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# Review of the New Basel Capital Accord
# Comments for FSA/Basel Committee

## 1. PARA[1] 22– BANKING BOOK/TRADING BOOK

### 1.1 Comment

This paragraph refers to "the 1988 Accord for risk-weighting banking book exposures". Apart from what is specifically disclosed in the document (i.e. paras 566 – 585); this suggests that the current trading book weightings will ***NOT*** be changed by Basel 2, as stated in this para, in particular:

- Specific risk for bank exposures in the Trading Book will remain;
- Counterparty risk treatment in the Trading Book will remain the same (i.e. with a ceiling of 50%).

### 1.2 Suggestion

We suggest that anomalies, where they are illogical, should be removed. However, where they are logical, they should remain.

The trading book should have risk weighting advantage because of the short-hold and minimum daily valuation that applies across the whole of this book.

## 2. PARA 29–33 - BANK EXPOSURES

### 2.1 Comment

There are still two options for bank risk. It is unclear which of the two options for bank exposures will be used by FSA/EU and whether it would be standardised across Europe.

[1] Para references are to the New Basel Capital Accord document published on 16 January 2001

## 2.2 Suggestion

Would it be possible to merge the two options together such that bank risk weightings would be determined as per Option 2. However, in the event that the country of incorporation/regulation was at least 2 grades higher than that of the bank in question, then its own risk weighting would be elevated to one level below that of its relevant sovereign.

# 3. PARA 72 - CORRELATION OF COLLATERAL WITH UNDERLYING EXPOSURE

## 3.1 Comment

This paragraph, as currently written could have far-reaching consequences. What will be the definition of "material positive correlation"? Would it disallow, say, sovereign risk collateral over a corporate exposure in the same country?

## 3.2 Suggestion

We suggest that the definition should be clear e.g. that disallowable collateral would be that which had been issued by the same obligor, or a related party of the obligor.

# 4. PARA 75–149 - RESIDUAL RISK IN RESPECT OF COLLATERAL

## 4.1 Comment

We note that there is a residual risk charge applied, in particular, to collateralised transactions.

We do not understand the logic of having both a residual risk charge and an operational risk charge, as they are likely to be covering the same type of risks (in the case of collateral, documentation and enforceability).

## 4.2 Suggestion

We suggest that either the residual risk charge structure is dropped or, perhaps more acceptably, that the amount of any Operational Risk charge should be reduced by

any amounts of calculated residual risk occurring within an institution's credit risk calculation.

## 5. PARA 76, 77 - ELIGIBLE COLLATERAL

### 5.1 Comment

We have two comments in respect of collateral:

- No commodities or commodity-related collateral is allowed (with the exception of gold). This excludes significant elements of the market in collateralised lending (e.g. loans against shipments of oil, sugar, LME warrants).
- The ratings threshold for acceptable sovereign collateral could exacerbate a country's problems in the event of a downgrade, by drying up interbank/repo liquidity at precisely the moment when it might be most needed.

### 5.2 Suggestion

- We suggest that consideration be given to commodity related collateral being acceptable so long as it fulfils the criteria for financial collateral and that it is subject to daily valuation. Obviously, this can only apply to commodities with a ready market, where the commodity does not deteriorate within the time-frame of the transaction (e.g. oil, base metals). Also, certain categories of commodity related paper (e.g. LME warrants) should also be allowable.
- Sovereign credits below BB-, again if they are subject to satisfactory valuation and a prudent haircut regime should be allowable as collateral.
- We suggest that, for sovereigns, in the event of a downgrade which takes any acceptable collateral outside the 'acceptable' threshold, a 6-month grace period should be allowed.

## 6. PARA 159-161 -ADOPTION OF IRB ACROSS ALL EXPOSURES

### 6.1 Comment

We note the EU consultative paper suggests some flexibility in this matter. It is understood that the Basel proposals are only intended to be applied to

"internationally active banks", but history shows that regulators worldwide have implemented previous Basel proposals across all banks in their jurisdiction.

Our concern about the Basel proposal, as currently worded, is that it would prevent banks using only those aspects of IRB which improve their understanding of major parts of their risk portfolio. For example:

- Predominantly retail banks may be prevented from adopting IRB over their retail exposures, because they would be forced (under current wording) to apply it to a small part of their business (or a minor banking subsidiary), which has predominantly sovereign, banking or other wholesale exposures.
- Regional or national commercial banks might benefit from the application of IRB to their, predominantly unrated, corporate and SME portfolios, but they would not benefit from having to adopt such an approach to their international sovereign or bank risk portfolios, where external ratings may be significantly more comprehensive than anything they could develop in-house.

### 6.2 Suggestion

It is suggested that individual institutions be permitted to apply IRB to selected elements of their portfolio at national supervisor discretion (very much as the model approval process works currently in the UK).

## 7. PARAS 164-166 - MINIMUM PERIOD FOR DATA/RATINGS

### 7.1 Comment

The wording suggests that the minimum period extends by a year for each year following transition. This means that unless banks have started in 2001 to collect data, they will have missed the boat – for ever! This will be particularly damaging in jurisdictions for which credit default data collection, modelling and analysis is a relatively new science.

### 7.2 Suggestion

Suggest that the minimum period for data should be fixed at 3 years with ultimate approval of whether an individual institution's data and modelling process is acceptable, subject to individual regulator permission.

## 8. PARAS 232/ 43 –COMMITMENTS

### 8.1 Comment

There appears to be an inconsistency in that commitments require to be weighted at 75%, regardless of maturity, under the Foundation Approach, when under the Standard Approach they are 20% (up to 1 year) and 50% over 1 year.

### 8.2 Suggestion

Suggest that the weightings should not penalise the more sophisticated approach.

## 9. PARAS 547-565 – OPERATIONAL RISK CAPITAL (NON-BANK FINANCIAL INSTITUTIONS)

### 9.1 Comment

- In the EU implementation, it will be critical to identify how the operational risk charge will be applied for non-bank financial institutions. The purpose of capital requirements for such institutions is fundamentally different than for banks. Capital is required for them to ensure that they have sufficient resources to ensure an orderly wind-down/transfer of their business in the event of difficulties, whereas for banks it is to ensure the continuing repayment performance for deposits.
- We note that the consultative document on OR (para 50) raises the question of the allowability of insurance and other OR risk mitigation techniques will be subject to further investigation.

### 9.2 Suggestion

- For non-bank financial institutions, it is suggested that the OR charge be expressed as a percentage of their Expenditure Requirement, rather than a turnover-based number.
- We would strongly support that insurance from suitably rated companies should be allowable as capital subject to appropriate haircuts. Such haircuts could be based on minimum payment periods in the event of a claim and also on past claims history of both the insurer and the insured.

## 10. PARAS 553- 554 - OPERATIONAL RISK CAPITAL

### 10.1 Comment

The calibration benchmark for the Standardised Approach is postulated at 20% of Minimum Regulatory Capital. Does the FSA intend to apply this number to MRC before application of trigger and target ratios, or after? Will the overall approach within EU be harmonised?

The overall level of this charge appears to be very high, relative to industry comments that 5-10% of MRC is closer to the real number.

### 10.2 Suggestion

We understand that detailed work is being done by both FSA and the Basel Committee on the calibration of the OR charge.

We also suggest that, in order to level the playing field across Europe, that regulators agree that current target and trigger ratios, if applied, will be adjusted downwards to compensate for the operational risk charge.

## 11. PARAS 581-585 - TRADING BOOK CAPITAL FOR SPECIFIC RISK AND CREDIT RISK MITIGATION

### 11.1 Comment

We note the possibility of there being anomalies between the calculation of specific risk in the trading book (for banks and corporates) relative to the new suggested treatment for the banking book.

It also appears that there is an anomaly between the treatment of credit derivatives in the trading book versus the banking book where exactly matching total return swaps in the trading book will be given 'full allowance' (para 584), whereas in the banking book minimum 'w 'is 15% (para 145). On the other hand, qualifying credit default swaps also have a minimum 'w' of 15% in the banking book, but have an equivalent deduction of 20% in the trading book.

We note also that the cap on counterparty risk weighting at 50% is to be removed from the banking book but no mention of it is made for the trading book.

## 11.2 Suggestion

We suggest that anomalies, where they are illogical, should be removed. However, where they are logical, they should remain.

The trading book should have risk weighting advantage because of the short-hold and minimum daily valuation that applies across the whole of this book.

## 12. PARAS 633-674 – DISCLOSURES

## 12.1 Comment

We note, and support the underlying philosophy behind the need for increased disclosure. However, we question, on a cost benefit basis, whether such disclosures will need to be confirmed by external auditors or not.

## 12.2 Suggestion

We suggest that factual financial data only should be verifiable by external auditors.

Other textual and, model-based disclosures, should not be subject to such external verification but should be covered by a more general statement of compliance from a bank's senior management that such disclosures agree with facts and numbers provided to the regulator.

## 13. GENERAL – EU IMPLEMENTATION

## 13.1 Comment

It is noted that the EU implementation will need to cover not just banks within the EU but also investment firms. This will mean that the EU's implementation will probably be more complex than the Basel proposal whose target audience is 'internationally active banks'. Much has been written in the press about the

difficulties of trying to shoe-horn the Basel proposals into the EU's 'CAD 3' timetable.

The difficulties that the EU will face with implementation are similar to those of all regulators around the world: effectively, how to apply rules that have been written with large international banks in mind to banking and other regulated markets in which the majority of the players are neither 'large' nor 'international' nor, even necessarily, 'banks'.

### 13.2 Suggestion

The EU could take a lead here and allow national regulators only to apply Basel 2 to nominated banks within their jurisdiction, according to the Basel timetable. The list of such banks could be made public. If there was advantage perceived by other banks in applying the Basel proposals to their book of business, then they could apply to their national supervisor for permission to adopt this approach.

In this way, Basel 2 could be made to apply to those institutions for whom it was originally intended, without affecting the vast majority of national and regional financial institutions for whom the proposals were never originally designed and on whom their application is likely to prove a considerable burden.

If large international banks then 'cry foul' that they are the only ones to whom the new operational risk charge would apply, the response can be that national supervisors would take this into account in their setting of target and trigger ratios, where applicable.