National

TAILORED FINANCIAL SOLUTIONS

NEW BASEL CAPITAL ACCORD

NATIONAL AUSTRALIA BANK'S RESPONSE

MAY 2001

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1.0 OVERALL COMMENT

National Australia Bank ("the National") welcomes the proposal to revise the 1988 Capital Accord as set out in the 16 January 2001 release of the Basel Committee on Banking Supervision.

While the existing Accord has simplicity as an attraction, it does not deal adequately with the more complex financial services industry in existence today. The existing framework contains inequities and is open to arbitrage which potentially reduces its effectiveness.

The National therefore supports the direction of the New Accord with its emphasis on accountability for effective management of risk and capital adequacy, and the recognition of risk management expertise and skills within banks.

However, we have a number of concerns, and these are expressed as follows:

First Pillar-Minimum Capital Requirements

The National notes that the New Accord does not consider a scope of application beyond the traditional structure of a bank owning an insurance company. Failure to consider other ownership structures in the financial services industry during this revision would be regrettable and a missed opportunity. An ownership structure headed by an insurance company currently presents arbitrage opportunities. This is considered to be inconsistent with a major objective of the New Accord.

With regard to the standardised approach, in the Australian context banks are significant lenders in the residential mortgage market. The National strongly believes that the Australian Prudential Regulation Authority (APRA) should be provided with scope to establish separate risk weights for residential mortgages. This is on the basis that loans against residential mortgages have a totally different risk profile to unsecured consumer lending.

Under the Internal Ratings Based approaches, the new framework will allow banks the opportunity to gain even closer alignment of their regulatory and economic capital provisions and reduce the incentive for banks to structure portfolios that arbitrage regulatory capital requirements. That said, an unintended effect of a closer alignment of internal ratings to capital requirement is to possibly introduce a systemic impact on the broader economy, and in some instances, adversely impact solvency of banks – through what is generally known as the “credit crunch phenomenon”. In other words, in a time of uncertainty with respect to credit environment, banks will in unison restrict credit growth and thus exacerbate swings in economic cycles.

Preliminary impact study results tend to suggest that there is a reasonable capital incentive to adopt internal ratings based approaches to credit risk. However, substantial additional work will be required to validate and realise these benefits, bearing in mind that these approaches to regulatory capital are proceeding on similar but separate paths to banks’ internal systems.

The National notes the progressive complexity involved in the options available to banks under the First Pillar. While we accept complexity as a necessary feature of a regime that links capital adequacy measures to banks' internal risk management capability, we believe that it is essential that the new framework be equitable, easy to understand and capable of being back-tested within a reasonable time frame. We will be expecting international consistency of application and model recognition across all regulators in a transparent manner. To some extent, we are concerned that (a) if too much is driven by assumptions and internal rules that are not readily apparent, and (b) if regulators are not uniformly equipped, this expectation may not be realised in practice.

Regarding the IRB Advanced approach to credit risk, it is of concern to the National that the proposed methods do not take geographic diversification benefits into account. Internal models of banks do explicitly factor in diversification of credit risk.

The National agrees that regulatory measures should be introduced to measure operational risk capital separately but recommends that the fourth proposed method, the Loss Distribution Approach is brought forward for use by January 2004.

The preference to maintain overall capital at the same level and imposition of an initial floor on capital reductions arising from the Advanced IRB approach provides confusing signals as to available incentives. In providing incentives to banks to implement the 1996 Market Risk amendments there was no floor placed on the likely reduction of the capital charge.

Finally, the National has serious concerns about the short comment period allocated to the New Accord, especially as many of the rules are still under development by the Committee. We believe that the comment period should be lengthened to take account of unresolved issues.

Second Pillar-Supervisory Review

The National welcomes the concept of the Second Pillar to complement supervisory assessment of bank capital adequacy. However, we note that regulatory resources must be sufficient to achieve an appropriate level of understanding of banks' sophisticated risk measures and to provide due recognition of more advanced methods employed by banks.

We have concerns about the ability of national supervisors to establish defined categories relating to higher capital thresholds. The use of categories such as "well-capitalised" may amount to raising the 8% minimum level by stealth, particularly if regulators restrict the activities of banks that do not meet these higher levels.

Third Pillar-Market Discipline

The National is committed to continuous improvement in the level of disclosure and welcomes the recognition of market discipline as a complimentary regulatory tool.The third pillar requires a bank to disclose a considerable amount of new information, some of which is quite complex. The National considers that information should be transparent and understandable to the user, and not impose undue administrative

burdens on banks. Given that Australian companies are not required to report on a quarterly basis, we would not favour quarterly reporting.

National is concerned that inclusion of the proposed disclosures in the financial statements gives rise to an audit requirement, which is not consistent with the way current management information is disclosed. For example, a number of risk management disclosures are currently provided outside the audited financial statement section of our annual report.

An alternative would be to include the information in the management discussion and analysis section of the annual financial report or to communicate it via some other form of regulatory reporting which is made publicly available.

We concur with Committee’s comments on the importance of promoting a consistent disclosure framework by working with the International Accounting Standards Committee (IASC). We believe that it is an absolute requirement for the proposal to be effective that there be harmonisation across all international accounting standards that impact the calculation of capital of a bank, and a consistent view amongst regulators as to how these standards apply. It is important that the Committee drives the coordination process.

National is concerned that the proposals may not have recognised the commercial sensitivity of some proposed disclosures. For example, we have found it necessary to strenuously oppose the disclosure requirements concerning capital management strategy. This is an extremely commercially sensitive area.

The National appreciates the opportunity to comment on this very important and far-reaching proposal, and we look forward to participation in the ongoing dialogue.

2.0 CONSISTENCY WITH ACCORD OBJECTIVES

2.1 Risk Sensitivity

The proposed New Accord will certainly result in capital charges that are more aligned with underlying risks than the previous accord. How well aligned remains unclear at this stage. The New Accord involves a large number of assumptions concerning how risk is measured, over a range of products, data histories, banks, regions, supervisors and is dependent upon future developments.

Broadly, if the New Accord is appropriately implemented and flexibly administered by supervisors in the future it is capable of generating reasonably comparable levels of capital for equivalent risk taking. However this comment does not necessarily apply to all products, eg securitisation where the National believes the New Accord over compensates for the risks involved.

As stated earlier, the National is concerned about the lack of recognition of geographic diversification of credit risk in the proposals.

2.2 Incentive Compatibility

Preliminary impact study results tend to suggest a reasonable capital incentive to adopt internal ratings based approaches to credit risk. However, verification and realisation of the benefits will involve a great deal of effort in terms of extraction, analysis and reporting, which will need to be undertaken on a parallel basis to internal developments in credit risk management.

Likewise, at this stage, it is not possible to determine whether incentives for capital arbitrage are reduced or eliminated, rather than being replaced.

The National has a concern over the didactic nature of many of the rules, which of themselves will not necessarily promote better risk management amongst all banks. Prime examples are the rules relating to capital requirements on collateral pledged, and to the proposed restrictions on the recognition of “credit risk mitigation” held by banks (the “*W*” factor). These rules appear to be something of a reaction to comparatively recent events in global markets, and based on the notion that banks need to be reminded of basic counterparty assessment and security-perfection procedures.

The overall thrust of these rules is technically appropriate, however, the pay-off in terms of the overall objectives of the New Accord would not appear sufficient to justify an immediate foray into a fairly complex and developing area.

The Accord implies that banks use securitisation, and to a lesser extent credit derivatives, for capital arbitrage rather than risk management. The inconsistency between the treatment of securitised assets and similar assets held on balance sheet is punitive towards the securitised instruments and appears to have been designed by the Committee to address its concerns over capital arbitrage.

Rather than use a blunt tool, such as a capital penalty, for all securitisation schemes the Committee should consider addressing the potential for capital arbitrage under Pillar 2. APRA currently does this through the enforcement of standards in respect of "Funds Management and Securitisation". Securitisation properly used can effectively reduce the demands on a bank's capital at vital times.

Any capital penalty for the use of credit derivatives vis-à-vis guarantees would stifle development of global credit risk markets and the benefits of spreading credit risks across a wide range of institutions rather than such risks remaining with the originator of the asset (a bank).

2.3 Competitive Equity

The proposals certainly place banks at a competitive disadvantage to non-banks, as does the current accord. Until the risks borne by non-bank competitors, including insurance companies, are the same as those borne by banks, there will be no competitive equity. Thus the Accord will be counterproductive in that it will drive certain risks out of the regulated sector into sectors where these risks are inappropriately or not regulated.

Being an internationally active bank, the National has concerns as to the equitable application of Capital Accords existing and future, by regulators around the world, whether or not we are active in a particular region. Put simply, and using Asia as an example, will the National and other Australian-based banks, be competing on a level playing field where the same regulatory capital requirements will be applied to the same risk profiles? We are greatly concerned about the lack of opportunity to tackle the issue of inconsistent application of the Accord in Asia, and wish to use this opportunity to raise the matter for consideration in the context of the New Accord.

Within the Accord there appears considerable scope for national discretion in the treatment of different product types. Internationally active banks are likely to be penalised by having to adopt the most restrictive capital treatment. This is especially so where the parent bank operates in the relatively more restrictive jurisdiction, eg the National must apply a 100% risk weighting to loans to UK housing associations, whereas UK banks may apply a 50% risk weighting. Banks operating in many jurisdictions will also have the associated administrative costs of applying different capital treatments to the "same" product.

Internationally active banks should be treated similarly so as to avoid competitive inequities and the capital arbitrages possible from operating in more favourable jurisdictions.

2.4 Safety and Soundness/Overall Capital

A fundamental flaw of the New Accord is the Committee's objective that it neither raises nor lowers the level of banks' overall capital. This is an explicit determination by the Committee that the level of capital in banking systems is currently appropriate. The Committee should consider whether minimum capital requirements within banking systems are appropriate given the global capital needs of sectors. The degree

of regulation by the Committee, supervisors and banks themselves might suggest the efficient level of capital in banking systems could be lower.

A further flaw of the New Accord is the Committee's unwillingness to address the question of what constitutes capital. Under the New Accord banks will focus an extraordinary amount of attention and resources on their risks without any consideration of the appropriate constituents of capital to support those risks. Since the previous accord there has been considerable development in the functionality of capital instruments and a wide range of non-bank institutions entering banking.

Further study is required to determine the levels of bank capital, which promote economic efficiency and overall financial and macroeconomic stability. Certainly greater overall financial and macroeconomic stability can occur without more demand for capital, through better risk management, supervisory review processes and market discipline.

2.5 Market Discipline

Generally, the National believes that there is a danger that the New Accord's ambition of enhancing market discipline may be thwarted if the large amount of new information to be presented is not provided transparently and in a way understandable to all users.

The Committee has not addressed the problem that market discipline might be counterproductive, eg media analysts may misinterpret disclosures and so raise concerns over soundness where there are none, or stock analysts may pressure a bank to reduce long term reserving to boost short term profits.

2.6 Implementation

The National has serious concerns about the short time frame imposed by the Committee for the digesting of the New Accord proposals and completion of associated impact studies. It is our view that the comment period should be lengthened. This is especially necessary as many of the proposals need further development by the Committee, and it is unrealistic for banks to have to accept rules still being developed under "work-in-progress". Accordingly, we cannot accept the rules as being immutable from the end of the comment period.

Regardless of the comment period deficiency, differing implementation timetables across jurisdictions could lead to competitive inequality amongst internationally active banks. We suggest the Committee mandate a timetable for national supervisors to adhere to, so that internationally active banks, at their discretion, may be able to implement the IRB Advanced approach by 2004.

3.0 SCOPE OF APPLICATION

3.1 General Comments

The National regrets that an opportunity has been missed to improve on the regulatory treatment of banks owning "wealth management" businesses and vice versa. The current process of deconsolidating all such subsidiaries is overly simplistic and provides no incentive for financial conglomerates to improve their understanding of the risk capital required by insurance and funds management operations. Furthermore, the deconsolidation process is unclear. The lack of clarity can potentially result in uneven regulatory treatment within the same regulatory jurisdiction, or between jurisdictions.

The National has the view that this area can potentially give rise to as much arbitrage opportunity, if not more than the existing framework.

The arbitrage opportunity is going to be between insurance companies and investment/merchant banks and licensed deposit-taking institutions.

We are also concerned about the lack of differentiation between life and general insurance companies which exhibit significantly different risk characteristics.

The rapid development of the credit derivatives market is partly to exploit this arbitrage opportunity and the proposed Accord will not close the gap as insurance companies and investment/merchant banks remain unregulated by this framework

3.2 Specific Comments

The proposal that 50% of the investment in deconsolidated entities be deducted from Tier 1 capital and 50% from Tier 2 seems arbitrary. The reasons behind this split is unclear. The National believes that the deduction should be entirely from total capital.

The National also wishes to clarify the treatment of “notional goodwill” (that is, the difference between the embedded and appraisal value of a wealth management business) for such subsidiaries. Under the proposed 50/50 split, is the 50% of the total investment to be deducted from Tier 1 and the remainder from Tier 2, or should all of the notional goodwill be deducted from Tier 1 as well as 50% of the embedded value? The National is opposed to the latter treatment, which it feels is unnecessarily harsh.

Any change to the current regulatory treatment of wealth management subsidiaries will require a lengthy transition period. The National would welcome additional detail in the Accord as to the expected time frame over which such a change would be implemented.

4.0 FIRST PILLAR-MINIMUM CAPITAL REQUIREMENTS

4.1 Credit Risk-General Comments

The National welcomes the more risk sensitive approaches to credit risk as an alternative to the more granular standardised approach. The thrust and principles of the New Basel Capital Accord are supported and endorsed and very much parallel the direction the National Australia Bank is pursuing in relation to the management of credit portfolios and the allocation of economic credit risk capital.

However, the National has some general concerns.

The standard model uses credit conversion factors of 20% for commitments with a residual maturity of 12 months or less, and 50% for commitments with a residual maturity greater than 12 months. However, in the IRB Foundation approach, Exposure at Default is calculated using a 75% credit conversion factor, which appears to be a significant increase in required capital for undrawn portions of revolving facilities.

The granularity adjustment is important in establishing accurate credit risk modelling, however, it appears complex and will be difficult to implement in the proposed form.

With respect to credit risk mitigation, the proposed "*W*" factor is noted. However, its rationale is not clear in that it appears to be seeking to cover operational risks (ie legal and documentation risks). Also, the Committee's decision not to include the effect of joint probability of default does not acknowledge the benefits inherent in the growing credit derivatives market.

Specific comments follow. In this document references to specific paragraphs in the the New Basel Capital Accord, or a Supporting Document relevant to the subject heading will generally be made using the following notation as an example:

Para 591. *Comment on "The New Capital Accord" and/or comment on a*
SD Para 4. *relevant "Supporting Document to the New Basel Accord"*

4.2 Credit Risk-Specific Comments

4.2.1 Credit Risk-the standardised approach:

Para 29-33. **Claims on banks**-The National favours the second option, based on the external credit assessment of the bank itself, as having a more logical basis. Otherwise, poorly managed banks in highly rated countries may receive an unwarranted risk weighting.

The proposal that claims "which are expected to be rolled over" (footnote 12) not attract the concession available in respect of claims with an original maturity of 3 months or less is not supported on the basis that it is impossible to monitor this requirement.

Para 47-60. **Disclosure**-The requirement that to disclose, by percentage of Risk Weighted Assets, the External Credit Assessment Institutions (ECAIs) used will present data availability issues particularly when multiple assessments are available (Paras 51-53).

Given the supervisor mandates ECAIs to be used, and the bank complies with the rules, there is little value, and potentially significant data availability issues, in providing the information.

Para 80-101. **Collateral**-Given that a 'haircut' is to be applied to the market value to protect against volatility, with which the National has no issue, it seems there is double jeopardy when a bank is required to still take into account the 'w' floor factor. When adjusting the value of collateral, the proposals involve a discount calculation, which does not appear to be in accordance with market practice.

Para 114. **SD Para 177.**	**On-balance sheet netting**-The meaning of this requirement is not clear. If it means that only deposits and loans maturing on the same day may be netted, very little offsets will be available to banks. The requirement under Para 112 (c) that banks monitor and control roll-off risks seems to endorse wider netting in banks internal measurements of credit risk.
SD Para 176.	**On-balance sheet netting**-The scope of on-balance sheet netting should not be limited to assets and liabilities with a single counterparty where appropriate cross guarantees are in place. This arrangement is currently applied and has not in the past raised any safety and soundness issues.
Para 122.	**Credit Derivatives**-Credit Derivative Protection defines the following: "Obligation"-what triggers a Credit Event. "Deliverable Obligation"-what can be delivered to settle the contract if physical settlement. "Reference Obligation"-what will be used for Cash Settlement if cash settlement. Generally the loan being hedged will not be specifically disclosed in the credit derivative contract, as Banks don't like disclosing their loans to competitors etc. There may also be confidentiality/ secrecy laws. Therefore the market allows more general definitions of the above, for example: Obligation will be defined as "Borrowed Money" Deliverable Obligation will be Bonds or Loans. This gets around any issues and works. So as long as the asset being hedged is a subset of the Obligation and Deliverable Obligation definition there is no need to look directly to the underlying asset. This requirement as drafted is therefore unnecessary and detrimental to Banks using credit derivatives to hedge their loan books if there are competition / confidentiality or secrecy issues.

Para 123. **Credit Derivatives**-Again this section is drafted far too widely. Most credit derivatives are executed with a counterparty under a standard International Swaps and Derivatives Association (ISDA) Master Agreement and Schedule.

The Master Agreement and Schedule will not only deal with Credit Events between the counterparties but also early termination events eg illegality and tax. This gives the right to both parties to the contract to terminate the contract if one of the Events is triggered. This will be subject to a close out mark to market on the contract.

We assume it is not intended that this would be treated as a unilateral right of the purchaser to terminate under this clause.

Para 126. **Credit Derivatives-**Para 126 (a): The National believes that the Credit Events specified on one hand omit relevant credit events but on the other go beyond what is appropriate:

- Bankruptcy of the Reference entity should be a required Credit Event
- Extension of Maturity of the Obligation beyond its scheduled repayment date should be a required Credit Event when due to credit deterioration
- Change in Ranking should ***not*** be a Credit Event as what matters is whether the Obligation gets repaid. Subordination is a timing issue.

Para 126 (b): Why should the Cash Settlement Valuation Date be restricted to 30 days after the Credit Event? It would seem more reasonable to have a longer Date eg 90 days to ensure market volatility has been excluded and the longer term value of the defaulted obligation determined.

Para 126 (d): Again why is this necessary? The standard Credit Derivative Contract provides unless otherwise specified a minimum Grace Period of 3 days. This is to prevent administrative or other technical defaults being triggered. If the Grace Period in the underlying loan is 0 days, hedged with a standard credit derivative where the maturity has been extended to include the minimum grace period of 3 days this provides a full hedge. Why wouldn't this be offsettable?

What this paragraph should say is that the credit protection must cover the grace period in the underlying loan and any minimum grace period in the credit derivative longer than that in the underlying loan must be covered by the maturity of the credit derivative protection.

Para 129. **Credit Derivatives-** The proposed range of eligible protection providers would seem to be overly restrictive. Credit Protection provided by a BBB corporate against a B corporate under the new regime does still have value and provides economic hedging. Why should this be excluded? If the rules being proposed work why should corporates of less than A quality be discriminated against?

Para 138. **Credit Derivatives-** Requiring that banks providing credit protection deduct the junior tranche from capital is far too restrictive. Many of these tranches are privately rated by the rating agencies. If this is so it would seem too extreme to provide a higher risk weight than would be achieved if an equivalent credit quality bond had been purchased.

Para 137-140. **Credit Derivatives-** As above, many of the retained senior tranches have a rating from the Rating Agencies. Again it would seem far too restrictive to give these retained tranches worse treatment than buying an equivalently rated asset.

Para 143-145. **Credit Derivatives-**The *"W"* factor discrimination against credit derivatives appears inappropriate. The discrimination is considered harsh where banks are using internationally accepted, legally robust ISDA documentation, with such documentation being accepted as supporting credit risk mitigation generally.

Para 148. **Hedge Maturity Mismatch-**The intention here is to prevent Banks obtaining capital relief when buying short term credit protection. Again, it seems draconian if the rules work to then prevent some offset when credit protection purchased has less than a 1 year maturity. Credit protection of less than 1 year maturity still has economic value. It would seem extreme to write it off as worthless.

In the situation where originally, 4½ year credit protection was purchased against a 5 year underlying asset, does that mean there is no offset in the last year of the underlying asset where there is still some credit protection?

4.2.2 Credit Risk-internal ratings based approaches*:*

Para 277-293. **Estimation of Probabilty of Default (PD)-**Retail defaults peak over a 6-18 month time horizon and thereafter plateau. It could therefore be argued that a 12 month provision is adequate and maturity of an exposure is not as important as for commercial (loss curve is essentially a mirror image).

SD Para 298. **Stress testing**-The ability to 'subjectively adjust PD or Expected Loss (EL) based on internal macro-economic forecasts' looks highly subjective, difficult to control/validate and potentially open to abuse. The statement is too open-ended.

Para 313. **Commercial Real Estate (CRE)**-While acknowledging that CRE is a high-risk area, the inability to claim any relief for CRE where the prime cash flow is from the underlying property seems overly harsh. Perhaps an approach of only allowing 50% of the normal calculation of the post 'haircut' market value could be used.

Para 319. **Valuation**–The requirement of initial and 3 yearly valuations by "a qualified professional" and interim annual valuations (presumably internally) is of concern. Whilst supportive of the requirement in relation to securities supporting commercial or business lending, reference to use of internal/external valuers infers that real estate securities will be inspected and valued externally. We contend that where such securities are taken to secure consumer loans, banks should be free to conduct internal valuations, including capacity to re-engineer their processes to remove costly, non-value adding activities such as physical inspection/valuation of properties, where loss experience warrants. Less costly activities can be undertaken to confirm the existence and value of the property without physical inspection ie sighting property rate notice, telephone call to solicitor/agent acting at the time of purchase etc.

Para 323. **Maturity-**3 years seems excessive for the non-residential consumer lending for cards and small overdrafts, and even personal loans where defaults peak over a 6-18 month time horizon and thereafter plateau. Also many personal loans pay early or are re-written/reconstituted, ie few loans run their full term.

SD Para 328 **Rating Structure-**Rating systems based on application scoring solely will become out of date very quickly unless a full review with updated information is undertaken on an annual basis. This approach would be unusual in the retail book.

Behavioural scoring, where in place, is the most powerful discriminator of risk and should be used in lieu of application scoring as the basis for rating systems

SD Para 331. **Segmentation-**More definition/clarity is required in the following statement-"(b) each segment must be made up of borrowers whose risk characteristics are reasonably homogenous".

SD Para 333. **Segmentation-**We refer to the requirement that "a bank must demonstrate that the level of segmentation adopted internally provides for a meaningful differentiation of risk." Scoring allows a continuum of the assessment of risks and is not restricted to a limited number of discrete segments. Is there any way this available continuum can be used to provide greater granularity to the allocation of risk weights?

"The orientation of this segmentation should be towards the risk of both the **borrower** and the **transaction**". It is not clear how this can be so. We would appreciate explanation.

SD Para 344. **Estimating average PD and Loss given default (LGD) or EL-**As an estimation technique, banks are required to consider "mapping to external data". What data are available?

SD Para 352. **Retail risk weights-**In the Australian context with banks being significant lenders in the residential mortgage market, which has a totally different risk profile to unsecured consumer lending, it is appropriate the banks, and APRA, continue to seek and establish separate risk weights for residential mortgages and other retail products.

Para 445. **Segmentation-** Segmentation based on application scoring will become out of date very quickly unless a full review with updated information is undertaken on an annual basis. This approach would be unusual in the retail book.

Again, in line with our comments under "Rating Structure" above, behavioural scoring, where in place, is the most powerful discriminator of risk and should be used in lieu of application scoring as the basis for segmentation.

Para 453. **Segmentation-** Similarly to above comments, if current information is required behavioural scoring is the most appropriate.

Para 456. **Review**-This is not feasible and is not necessary if behavioural scoring is used.

Para 459. **Orientation of rating system**-While it is appropriate that the ability to differentiate risk should be both plausible and intuitive, it must, in the first place, be based on empirical data that reflects the actual behaviour of the account.

Para 466. **Default**-We have these comments in respect of the first two bullet points:

- The event when "it is determined that the obligor is unlikely to pay its debt obligations (principal, interest or fees) in full" is too subjective. It suggests that it would be necessary to make judgements on individual accounts rather than taking a portfolio view and assessing default against a predetermined number of "days irregular".

- The act of "forgiveness or postponement of principal, interest or fees" is a collection technique designed to achieve recovery of a debt and avoiding default.

Para 472. **Historical observation period**-The requirement that "the length of the underlying historical observation period used must be at least five years" can present issues:

- Data over this period is not always available;

More recent data will be more relevant to the present-i.e. cycle averaging will be right, on average, over a given period, but wrong all the time for a given point within the period.

4.3 Trading Book

4.3.1 General Comments

The National sees the new capital accord as materially reducing the distinction between the "Trading Book" and the "Banking Book". This should reduce the incentive for regulatory arbitrage, encouraging an internal assessment of risk based on the specific character of instrument rather than the most advantageous capital treatment.

The National welcomes the broadening of the Trading Book definition as the implicit recognition that the primary risks associated with holding investment grade assets are related to shifts in prices rather that default events.

4.3.2 Specific Comments

Para 571-580. **Valuation Guidance**- The new Accord places specific emphasis on issues relating to portfolio valuation. The National views most of the requirements as consistent with best practice.

Para 583-585. **Specific Risk under Standardised Methodology-Credit Derivatives**- We note that the New Accord proposes only an 80% risk offset for Physical positions hedged by Credit Derivatives of matching currency and reference asset in the Trading Book environment. This is consistent with correlation analysis conducted by the Bank.

We question the appropriateness of the disallowance of any specific risk capital relief for the use of a Credit Derivative hedge where currency or maturities mismatch (Paragraph 585). The history of foreign exchange movements in the major currencies in which the Bank does business (AUD, EUR, GBP, JPY, NZD &USD), and the high correlation of credit spread movements between credit derivatives of varying maturities, suggest that some relief on the specific risk capital charge would be appropriate.

4.4 Operational Risk

4.4.1 General Comments

In general, the National welcomes the proposed new methods for measuring regulatory Operational Risk Capital. The National agrees that regulatory measures should be introduced to measure its Operational Risk Capital separately, however, we recommend that the fourth method proposed, the "Loss Distribution Approach" (as discussed in Annex 6 of the Basel Operational Risk consultative document), should be available for use at the start of 2004.

The principle of the Accord is for the Financial Services Industry to improve its Operational Risk capabilities and move towards more granular calculation of its Operational Risk Capital. By having to adopt one of the first three approaches proposed under the Accord, the National would need to run parallel systems, one for regulatory purposes and one with an eye on the future (LDA), which will create additional workloads and confusion within the Group.

4.4.2 Specific Comments

During 2000, the National successfully implemented globally the PricewaterhouseCoopers (PwC) designed "OpVaR" model, as the method for calculating its operational risk capital. This model was identified as the world's best practice following an extensive global search of many consulting firms, and closely aligns to the Loss Distribution Approach.

The PwC OpVaR approach to measuring Operational Risk Capital is very similar to the Loss Distribution Approach as detailed in the Operational Risk consultative document and is more advanced than the three recommended approaches (the Basic Indicator, Standardised and Internal Measurement Approach).

The PwC OpVaR model is based upon the following approach:

- It is a statistical / actuarial methodology
- It uses a bottom up approach; ie it calculates a separate Value at Risk (VaR) for each Business Unit.
- The data used in the model is a combination of internal and external loss data
- A Monte-Carlo Simulation is used to generate Operational Value at Risk Capital to the 99.97 percentile to comply with the National's AA rating.

After calculation of OpVaR by Business Unit, we then apply a discount based on the quality of the controls in place.

Regarding the definition of Operational Risk as quoted in the Accord, this definition is consistent with the definition adopted by the National in using the PWC OpVaR model.

Why Loss Distribution Approach (LDA) should be approved now:

The Loss Distribution Approach is the most risk sensitive approach compared with the other three recommended approaches, as the bank specifies its own loss distributions, business lines and risk types for calculating its Operational Risk Capital Charge.

Under the Internal Measurement Approach (IMA) (the most advanced of the other three proposed approaches), regulators will specify and determine the loss distribution, business lines and risk types to be used in the calculation.

The main reasons why we believe the LDA should be approved for 2004 are as follows:

1. Using any of the other three approaches will penalise larger firms with higher gross income and the methods do not take into account the strength of the control environment in place. Under the IMA with all things being equal, an institution double the size (primarily determined by the exposure indicator) will get double the capital. Operational Value at Risk, does not necessarily increase linearly with size, but is based on volatility or unexpected loss, around a calculated mean.

2. Under the Standardised and IMA, Operational Risk capital is mapped to Basel proposed Business Lines. Going forward this is a major restriction for the National, as in the last financial year we implemented a National Business Model with a very different structure to the Basel proposed model. Under the LDA, Operational Risk Capital is calculated separately for each Line of Business and is not restricted to suit a static business model.

   Should the National need to adopt the IMA, we would need to map our business units to the Basel proposed model, which is not reflective of our actual structure.

3. In reality losses by category are not stable year after year as assumed under the IMA. It could take many years to calculate a stable average loss, causing potential volatility of capital and making it difficult for an institution to budget. In addition correlations across risk categories (including market and credit risk) cannot be evaluated and therefore the significant diversification benefit remains unrecognised.

4. The LDA is the only approach that is truly risk sensitive. Selecting one exposure indicator by category is extremely limiting under the three proposed methods. A positive step is the use of a risk profile index to adjust the results of the IMA process if any one institution can prove its distributions are different from the standard. However, this means that an institution will have to implement the LDA anyway to prove these differences to a regulator.

5. There are insufficient incentives under the first three approaches for companies to invest in controls, whilst the LDA promotes operational loss mitigation. That is, if an institution can reduce the frequency and / or severity of its operational losses going forward, generally, this would lead to a lower capital charge in the future.

Whilst this is implied, we prefer to create a more transparent approach. Consequently, as an adjunct to the OpVaR methodology, the National has developed "Risk Evaluation Networks". These networks assess the risk and control environment for each Line of Business and provides the business with the ability to better manager their risk exposures and capital allocation.

6. Only the LDA can model insurance and the National has incorporated this in its modelling. Each Insurance contract is different as to what is insurable and institution specific in terms of the deductible and maximum coverage. The LDA model can alter the distributions to reflect the actual insurance cover in place and provide an analysis of events likely to be insurable.

7. The National implemented the Stern Stewart performance measurement, Economic Value Added (EVA), last financial year whereby the performance of each line of business is linked to their capital charge. Under the LDA, each line of business understands that by reducing their operational losses, their capital charge may be reduced going forward and thus promotes operational loss awareness, mitigation and improved controls within each line of business.

In terms of the issue of internal loss data integrity, the National has robust data in Australia going back many years, but this is not the case in the other regions it operates within. Whilst we are now collecting this data in a globally consistent fashion to accommodate our modelling requirements, we are also using Australian data to proxy this to the regions based on size until such time that we are sufficiently comfortable with the regional data.

4.5 Asset Securitisation

As previously noted, the National broadly concurs with the submission to APRA made by the Australian Securitisation Forum (ASF). The National had active involvement in the preparation of the ASF submission. Accordingly the submission represents the National's views and is therefore incorporated as an Attachment to this document.

The main points coming out of the ASF submission are as follows:

- The general concepts proposed by the Committee and its approach to aligning a financial institution's minimum capital requirements with its overall risk profile are supported. The expansion of the internal rating based approaches is seen as a further positive step.

- Inconsistencies and anomalies however, in the Committee's conservative approach to securitisation creates clear disincentives for banks to become involved in securitisation (as either an investor, originator or sponsor). Banks should hold capital commensurate with their securitisation risks however, the capital should not be greater than for similar risks involved with non securitisation exposures.

- To ensure that securitisation is available as a risk management tool for banks, the Committee should apply a consistent approach across similar risks regardless of whether a bank is acting as originator, sponsor or investor. Facilities provided to securitisation vehicles are provided on an individual, arms-length basis and should be regarded as any other third party transaction.

- There is a need to ensure that measures implemented to reduce the incentives for regulatory arbitrage do not make it uneconomic to carry out portfolio risk management through the use of synthetic securitisation.

5.0 THE SECOND PILLAR-SUPERVISORY REVIEW

5.1 General Comments

The National welcomes the concept of the "Second Pillar" to complement supervisory assessment of bank capital adequacy. Such reviews are well known to us as our national supervisor has a well-developed program of risk-based supervisory visits, which imply a measurement of risk versus capital.

However, introduction of more sophisticated measures of regulatory capital places greater burden on supervisors to monitor compliance. We would be concerned if lack of regulatory resources were insufficient to achieve an appropriate level of understanding of such sophisticated measures would retard transition to more advanced methods.

If national supervisors are able to establish defined capital categories relating to higher capital thresholds, then it is essential that the selection criteria be transparent and well understood by banks and their shareholders. The use of categories such as "well-capitalised" may amount to raising the 8% minimum level by stealth, particularly if regulators will restrict the activities of banks that do not meet these higher levels.

5.2 Specific Comments

Para 591. **SD Para 4.**	**Compliance Assessment**-As mentioned above, the introduction of more sophisticated measures of regulatory capital places greater burden on supervisors to monitor compliance Would this lead to delay in permitting banks to move straight to using the advanced IRB method for measuring regulatory credit risk capital and advanced methods for operational risk capital?
SD Para 7.	**Supervisory Consistency**-The document lacks details on how international consistency in supervisory approaches will be encouraged. This becomes a significant issue as the compliance burden on regulators increases. One way around the problem, for internationally active banks, would be for affected financial institutions' home regulators to set standards for those institutions global operations that other signatories to the Basel Accord were willing to endorse. Even if the home regulator approach is not approved, there ought to be a limit on the number of regulatory authorities reviewing the Group's activities, given that all regulators are signatories to the Accord.

SD Para 33.	Internal Reporting-The National supports the proposal that senior managers receive regular reports on the bank's risk profile.
Para 610.	**Internal Controls**-The extent to which supervisors are willing to rely on audit advice concerning internal risk analysis processes is unclear
SD Para 39.	**Composition of Capital**-The final dot point in this paragraph discusses the composition of capital, which does not appear to be defined anywhere else in the document.
Para 624. **SD Para 59.**	**Capital Levels**-We are concerned with national supervisors having the ability to establish capital categories relating to higher capital thresholds. It would be essential that the selection criteria be transparent and well understood by banks and their shareholders. The use of categories such as "well-capitalised" may amount to raising the 8% minimum level by stealth, particularly if regulators will restrict the activities of banks that do not meet these higher levels.
Para 605, 632. **SD Para 79-82.**	The National endorses the proposed principles for the management and supervision of interest rate risk and does not believe that their adoption will lead to any significant change in the way the Group currently manages this risk.

6.0 THE THIRD PILLAR-MARKET DISCIPLINE

6.1 General Comments

Limits to extent of disclosure

The National is committed to continuous improvement in the level of disclosure and welcomes the regulatory focus in the New Accord.

We understand the quest for the widest possible disclosure, however, we are concerned that the proposals may not have recognised that commercial sensitivities can effectively limit the scope. For example, we have found it necessary to strenuously opposes the disclosure requirements in paragraph 82, concerning capital management strategy. This is an extremely commercially sensitive area.

Usefulness of information to reasonable investor

The underlying purpose of Pillar 3 is to provide sufficient information to a “reasonable” investor to enable him/her to obtain a clear picture of a bank’s risk profile and capital position in order to assess its ability to absorb losses. However, given the amount and complexity of the required disclosures the risk is that the general user of financial statements may not find the information understandable or superfluous to the user’s requirements. It is likely that only professional users (such as analysts) would fully comprehend the significance of the financial statements. Therefore, we question whether the financial statement is the most appropriate vehicle for disclosure of this detailed information.

Requirement to Audit

Including the proposed disclosures in the financial statements would give rise to an audit requirement, which is inconsistent with the way current management information is disclosed. A number of our risk management disclosures are currently provided outside the audited financial statement section of our annual report. Consideration should be given as to whether much of the information would be better placed in the management discussion and analysis section of the annual financial report or communicated via some other form of regulatory reporting which is made publicly available.

6.2 Specific Comments

SD Para 13. **Consistency between disclosure frameworks**-We concur with Committee's comments on the importance of promoting a consistent disclosure framework by working with the International Accounting Standards Committee (IASC). Consistent application of the Basel requirements also relies on each country harmonising its own accounting standards with the international standards.

The AASB has publicly expressed commitment to international harmonisation of accounting standards. Notwithstanding the commitment of the AASB to international harmonisation, sufficient lead-time should be provided for the development of Australian Accounting Standards that harmonise with the relevant international standards embracing the Basel Accord. To ensure that the disclosure requirements are consistent with international accounting standards, we believe it is important that the coordination process is driven by the Basel Committee.

SD Para 22. **Frequency**-It is stated in Pillar 3 that for the type of information required to be disclosed, annual disclosure is not sufficiently timely. Half yearly or even quarterly disclosure in a company's financial statements is recommended.

Current practice within Australia is to provide a detailed annual report prepared in accordance with all Australian Accounting Standards, Urgent Issues Group consensus views, and the Corporations Law and a streamlined set of financial statements for the half-year in accordance with Australian Accounting Standard AASB 1029 "Half-Year Financial Statements". Half-year financial statements are significantly less detailed than annual financial statements and many of the detailed disclosures contained in the annual financial statements are excluded at half year. Unlike in the United States where quarterly reporting is common practice, Australian companies do not report its financial statements on a quarterly basis.

The volume and complexity of proposed disclosures, if applied to half yearly financial statements would add considerable time and cost to the preparation of half year financial statements and the volume of regulatory information required under the accord would possibly exceed the existing financial statement disclosures. Subject to the overall comments on the volume and complexity of proposed disclosures made above, we recommend that the majority of half-yearly and quarterly disclosures be made outside the half-year financial statements.

SD Para 58–70, Appendix 4	**Market Risk Disclosure-**the requirements include: • Description of the stress test program • Back testing results at an aggregated level. • Details on the movement of desks between standard model and internal model The proposed market risk disclosures are radically different to the existing disclosures and significantly more detailed. Current disclosures are at a group level whereas the proposed disclosures are for VaR and Stress Testing at desk level i.e. the lowest operating level. As an example of how detailed the resultant disclosures will be, the National currently runs 90 individual desks / portfolios that are tested for VAR levels and averages for FX risk, Interest Rate Risk, Volatility Risk and Commodity Risk. Multiply this by 90 to appreciate the volume of disclosures under the new proposals. The amended Accord relies on disclosure of VaR and maintains that it is a consistent measure of risk for all banks. Our view is that VaR gives an indication of the relative magnitude of risk but little else. Australian banks do not use a standard internal model VaR methodology and it has been demonstrated that VaR results on standard transactions vary by as much as 20%. Thus comparing VaR levels has limited value. Comparing one bank's VaR results from one year to the next can be meaningless as the rate histories used to generate VaR are updated quarterly. VaR results can vary as much as 30% over 12 months as the trading conditions reflected in the rate histories change radically. None of these weaknesses are resolved by moving the level of VaR disclosure to desk level. Desk level VaR results might give some indication of risk appetite and business focus. However, the desk level data will not be very useful without further information about the products traded and trading strategies that govern their use.

SD Para 58–70, Appendix 4	**Market Risk Disclosure (continued)-**Comparison of Bank stress testing results is meaningless unless there are standard scenarios used. Even those results might be misleading if comparing banks that focus on different products, currencies or regions. One view is that desk level VAR is commercially sensitive information. If this is so, the proper place for such disclosures is as part of the quarterly APRA reporting cycle. Overall, it is likely that the information disclosed will convey nothing of value and simply give rise to confusion.
SD Para 71–74, Appendix 5	**Operational Risk Disclosure**-In general, the required operational risk information is meaningful and will help regulators monitor the National's operational risk exposure. National has no objection with providing the required disclosures in the annual report except for the supplementary disclosure on operational losses. Details on the National's historical losses should be kept confidential and only disclosed to regulators in a summary format. There are privacy issues with this data (i.e. legal, criminal and confidential human resource loss issues).
SD Para 37–57, Appendix 3	**Credit Risk Disclosure**-We accept the required disclosures except for the items listed below. Standardised Approach:
Table 3.2 Qualitative disclosures	In Section (i), we are required to disclose the percentage of bank’s outstandings in each risk bucket which is covered by each agency’s rating. It is our view that the fact that the supervisor will approve ECAIs should be sufficient for the market. The overall risk breakdown by risk bucket will be provided elsewhere. IRB Approach:
Table 3.3 Qualitative disclosures	The National is of the view that a number of the qualitative disclosures contained in Table 3.3 do not provide meaningful information as we believe that approval of the regulator should be sufficient information for investors and users of financial statements. The following specific requirements are covered by this view:

SD Para 37–57, Appendix 3	**Credit Risk Disclosure (continued)** • 1(iii)For each portfolio describe methods for estimation and validation of PD, LGD and Exposure at default (EAD) • 1(vii) For each portfolio, with subdivision as necessary (a) employed definitions of PD, (LGD, and EAD), (b) mapping of internal and reference definitions of default • 2(ii) For each portfolio, - PD (and LGD) assumptions related to each PD (and LGD) grade – for each PD(LGD) bucket, (or by segment in the retail portfolio) nominal exposure amount before and after Credit risk mitigation techniques (CRMT) - (for credits with variable exposure, EAD assumptions used for estimation, nominal exposure amounts and EAD estimates, both before and after recognised CRMT for each PD-LGD bucket (by risk segment in retail)). We do not believe that the information required in Table 3.3 sections 3(i), 3(ii) and 3(iv) is meaningful. Without providing these numbers as some relationship to the total portfolio this type of information will be misleading. Portfolio based information would be more meaningful.
SD Para 75–80, Appendix 6	**Interest Rate Risk Disclosure-**We have concerns with section 1(ii) of Appendix 6.1. This section requires the following qualitative disclosures: "Identify the nature of IRR in the banking book and key assumptions employed in its measurement. In particular, identify size of portfolios with embedded optionality and the empirical or judgmental assumptions employed to model them, such as assumptions regarding loan prepayments and behaviour of non-maturity deposits." Our opinion is that this level of disclosure is too detailed. Some of the required information is proprietary information regarding our treatment of these items, and we would not be prepared to provide this publicly. Much of the information is subjective in its treatment and modelling and is difficult to precisely quantify. We do not believe that these disclosures would add value to an investor's assessment of the bank's risk profile.

SD Para 27, 29–32, 81–83, Appendix 7

Capital Adequacy Disclosures-We oppose the disclosure requirements embodied in paragraph 83. Although the Group does allocate economic capital, there are commercial issues with disclosing the allocations because the methods for allocating economic capital differ widely between banks. One of the virtues of the New Capital Accord is that the more sophisticated formulae proposed for credit and operational risk make regulatory capital at better proxy of economic capital than it is at the moment while simultaneously ensuring that all banks apply a consistent approach to measurement. Disclosing economic capital figures as well as regulatory capital simply clouds the issue.

The final sentence in the paragraph: "A summary comparison / analysis of internal estimates of aggregate economic capital requirements versus reported capital amounts versus regulatory requirements is also a useful disclosure" appears to be truest for regulators, who would get the chance to validate their regulatory model against banks' internal models.

We strenuously oppose the disclosure requirements in paragraph 82. The National's capital management strategy, its contingency plans and its future capital plans are all extremely commercially sensitive, and would not be released to the market in any but the most general of terms. Indeed, the very act of disclosure would, in some circumstances, force the Group to change its strategies

ATTACHMENT

Australian Securitisation Forum

Submission to the Australian Prudential Regulation Authority regarding the

Consultative Document for the New Basel Capital Accord (January 2001)

30 April 2001

1. Introduction

1.1. This submission contains a response by the Australian Securitisation Forum (ASF) to the Basel Committee on Banking Supervision's (Basel Committee) Second Consultative Package on the New Basel Capital Accord, dated January 2001 (Second Consultative Package).

1.2. The ASF wishes to table this submission with the Australian Prudential Regulation Authority (APRA) for its consideration when corresponding with the Basel Committee in relation to the Supporting Document in the Second Consultative Package entitled "Consultative Document – Asset Securitisation".

2. The Australian Securitisation Forum

2.1. The Australian Securitisation Forum (ASF) is the peak body representing the securitisation industry in Australia. It has been in existence for over 10 years and its purpose is to promote the development of securitisation in Australia.

2.2. The ASF's members include representatives from major banks, investment banks, insurers, rating agencies, trustees and legal and accounting firms.

2.3. A sub-committee of the ASF was formed to consider the Second Consultative Package and to prepare this Submission. A list of member organisations of that sub-committee is attached as Appendix A.

3. Summary

3.1. As the Basel Committee recognises, both traditional and synthetic securitisation are balance sheet management tools that can provide a number of benefits to financial institutions, be they acting as originator/seller, investor or sponsor (ongoing reference will be to "banks" for consistency with the Second Consultative Package).

3.2. The ASF supports the general concepts proposed by the Basel Committee and its approach to aligning a financial institution's minimum capital requirements with its overall risk profile. The expansion of the internal rating based approaches is a further positive step supported by the ASF.

3.3. The ASF recognises that where a bank takes on risks through its involvement in securitisation that the bank should hold capital commensurate with those risks. However, the ASF does not support the Basel Committee's conservative approach to securitisation, both in the traditional sense and synthetically, vis a vis other exposures of a similar nature (eg direct rated corporate exposures) on the basis that this conservative approach creates clear disincentives for banks to become involved in securitisation.

3.4. To ensure that securitisation continues to be available as a risk management tool for banks, the ASF recommends the Basel Committee apply a consistent approach across similar risks. For example, for banks applying the Internal Rating Based Approach (IRB), this means allowing the securitisation related exposures to be assessed within a bank's IRB model in line with similar exposures. The incentive for using securitisation for regulatory capital arbitrage will be removed as the on balance sheet exposures attract a capital charge more reflective of the economic risk and banks are only able to reduce the capital held to the extent there is true risk transferral.

3.5. The ASF believes any potential concerns relating to structural or moral risk associated with securitisation are addressed adequately through the proposed operational requirements (paragraph 90) and disclosures presently made within securitisation structure documentation. The ASF does not therefore support any differentiation in the treatment of securitisation exposures between banks acting as originators, investors or sponsors.

3.6. The ASF consider that the objectives of the Basel Committee in relation to synthetic securitisation are consistent with the overall economic incentives of synthetic securitisation. The ASF believes however, there is a need to ensure that measures implemented to reduce the incentives for

regulatory arbitrage do not make it uneconomic to carry out portfolio risk management through the use of synthetic securitisation.

4. Specific Comment

4.1 <u>Explicit Risks in Traditional Securitisation – Standardised Approach</u>

4.1.1. Paragraph 16 – Minimum capital requirements for credit enhancements

The ASF does not support the Basel Committee's approach to second loss enhancements. In particular the ASF does not support the Basel Committee's requirement that first loss protection must be sufficient to elevate the credit quality of the second loss enhancement to an investment grade level before treating that second loss enhancement as a direct credit substitute.

The ASF supports APRA's current guidelines which permit a bank to provide both first and second loss facilities in the same transaction, to treat them as separate facilities and to treat the second loss facility as a direct credit substitute provided that:

(a) the facilities are separately documented and clearly function separately;

(b) the second loss facility is protected by a "substantial" first-loss facility (ie. where the first-loss facility covers a multiple of historical losses or worst-case loss and the adequacy is assessed on an arm's length basis by the relevant bank, including an assessment of opinions from reputable third parties such as rating agencies concerning the adequacy of the first-loss facility);

(c) the second loss can only be drawn after the first-loss facility has been completely exhausted;

(d) the second loss cover only extends to losses beyond those covered by the first-loss facility; and

(e) the second loss facility is made up of subordinated securities (or some form of marketable credit enhancement) which could be readily transferred by the bank at any time.

4.1.2. Paragraphs 26 and 27 – Minimum capital requirements for investments in ABS

The ASF recommends revised risk weightings for investments in ABS in line with those applied to unsecured rated debt, as the differential is unwarranted and disadvantageous to securitisation.

4.1.3. Paragraphs 29 and 30 – Treatment of unrated securitisations

The ASF supports the "look through" approach proposed by the Basel Committee. The ASF questions however, the approach to investments in mezzanine or subordinated debt (paragraph 30). The ASF believes a risk weighting should be applied commensurate with the applicable risk weighting of the underlying assets, regardless of whether the debt is senior, mezzanine or subordinated.

The ASF does not support the differential between the treatment of unrated subordinated debt between originating banks (deducted from capital) and sponsoring banks (100% risk weight). Any such investment is provided on an individual basis and documented separately. Obligations are clearly disclosed and the underlying risks are the same regardless of whether the investment is made by an originator or sponsor.

The ASF recommends the look through approach be extended to unrated second loss enhancements and other unrated exposures such as liquidity facilities, interest rate and

cross currency swaps and underwriting facilities. For the capital charge to reflect a banks underlying risk position, the risk weightings applied should have regard to how the facility ranks in the event the securitisation structure is wound up. For example, facilities that rank equally with AAA rated securities should attract a 20% risk weighting, while a facility that ranks equally with A+ rated securities should attract a 50% risk weighting. Where such facilities do not rank equally with issued securities, for example, they rank after AAA securities but before BBB securities, they should attract the risk weighting applicable to the next ranking security.

The ASF also recommends banks investing in unrated holdings be able to utilise the IRB approach to determine a capital charge. This could be achieved through either calibration against other rated tranches, looking through to the rating of assets in the underlying portfolio or an adaptation of the sliding scale approach, depending on the specific circumstances of the transaction.

4.2. <u>The treatment for sponsoring banks in conduit programs</u>

4.2.1. Paragraph 34

The ASF does not support the proposed differential treatment of second loss enhancements between sponsoring banks (based on external ratings) and originating banks (capital deduction). Each enhancement is provided on an individual basis and documented separately. Obligations are clearly disclosed and the underlying risks are the same regardless of whether the enhancement provider is an originator or sponsor.

4.2.2. Paragraph 54

The ASF supports the Basel Committee's objective to ensure a common approach to liquidity facilities provided to conduits. The ASF supports the need to ensure that liquidity facilities do not provide credit support to investors and therefore should not be available to cover "defaulted" assets. The ASF does not support however, the Basel Committee's proposed "deteriorated assets" test. For example, liquidity facilities industry wide typically protect investors against an inability to issue commercial paper due to the downgrade of underlying assets but quite rightly do not protect investors against defaulted assets.

4.2.3. Paragraph 55

The ASF does not support a 100% risk weighting for liquidity facilities. As set out in 4.1.3 above, the ASF strongly supports the adoption of a look through approach to liquidity facilities.

4.3. <u>Internal Rating Based (IRB) Approach</u>

4.3.1. Paragraph 59 – The treatment for issuing banks

Once again, the ASF opposes the differing treatment of originating, sponsoring and investing banks. There is no justification for the requirement that originating banks deduct the full amount of retained first loss positions regardless of the IRB capital requirement.

4.4. <u>Specific Issues/Questions for Comment:</u>

4.4.1. What are the industry's views on the best way forward for the development of a more risk-sensitive approach to securitisation in the IRB approach?

Banks are being encouraged to use the IRB approach but the Basel Committee still proposes 'for the sake of conservatism' to apply a 100% LGD to securitisation tranches. However, as per paragraph 64, it will continue to look at alternative approaches.

Banks should be able to apply a transparent assessment of the expected Probabilities of Default (PD's) and LGD's when assessing securitisation exposures. The differential

to unsecured rated debt for example, is unwarranted and disadvantageous to securitisation.

The imposition of a 100% LGD for securitisation exposures does not align the capital requirement with the economic risk in many instances. In the case of highly rated senior securities (AAA or AA) applying a 100% LGD under the Foundation IRB approach will produce a higher risk weighting than that achieved under the Standardised model (28% vs 20%) and a risk weighting double that required for non-securitised exposures (corporates at 14%).

The adverse capital treatment is compounded for liquidity facilities provided to securitisation vehicles. These facilities typically rank pari passu with AAA rated note holders in the event of a wind up and contain restrictions on their ability to be drawn down. However, banks applying the foundation IRB approach must apply a 75% Exposure At Default (EAD) and a 100% LGD. This results in a capital charge far in excess of the underlying economic risk position (75% x 28% x 8% = 1.7%). This is a significantly higher capital charge than that produced by internal economic risk capital allocation models.

The ASF recommends allowing banks to calculate a LGD within its IRB model in the same manner as for non securitised exposures.

4.4.2. With respect to the two-legged or sliding-scale approach, what are the industry's views on possible methods for calibrating numbers for the adjustment factor consistent with less than dollar-for-dollar deduction of first-loss positions?

Where a bank retains a first loss position, the ASF supports the two-legged sliding scale approach. In this case it will involve determining an amount of capital held on balance sheet against the underlying assets and then assessing how much credit risk on the portfolio has been transferred to quantify the capital released. Where a retained first loss position is less than the on balance sheet IRB capital requirement, an amount of capital should be released.

However, the ASF does not support the concept that the total amount of capital allocated to a securitised portfolio should be in excess of the balance sheet requirement. The ASF does not support that the aggregate amount of credit risk on the underlying assets increases as a result of securitisation.

4.4.3. Does the differentiation in treatment on the basis of being an issuer or investor bank provide a balanced and consistent economic approach?

To ensure that securitisation is available as a risk management tool for banks, the ASF recommends the Basel Committee apply a consistent approach across similar risks regardless of whether a bank is acting as originator, sponsor or investor.

The ASF believes any potential concerns relating to structural or moral risk associated with securitisation are addressed adequately through the proposed operational requirements (paragraph 90) and disclosures presently made within securitisation structure documentation. The ASF does not therefore support any differentiation in the treatment of securitisation exposures between banks acting as originators, investors or sponsors.

The ASF supports the effective operation of APRA's existing guidelines APS 120, requiring individual documentation, transactions to be undertaken on market terms and conditions and disclosure regarding the extent of the facility, to ensure exposures can be treated as arms length.

4.5. <u>**The Treatment of explicit risks associated with synthetic securitisation**</u>

The ASF is supportive of the Basel Committee's objective to close the opportunity for regulatory arbitrage through the use of synthetic securitisation. It is important however, for the continued development of the market that the post securitisation treatment of such exposures is not unnecessarily conservative, which when combined with the additional

costs associated with such transactions could significantly inhibit the development of this market .

The ASF recommends an overall objective to ensure that the risk weighting of an asset portfolio cannot be increased through dividing the risk participation into tranches through synthetic securitisation. Hence, the sum of the capital requirements for each tranche (including any first loss tranche) should be identical to the capital required to support the portfolio on balance sheet.

When allocating the appropriate risk weightings on tranches under the *standardised approach,* the balancing item should be the risk of the last to default piece (ie the super senior tranche) regardless of its external rating. Given that the originating bank typically retains the first loss tranche, the equation should balance out fairly. By way of illustration:-

Pre **Securitisation:**

Portfolio Size ($)	Rating	Risk Weighting On Balance Sheet	Risk Weighted Assets	Capital at 8% ($)
1,500	A	50%	750	60.0

Post **Securitisation:**

Tranche Size ($)	Rating	Risk Weighting Post Synthetic Securitisation	Risk Weighted Assets	Capital at 8% ($)
50	Unrated	Capital deduction		50.0
100	Subordinated BBB	100%	100	8.0
100	Senior AAA	20%	20	1.6
1,250	Super Senior AAA	Preferential	Implied	0.4

Note Super senior cannot have a negative risk weighting.

In this example, had the originator chosen to retain all AAA rated bonds (1,350) the appropriate capital required is 2.0 (such that the total still equals 60).

Under the ***IRB approach***, if a bank chooses to retain a senior piece (because it is satisfied with the risk profile and it would be uneconomic to transfer this to a third party), the bank should simply be able to assign an appropriate PD and LGD to the restructured risk. There should be no arbitrage opportunities since the bank assigned the PD and LGD to the asset portfolio in the first instance – why arbitrage itself!

4.5.1. Paragraph 81 and 82 – Retained/repurchased senior/mezzanine risk

The ASF does not support the Basel Committee's requirement that a bank transfer senior risk if it is comfortable with the exposure. It is generally accepted by ratings agencies that a bank has successfully reduced its credit risk to the extent it is able to sell off debt with a lower rating than its own. For example, a AA rated bank is improving its overall credit profile by selling off an A rated subordinated tranche.

The ASF recommends that retained first loss positions should attract the same capital requirement as that of a traditional securitisation, calculated utilising a sliding-scale approach capped at the on balance sheet IRB capital requirement. Limiting the size of the first loss tranche to expected loss will prevent transactions where a portion of unexpected loss, but not all, is transferred. These transactions are still of benefit to banks. This argument should also be applied to situations where the bank retains the first loss and super senior exposures.

4.5.2. Paragraph 83 – Retention of both first-loss and senior risk

The ASF is of the view that requiring the sale of a minimum amount of senior risk to gain capital relief on retained super senior risk exposures, may make transactions uneconomic and prevent transactions that have positive risk transferral of the lower levels of risk.

Arbitrage should be prevented as the retained exposures are assessed as part of the IRB model. The ASF is also of the same view where it is proposed a bank retains the first loss and super senior exposures.

4.5.3. Paragraph 85 – Operational Requirements

The ASF requests further clarification on what the Basel Committee proposes to be a "preferential" capital charge.

4.5.4. Paragraph 86 – Structural Criteria

The ASF does not support the requirement that a substantive amount of AAA rated notes be issued or the need for two ratings agencies. The ASF believes both requirements again may create a disincentive to transfer risk via synthetic securitisation.

4.6. Implicit and Residual Risks

4.6.1. Paragraph 89

The ASF opposes the introduction of a capital charge for securitisation to address implicit or residual risks such as moral risks.

The ASF believes any potential risks are addressed adequately through the proposed operational requirements (paragraph 90) and disclosures made within securitisation structure documentation. Each facility is provided on an individual basis and documented separately. Obligations are clearly disclosed and the underlying risks are the same regardless of whether the facility provider is an originator, sponsor or investor.

This is evidenced through the effective operation of APRA's existing guidelines APS 120, requiring individual documentation, transactions to be undertaken on market terms and conditions and disclosure regarding the extent of the facility, to ensure exposures can be treated as arms length.

4.7. Disclosure Requirements

4.7.1. Paragraph 93 – Disclosure of liquidity facilities

The ASF does not support the Basel Committee's proposed disclosure requirements for liquidity facilities in Statutory Accounts. The ASF does not believe there are features of liquidity facilities to CP conduits that warrant more detailed or separate disclosure to liquidity commitments extended by banks to corporate or other entities. In addition, disclosure of such information by deal would require ASF members to disclose confidential competitive information.

Appendix A

ABN AMRO Australia
Adelaide Bank
ANZ Bank
Bank of Queensland
BankWest
Bendigo Bank
Clayton Utz
Commonwealth Bank
Corrs Chambers Westgarth
Credit Suisse First Boston
Deloitte
Deutsche Bank
Freehills
Gadens Ridgeway
Homeside
JP Morgan
Macquarie Bank
Mallesons Stephen Jacques
Members Equity
Merrill Lynch
National Australia Bank
Perpetual
Salomon Smith Barney
SG Australia
St George Bank
Suncorp Metway
UBS Warburg
Westpac