirement and that the New Accord brings this requirement to previously unseen levels of risk differentiation and sophistication.

It is our view that capital determination is no more than guess work at best and that no one can state with certainty or authority what amount of capital is required for defined risks. Basel and ratings agencies have their own formulas, which they do not claim to be right or wrong, but which serve the very good purpose of creating benchmarks against which most banks can be compared and judged.

It appears rather futile to us to try and create our own formula for capital determination, as this can have no credibility and can serve no purpose that we can see.

Our understanding is that many banks have internal capital allocation models. But these are very different from capital determination models, as they do not attempt to calculate the amount of capital required to support a bank's business, but rather allocate a given amount of capital (usually determined by the bank's judgement of the market's requirement) to various risk exposures.

We believe that the New Accord's requirement for banks to have internal capital models and for regulators to check these should be removed. This requirement will only create aggravation between banks and their regulators and will waste valuable bank management time and bank resources.

Please let me know if you wish us to expand on any of the points above or to discuss them further with you.

Yours sincerely

Max Merven
Director
Risk Management Division