Standard & Poor's Response to The New Basel Capital Accord

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Executive Summary

This document represents Standard & Poor's continued commitment to active participation in the evolution of The New Basel Capital Accord (New Capital Accord). It highlights our concerns and comments in the following areas:

- Weightings under the Standardised Approach,
- The eligibility criteria and implementation considerations for external credit assessment institutions (ECAIs),
- Issues surrounding the Internal Ratings Based Approach (IRB), notably the possible increased cyclicality of such a method,
- Treatment of Project Finance,
- Treatment of Asset Securitisation,
- Operating risk, and
- Market Discipline and Disclosure.

Within the Standardised Approach, we hold to our view that claims on public sector enterprises and banks should be judged on their merits alone, and not on the basis of their sovereign of incorporation or the nature of the institution. We remain concerned that weighting unrated assets better than high-risk assets will reduce, rather than enhance, credit risk transparency. We support a super-weighting of over 150% for all unquoted equity participations, private equity participations and venture capital given the traditional risks and funding of such participations. S&P recommends that any use of short-term ratings to impute long-term ratings and thus risk weightings, should be used in the most conservative possible fashion.

Eligibility criteria for ECAIs and the use of ratings are sensitive subjects. We believe it is in the market's best interest to ensure as transparent a mapping process of agency ratings to ratings default performance as possible, over as long a time frame as possible. The consistent use of rating agency mappings across borders may be difficult to ensure in light of the national supervisory discretion permitted in these matters. The treatment of multiple ratings on an obligor warrants revision if regulators wish to discourage banks from selecting ECAIs according to the highest rating instead of the most accurate.

Within the IRB Approach, we present data demonstrating the risks of basing capital on one year's rating performance, and recommend that appropriate levels for capital focus on a recessionary scenario and a possible period of illiquidity that could accompany it.

Standard & Poor's is skeptical that the IRB Approach can be effective in the determination of capital for asset securitisation given the variety of techniques, structures, and legal jurisdictions involved. It is impossible to arrive at rules that will remain both relevant and binding in a rapidly evolving market. For these reasons, we recommend that the Standardised Approach be used for asset securitisation, even by banks qualifying for the IRB Approach in all other regards. The current proposals, in their attempt to encompass all jurisdictions and structures, are entirely too punitive for many structures which fall into these categories in form but not in substance. In order to avoid the competitive pressure that may be imposed on rating agencies to relax their criteria, Standard & Poor's recommends required disclosure of performance data on rated transactions in order that regulators, banks and investors might judge for themselves the appropriateness of the ratings assigned over time.

Standard & Poor's is supportive of the Basel Committee's (the Committee) work on operational risk, disclosure, and supervisory oversight. Our chief concern is that the sophistication of the operational risk measure may be more apparent then real, and may lead to false confidence that these risks are covered.

Introduction

Standard & Poor's welcomes the opportunity to continue to present our views on the New Capital Accord as it evolves. We appreciate that many of our comments on the first round draft were taken into account in the second round proposals, and have found our interim exchanges with various of the Basel Subcommittees and taskforces to be fruitful. We will not re-iterate in this response material that has been presented elsewhere. However, we hope that the Committee and its members will appreciate our need to emphasize some comments previously voiced, as well as to highlight key points that are more pressing this time around, given the imminence of the final capital adequacy standards. We will only comment on those subjects where we believe Standard & Poor's opinions add value to the process.

The organization of our comments has been designed to follow the outline set out in The Consultative Document entitled *The New Basel Capital Accord* dated January 2001.

Part 2. II Credit Risk- The Standardised Approach

A. General Rules

1. Individual Claims

<u>(ii) Public Sector Entities (PSEs):</u>

Standard & Poor's recognizes in the categorization of possible examples of types of PSEs that many of our previous comments were taken into account. Nonetheless, the document has retained 'national discretion' over whether PSEs are weighted the same as governments, one category lower, or based on ratings from ECAIs. Moreover, it suggests that where a country uses this discretion, supervisors from other countries may weight claims on such institutions in the same manner. Standard & Poor's continues to believe that it is both inappropriate and misleading to evaluate automatically public sector entities as risks equivalent to, or one category lower than, the sovereign rating. We are concerned that this will discourage, rather than encourage, greater attention to the assessment of credit risks among banks using the Standardised Approach. Given the discretionary treatment at the national supervisory level, banks and borrowers alike could end up with significant inconsistencies in the treatment and thus weighting and pricing of their risks, inconsistencies which would abet competitive inequalities and hinder transparency.

The economic role of governments in many countries is undergoing considerable transformation. Increasingly, governments are relying on market mechanisms to address the inefficiencies of the public sector. Even where privatisation is not currently on the political agenda, policymakers worldwide are showing a growing tendency to expose remaining government-supported entities to market discipline.

In recent years, Standard & Poor’s has adjusted its methodology for rating government-supported entities to reflect these trends. Whereas twenty years ago, ratings of such institutions were most often equalized with the ratings of their owner-governments, Standard & Poor's analytical approach has shifted towards: (i) an increasing focus on the “stand-alone” credit quality of the entity; and (ii) determining the durability of the entity’s links with the government. This approach aims to ensure that government support is measured consistently and, where there is evidence that support is being reduced, that greater weight is given to stand-alone credit factors when determining the appropriate issuer rating.

Standard & Poor’s analytical approach reflects:

- evidence in a growing number of countries of a reduction in government commitment and support for public sector enterprises. The privatization of enterprises, including entities once thought to be a permanent part of the public sector, are now relatively commonplace. Occasional defaults of public sector enterprises have been allowed to occur. Many governments’ official statements of support for public sector enterprises have become weaker or less clear-cut.

- the widespread sale of state enterprises and policy developments such as competition policy in the European Union (EU), which not only are encouraging privatisation but, equally important, are discouraging the use of government guarantees and other forms of ongoing state support.

Regardless of the outcome of the deliberations on this subject, and the ultimate treatment chosen by national supervisors, Standard & Poor’s will continue to look at state’s obligation to these PSEs as contingent liabilities when we believe the government has a legal or moral obligation to support them. To the extent that we believe the government is effectively providing its implicit guarantee or safety net to these institutions by giving them preferential regulatory treatment, we will continue to add these effective contingent liabilities to the debt burden of the sovereigns in question.

(iv) Claims on banks

Option 1 for the treatment of claims on banks would, in Standard & Poor’s view, penalize better-quality banks and could benefit weaker institutions. If a sovereign were rated ‘AA’, for example, the highest rating any bank could get would be ‘A’, which would penalize banks with higher ratings, while weaker banks that might be rated ‘BBB’ would also be treated as ‘A’ rated. Use of this method might also implicitly suggest that the sovereign would come to the rescue of any regulated bank, a development that could be negative for the sovereign’s creditworthiness and that is also at odds with the worldwide trend toward less government support for banks.

Standard & Poor’s strongly prefers Option 2. It has the merit of assessing banks individually, even though the 50% weighting for unrated banks would reward banks that would achieve lower ratings on their own. An alternative proposal could be to apply the second option and revert to the first option if a bank is unrated. The proposal to treat securities firms the same as banks would make sense only if the second method is chosen and the risk weighting is based on these firms’ own

ratings, since there is little reason to suppose that sovereigns would support most securities firms.

Short-term bank claims

The proposal of the New Capital Accord to shorten the maximum maturity for preferential treatment to three months from the six months offered in the June 1999 Consultative document would help to limit the potential negative effects by reducing the amount of interbank financing that qualifies for the preferential treatment, but it will not eliminate the incentive to fund short-term. It might even push banks to shorten maturities further. A solution that might counterbalance the negative consequences of this proposal is to limit the preferential treatment to the highest-rated entities and expand it across industries to include corporates and sovereigns as well as banks.

(vi) Claims on corporates

Standard & Poor’s appreciates the Committee’s recognition of the lack of differentiation among corporate risks by the inclusion of an additional risk bucket (50%) for corporates. However, we would highlight the fact that this new category continues to encompass a relatively large range of default probabilities.

The Committee’s most recent draft retains a lower risk weighting for unrated corporates than for lowly rated exposures. Standard & Poor’s recognizes that the Committee did not want to penalize small and medium-sized businesses (SMEs). This weighting is equivalent to a default rate per asset of 8%, assuming a three-year average default rate, which effectively attributes these assets with risk characteristics in the BBB category. Standard & Poor’s bank rating business and the portfolio analysis we do for collateralized debt obligations (CDOs) demonstrates that most banks’ corporate portfolios are, on average, of somewhat lower than BBB quality. This provision may leave banks undercapitalized. In addition, Standard & Poor’s reiterates the financial incentive this provides to banks to reduce information, and thus transparency, on the credit quality of bank assets.

Standard & Poor’s also recognizes that the new draft allows individual supervisors to consider whether the corporate claims held by individual banks should warrant a risk weighting of higher than 100%. We applaud this, but warn that, like the treatment of PSEs and national discretion for the treatment of bank claims, such discretion only encourages the differential treatment of banks by national supervisors, decreasing rather than increasing the level of competitive equality across banking systems.

(viii) Claims secured on commercial real estate

Standard & Poor’s believes that the exception granted for some, conservatively underwritten, commercial real estate loans where historic losses are low, to be inappropriate. Standard & Poor’s will continue to evaluate banks’ capital bases with an eye to the need to have strong capital backing for commercial real estate exposure and would regard negatively regulations that permit commercial real estate backed loans, subject as commercial real estate is to repeated bouts of illiquidity and price volatility, to receive preferential capital weighting. Standard & Poor’s does accept commercial real estate as collateral for securitised transactions, where we

believe appropriate credit enhancements, cash flow tests and legal protections can make these assets useful collateral. Only where similarly stringent tests were in place for commercial real estate as loan collateral could Standard & Poor's be comfortable with the use of these assets to back loans.

(ix) Higher-risk categories

Past Due Loans

To recognize that past due and doubtful loans warrant higher weightings is logical, especially where losses are expected but have not yet materialized. However, this could be counterproductive to the extent that it may 1) discourage banks from placing loans on 'past due' status, and 2) discourage adequate provisioning where discretion is permitted, when a bank knows that the loan is going to be 'super-weighted' *after* provisions.

Venture capital and private investments

Equity participations, investments in commercial entities, investments in deconsolidated entities and venture capital, while they may differ somewhat, all have relatively high risk profiles. Yet merchant equity and participations will potentially be risk weighted at 100%, and capitalized at levels no better than a BBB rated loan. While the New Capital Accord would grant national supervisors the right to apply a 150% or higher risk weighting to venture capital and private equity investments, Standard & Poor's views these as high risk categories that should receive an over weighting on a mandatory basis. Even at a 150% risk weighting, the capital requirement would, in Standard & Poor's view, be extremely low given the risk profile of the asset and the fact that other major players in the industry, namely the private equity funds, are generally capitalized with 100% equity.

2. External Credit Assessments

In our comments on the first proposal, Standard & Poor's explained its concerns with implementing the recognition criteria and process on a country-by-country basis. We ask the Committee to reconsider our earlier comments as many of our concerns remain under the New Capital Accord. In particular, we are concerned about how supervisors will exercise their judgment in applying and interpreting the criteria, and the risk of inconsistent interpretation and application across countries.

Standard & Poor's agrees with the Committee that supervisors should continue dialogue with market participants on this topic. Since the Committee released the draft New Capital Accord, we have met with numerous supervisors, including in countries where ratings usage has been in place for many years without any recognition requirements. We strongly request that the Committee take an active role in formulating specific recognition criteria and impressing on supervisors that the recognition process be open, fair and consistently applied across country lines. Supervisors should publish their criteria and explain the recognition process. They should also publish their list of recognized ECAIs.

We are aware of, and welcome, the idea that a ‘college of supervisors’ be established under the Committee to help in the implementation of consistent ECAI eligibility, mapping and the IRB Approach across countries. Nonetheless, to the extent that this equivalency can be put in place at the outset as a guiding principle, we believe that this would be consistent with fostering a fair competitive environment.

Standard & Poor’s generally agrees with the eligibility criteria with the following reservations. The back testing requirement to determine objectivity is unclear. Given that back testing is limited to a one-year requirement, and that period is insufficient to determine the performance of a ratings scale, Standard & Poor’s is unclear how regulators will conduct a review of the methodology, and how judgments of objectivity will be made. A 3-year period is more appropriate to determine the quality of rating performance, though even three years, which did not encompass a period of recession, could produce skewed results (see discussion of the IRB Approach below for an explanation using S&P’s default data).

Standard & Poor’s has previously emphasized that in order to retain credibility in the capital markets, ECAIs must remain independent of regulatory influence. The Committee should urge caution against regulatory approval processes that allow for regulatory influence over rating methodologies. Such influence can occur in subtle ways and can create pressure on an ECAI to change operating procedures that are fundamental to its business, thereby affecting the ratings assigned. A test for objectivity that permits regulatory influence over methodologies would defeat the goal to use only the ratings of reputable, credible, and independent ECAIs. In fact, the additional test in the New Capital Accord - to consider the reliance of independent parties’ (investors, insurers, trading partners whose prudential interests are aligned with those of the ECAIs) on ECAIs’ assessments as evidence of their credibility - should also apply in evaluating their independence and objectivity. Standard & Poor’s believes a “market usage” test is consistent with the Committee’s research, reflected in its working paper, *Credit Ratings and Complementary Sources of Credit Quality Information* (August 2000, pgs. 49 - 51).

Standard & Poor’s notes that the European Commission’s (the Commission) *Second Consultative Document on Review of Regulatory Capital For Credit Institutions and Investment Firms* (January 2001), raises additional ECAI recognition process issues that are important in the EU context (paragraphs 97 - 98). Specifically, the Commission proposes 2 alternatives - “full” or “ “bounded” recognition - for Member States to consider in deciding which ECAIs to recognize.

Standard & Poor’s addressed these issues in its earlier comments to both the Committee and the Commission. To the extent ratings are used in capital adequacy regulations, we agreed with the Commission’s concerns that allowing each local supervisor to control the recognition process could lead to competitive distortions. Furthermore, we urged the Commission and the Committee to establish a body or affirm the ability of an existing central authority to decide which ECAIs to recognize as well as the recognition criteria.

The Commission’s second proposal does not specify the idea of centralized recognition and the two alternatives allow Member States different degrees of discretion in recognizing ECAIs. While we have concerns about a country-by-country recognition process, we are uncertain how onerous the obligation could be under the “full approach” to automatically accept local rating agencies that other Member States previously recognized, even if such recognition only extends to rated exposures in the Member State that recognized the agency. Standard & Poor’s continues to urge the Committee and the Commission to implement a uniform

recognition process for all countries and, at least, for all international rating agencies, for practical, economical and efficiency purposes. In this regard, we strongly agree with the Commission's directive that, whichever recognition process is used, "Strong common standards for both recognition and for the mapping of the ECAI ratings into a common scale are a necessary minimum requisite for recognition of ECAIs between jurisdictions under either scenario." (paragraph 98)

Disclosure and Reporting

Given the divergence in rating scales and what they denote, even incremental disclosure of both qualitative and quantitative information by ECAIs will make comparisons difficult and the comparability of disclosure across banks problematic. With respect to the required disclosures in Annex 1 to "The Standardised Approach to Credit Risk" (a supporting document), ratings provide significant information about the potential for credit deterioration or default over a range of time frames, and as such, the "point in time" versus "through the cycle" distinction appears to grossly oversimplify time horizon considerations. While we support these disclosure requirements, it is important to recognize that they need to be compared through an objective barometer of risk or will be useful only as a comparison with their own performance through time.

Annex 1 calls for disclosure of the definition of default. Standard and Poor's agrees that understanding the definition of default upon which ECAI ratings or internal bank ratings are based is vital to understanding and interpreting ratings performance, and therefore essential to the tasks assigned to regulators of mapping ratings to risk buckets. Definitions of default may vary among ECAIs, adding complexity to the regulatory task of assuring reasonably consistent mapping processes, and consistent bank capital measurement across different regulatory regimes. Regulators should also be aware that other aspects of the ratings definitions both of ECAIs and banks, and rating criteria, could vary materially, adding additional complexity. For example, ratings provided by local rating agencies and national scale ratings provided by global ratings providers may exclude, to varying degrees, direct elements of sovereign-related risk.

3. Implementation Considerations

(i) The mapping process

The principles by which the ratings of ECAIs are 'mapped' into the risk buckets under the Standardised Approach are central to the accuracy and efficacy of that method of capital sizing for credit risk. As yet, other than for our own ratings, the mapping exercise has not been published for any other rating agency. Standard & Poor's believes that a few guiding principles for this mapping need to be made clear in the New Capital Accord from the outset.

First, the mapping exercise should be universal for any agency that operates internationally. Standard & Poor's believes that the Committee's intention of allowing local regulators to map external ratings to risk buckets may result in inconsistencies in capital measurement across countries. These inconsistencies may be material in the mapping of national ratings scales to the risk categories in the Standardised Approach, as these risk categories are not defined in terms of default probability.

National discretion in mapping could lead to different countries using the same ratings in different ways.

Similarly, while Standard & Poor’s believes the well-documented performance of its ratings and related criteria could serve as a means of mapping the performance of internal risk ratings systems, variable standards by which this mapping is evaluated or accepted, could result in inconsistency in the regulatory appraisal of IRB systems.

Only demonstrable ratings performance statistics should be permitted for those agencies wishing to operate internationally. The requirement for ECAIs to report and publish their default statistics over time should help to improve transparency and accuracy for all ECAIs, including those not currently in a position to produce such data. We also recommend that regulators responsible for certifying eligibility of the ECAIs treat data in the early years with some skepticism, as the predictive power of ratings that have yet to perform through a recessionary period may be overstated.

Standard and Poor's understands that various regulatory taskforces are at work to define the details of mapping bank and ECAI ratings to risk buckets, and to develop guidelines for regulators around the world to conduct this mapping process. Standard and Poor's has provided some guidance to these groups and hopes to play a continuing role as it pertains to the mapping of our own ratings, and to the mapping process in general.

National scale ratings

Standard & Poor’s notes that there are increasingly divergent practices in the ratings industry with respect to national rating scales. Some external credit assessment providers intend their local scales to be relative rankings of local companies’ creditworthiness, without any meaningful component of absolute creditworthiness. Such ratings may remain stable or change only marginally despite material credit deterioration so long as the relative ranking of creditworthiness within the country is maintained. Local rating scales based on this intent could be misleading if relied on in the context of the Standardised Approach. In many countries, differentiating the performance of these scales is obscured by their relatively short performance history. Standard & Poor’s urges the Committee to consider methods for local regulators to differentiate national rating scales based on the intent of the scale, as well as the scales performance, in the benchmarking process.

(ii) Multiple assessments

Competition for the highest rating

The Committee is surely aware that the use of ratings in regulation has the potential to turn the ratings product into a commodity. Standard & Poor’s remains concerned that the proposals create both meaningful rating disincentives for corporates and banks, and, more importantly, bias the rating selection process by banks to higher or more liberal ratings. Standard & Poor’s notes that the rating disincentives to companies that rely predominantly on bank financing may be significant. By weighting unrated corporates in the 100% risk bucket, the proposal seeks to maintain some continuity between the 1988 Accord and the new one, but this may retard the development of ratings at the lower end of the credit spectrum. Similar disincentives exist as a result of the 50% weighting of unrated banks.

Moreover, the standards recommended for interpreting situations where multiple ratings are outstanding provide a clear bias for the market to select higher and more liberal ratings. Cases three and four in Annex 2 of the Standardised Approach supporting document seem to encourage the use of higher ratings, a peculiar decision in light of the Committee's desire to discourage ratings shopping. By encouraging regulators to rely on the two highest ECAI assessments, the Committee would be encouraging the market to rely on relatively weaker credit standards. Standard & Poor's again urges the Committee to review whether certain of these proposals could undermine the effectiveness of ratings systems in their primary role, that is to support the development of the capital markets. Ideally, the Committee would align the incentives inherent in the proposal with those of securities market regulators, or at least identify and reduce areas of potential conflict, as they pertain to the role of ratings in capital market development.

(iv) Short-term/long term assessments

Standard & Poor's short-term ratings correspond to an overlapping range of long-term ratings, and do not translate consistently into the risk buckets for banks or corporates as defined in the standard approach. For example, the A-2 short-term rating corresponds to a range of long-term ratings from A to as low as BBB-, and could fall into either the A+ to A- or the BBB+ to BB- corporate risk buckets. Thus, inferred long-term ratings that are deduced from public short-term ratings could be inaccurate, and Standard & Poor's advises against their use. However, if the Committee is intent upon allowing local regulators to infer long-term ratings from short-term ratings in those cases where long-term ratings do not exist, Standard & Poor's encourages the Committee to incorporate conservative standards for doing so. A-1+ ratings would equate to the long-term ratings of AA- and above, A-1 short-term ratings would equate to A or A+, A-2 to A- and BBB+, A-3 to BBB and BBB-, B to BB+ through BB-, and C to below BB-.

Standard & Poor's is not convinced that the universe of short-term ratings without long-term ratings is sufficiently large to warrant a translation of short-term ratings into the Standardised Approach risk buckets. As an example, in our European Industrials group, only 17 of almost 400 clients have opted to publish their short-term ratings only.

Asset-backed commercial paper is perhaps the exception to this. In this case, because of the short-term nature of the paper and the single purpose nature of the issuing vehicle, a short-term rating would be the only one ever assigned to the vehicle. The use of the correspondence between long-term and short-term ratings suggested above might make a significant difference to the percentage of bank assets that would be able to be treated as rated under the Standarised Approach.

As a matter of principle, Standard & Poor's would be more comfortable with short-term ratings being used for short-term obligations, as our time horizon is shorter in assigning these ratings and they are intended only to address debts due within one year. We recognize that, in the proposals as currently drafted, this is not a possibility since short-term bank facilities are the only assets where maturity will be recognized. As stated in the section on short-term bank assets, we encourage the Committee to reconsider the treatment of all classes of short-term assets, permitting only the very highest quality short-term assets, across asset classes, to receive preferential treatment, so as to discourage the short-term funding of less creditworthy borrowers.

(v) Level of application of the credit assessment

We applaud the fact that the Committee has recognized that members of a corporate group may be of differing levels of credit quality. However, where an explicit guarantee exists, it may be possible to extend the rating of the issuer to the guaranteed subsidiary (as is the case under paragraph 181 of the Credit Risk Mitigation section). In the examples section, the weighting for such an asset would be 32%, as it would be the weight of the guarantor plus the *w* (0.15) factor. We would hope where Standard & Poor's had rated the guaranteed transaction, and therefore checked the documentation and legal opinions, that such a transaction would be given the weight of its rating and not its rating plus the *w* factor.

(vi) Unsolicited ratings

Standard & Poor's agrees that ECAIs should disclose which of their ratings are solicited versus unsolicited. We also recognize that we are the only international rating agency to disclose this information on an ongoing basis as a subscript ("pi") to our ratings symbols. We believe these ratings add value to investors and developing capital markets, particularly where there is no other published rating on an obligor. Standard & Poor's also recognizes that there are inconsistencies across ECAIs in the interpretation of what is a solicited and what is an unsolicited rating. Nonetheless, credit assessments, responsibly based on public information and a sound analytic process, and clearly identified, do provide a market discipline, and we would be wary of limiting ECAIs from providing this service to market participants. We urge the Committee to present a consistent standard in this regard, and to require disclosure of the information used and the process followed in assigning and monitoring unsolicited ratings.

B. Credit risk mitigation in the Standardised approach

Standard & Poor's cautiously supports the New Capital Accord's broader framework addressing the types of collateral and credit risk hedging techniques that are designed to reduce credit risk. The framework reflects the sustained development of these techniques in the 12 years since the current capital accord was put into place, and the advantage these techniques bring to the management of credit risk. Standard & Poor's supports the current proposals on collateral, which do not give credit for real estate secured loans, other than for single-family mortgages or those pledged in structured transactions such as *Pfandbriefe*, or for loans secured by illiquid securities[1]. In addition, the legal infrastructure and a bank's claim to the collateral must be strong, and the bank must have the appropriate internal information systems in place to track the collateral. While these conditions are sensible and prudent, as pointed out above, supervisors will shoulder the potentially heavy burden of ensuring that banks are sufficiently equipped to monitor and control the market risks and operational risks inherent in the use of collateral to hedge credit risk.

The proposed haircuts in the comprehensive approach and the introduction of a floor capital requirement – the famous *w* of 0.15 – appear to reflect appropriately the risks associated with establishing title to the collateral and the risks of volatility of collateral value and liquidity of collateral for deeply traded markets, although the

[1] Use of these and other assets as security for asset securitisations, where adequate credit, liquidity, and structural supports are added to enhance the underlying collateral, can be appropriate.

framework needs to be tested on a variety of portfolios under different scenarios. Clearly, the more the market for the collateral is volatile and thinly traded, the greater the importance of the credit risk of the underlying exposure. In most debt and equity markets outside of the major global capital centers, trading volumes are often thin and liquidity risk is great. This is particularly true in mid-sized mature markets and almost all emerging markets. Consequently, Standard & Poor's considers the simple approach to be more applicable for all markets where liquidity is uncertain. In general, as trading volumes and prices can change rapidly in a short period of time, additional responsibility will fall on supervisors to ensure that banks adhere to the requirements for haircuts, marking to market collateral on a timely basis, and matching duration of the hedge with the underlying credit exposure.

With respect to credit derivatives, Standard & Poor's would note that while credit derivative transactions could be effective mechanisms for risk transfer; it is hard for outsiders to quantify the amount of any capital credit, which would depend on the extent to which credit risk is actually transferred. To the extent that the market supports a range of risk transfer in such transactions, a variety of responses are appropriate. The regulatory burden of surveillance will be substantial as these techniques become widespread; the service provided to the markets in insuring that there is an independent assessment of their effectiveness will be commensurately great.

III. Credit Risk - The Internal Ratings Based Approach

<u>Capital for average probabilities of default (PD)</u>

Standard & Poor's believes that capital should be able to withstand an unexpected, rather than merely an expected level of credit losses. In other words, banks should be able to get through a recession of some magnitude to be considered investment grade. How severe a recession the bank is deemed to be able to survive will then determine what rating level it will achieve. We are concerned that basing capital on an average level of PD will dilute the picture of what could happen in years of recession, when the PD can become a multiple of the average level. Our own data on default rates portrays this phenomenon. During the last recession, in the 1990-92 period, the PD for a three-year time horizon rose dramatically, to 1.6 to 15 times the average levels, depending on the rating level (see table). One can only presume that bank corporate loan defaults follow similar patterns. One can also presume that, as the 1991 recession was a fairly mild one, the experience would be worse in more severe recessions. Because recessions cannot be predicted very far in advance, we believe that capital should be maintained in expectation of a possible recession at all times. By the time a recession is diagnosed, it is frequently too late to raise capital on advantageous terms. In any case, banks have not generally tried to raise capital levels before losses began to erode existing capital, and market confidence in them has been fairly beaten down.

Default Rates for static pools 1981-00

	CCC	B	BB	BBB	A	AA	AAA
1 Year Average rate	21.94	8.3	.94	.22	.05	.00	.00
3 Year Average Cumulative	34.37	21.00	4.62	0.74	0.17	0.00	0.03
Minimum (3 yr)	6.67	8.24	1.22	0.00	0.00	0.00	0.00
Maximum (3 yr)	58.33	24.38	14.18	2.99	1.15	0.86	0.45

A related issue is the period of time over which data would need to be collected to calculate the average PD. We strongly urge that the data be required to encompass a recessionary period. Even estimation techniques for extrapolating performance data back to periods before the bank began tracking such data are preferable to not incorporating a recession at all. At the moment, a five-year period would reflect a sustained period of robust economic growth, yielding no indication of what a recession might bring. In fact, currently, use of data from the most recent period alone might yield a more conservative result than use of the whole five years.

Stress testing would be helpful in incorporating a recessionary scenario in capital. However, guidelines are required to address how the results of the stress tests should be incorporated into the capital calculation. A simpler approach would be to simply focus on PD experience exclusively in recessionary periods.

Absent use of a recessionary scenario, the substantial risk sensitivity of the IRB Approach could imply changes over time in the capital required for particular assets as their quality varies over the course of an economic cycle, particularly if the ratings upon which they are based are cyclical rather than "through the cycle". Not only is capital expensive and not always available in stressful periods, but also the effect on markets may prove procyclical.

Maturity horizon

The Advanced IRB Approach holds out the possibility of assessing capital based partially on the maturity of the loan. Standard & Poor's prefers the assumption of a 3-year life, as in the Foundation Approach. This is because we view lending as essentially a relationship business. Loans are made in the expectation of rolling them over, especially in more difficult economic times, when liquidity is tight, and borrowers are unable to raise funds elsewhere. Banks are also often tempted to try to work with a borrower once difficulties arise, in the hopes of increasing their chances of being repaid eventually. Based upon observations of credit cycles, both in terms of bank loss data and our own default data, we believe periods of heightened credit losses, during which liquidity is tight, would last about three years. Therefore, we like to assume banks need capital to cover recessionary levels of cumulative losses for a three-year period.

Operating banks are not static portfolios

Given the confidence dependent nature of the banking business, we also believe that it is insufficient for banks to think in terms of capital covering only the worst-case loss scenario. Bank portfolios are not closed end pools. To remain an operating entity with access to market funding, banks need to have some minimal level of

capital after covering worst-case losses. That level of capital might be thought of as able to support a reduced amount of risk exposures at a desired rating level.

<u>Risk weights based upon PD assumptions</u>:

The substantially broader range of risk weights for varying internal rating levels is a major improvement over the one-size-fits-all approach of the prior Accord. However, we are concerned that the risk weight (RW) does not increase as rapidly as the corresponding PDs do, so that effectively, capital coverage of assumed losses declines as the PDs reach the higher ranges.

For example, for loans with an average 1-year PD of 20% (corresponding to a CCC rating), the minimum Tier 1 equity capital would be 25% (625% RW times 4% Tier 1 capital). In a recessionary year, according to our statistics (see table), that portfolio of CCC loans could suffer losses of 40%, so minimal capital would provide only 1.25 times coverage, assuming an LGD of 50%, unless reserves were available to cover the expected 20% loss. Additionally, if one saw the recession lasting 3 years, during which the portfolio remained illiquid, the cumulative default could rise to 52% and the loss to 26% (50% LGD), exceeding the level of capital.

At the lower PD levels, for example the 0.7% level (which corresponds to a BB rating) with a risk weight of 100%, minimal capital would be 4%, for 2.9 times coverage of the average expected one-year loss (with 50% LGD). A recession level of loss would be about 2.0%, for 2 times coverage, while the three-year cumulative loss in recession would be about 4%, equaling capital. With unequal loss coverage requirements, the return on risk could still be seen to increase with the risk of the loans, and some (albeit nowhere near as much) of the incentive remains for banks to tier down to riskier borrowers, and eschew the more creditworthy borrowers.

Therefore, we recommend that the slope of risk weights track the slope of the increases in PDs more closely. We also recommend that Tier 1 minimums be calibrated in such a way that the recessionary maximum cumulative loss levels for three years depicted in the table above be covered by Tier 1 capital plus general, or unallocated reserves (if some international comparability of general reserves can be achieved). Such levels would be consistent with A rated banks, a level to which most mature market banks aspire. For a minimally investment grade rating, capital levels of perhaps 25% less would be appropriate.

These levels would be higher in the non-investment grade range than those contemplated in the current Foundation IRB Approach. Other than the time horizon issue and the focus on average rather than recessionary levels of PD, we believe that the difference in capital levels rests on the difference in approaches between the structured loan pools, such as CLOs, and operating companies. It is insufficient for operating companies to merely cover worst-case losses. They must retain sufficient capital at the end of the credit cycle to be able to support a, perhaps reduced, but nevertheless similarly sized portfolio, and to continue to make fresh loans. Standard & Poor’s own models for CLO credit enhancement requirements, for example, more closely mirror the levels indicated by the foundation IRB minimums. Another difference is that we focus more on initial, gross losses, rather than estimated losses after recoveries. Assuming that the accounting regime is fairly conservative in estimating the initial loss, an operating bank must be able to withstand that level. Recoveries come usually only after a lag.

Assuming that major international banks' portfolios consist of "BB" rated loans, on average, we do not believe that such levels of capital requirements would be a burden, but would merely bring minimum capital standards more closely into line with actual current levels, with Tier I capital of about 5-6%.

There also appears to be a more onerous capital requirement for non-investment grade loans under the IRB approach than under the Standardised Approach. Under the Standardised Approach, loans rated below BB- are risk weighted 150%. The risk weights under the IRB approach would range between 192% for a BB- loan (corresponding to a PD of 2%) and 625% for a CCC loan (corresponds to a PD of 20%). Similarly, loans rated between BBB+ and BB- are risk weighted at 100% under the Standardised Approach, while they would fall into the 29% to 192% range under the IRB Approach, with BB and BB- loans receiving weights over 100%. Banks with significant amounts of non-investment grade loans thus may well prefer to stick with the Standardised Approach, unless there were more substantial relief for the very highly rated exposures to offset that effect. It would not, however, be advisable to lower the risk weights for the riskier loans, given their already low coverage levels.

Project Finance

Standard & Poor's has a long history of rating project finance transactions in most major geographic regions of the world. We have found that our method of analysis and results are relatively similar to those used by banks, whether the individual transactions are rated or not. Two aspects of our approach, however, tend to diverge significantly from most bank approaches. First, Standard & Poor's adheres to the notion that project finance debt is inherently a put option that gives the sponsor the option to walk away from the project (as some have in the past) if the economics of the transaction deteriorate; as a result, Standard & Poor's assigns very little weight, if any, to sponsor reputation when assessing project finance risk. Second, Standard & Poor's does not use a "scoring-based" model of analysis because project finance, in essence, is a form of structured finance. Under this philosophy, even a small deficiency in a deal can outweigh a project's many other strengths because of its serious credit implications – such as the absence of a debt service reserve fund or restrictions on issuing additional debt.

To be economically attractive, from a financing perspective, most of these transactions tend to cluster in the BBB range, though obviously there are some deviations. We have detailed below the key elements that Standard & Poor's looks at in assigning ratings to these projects, which may be useful in the Committee's deliberations on the appropriate way to assess and weight such bank assets under the IRB Approach. Under the Standardised Approach, once rated, these transactions should be weighted as any corporate asset of equivalent rating.

A project company is a group of agreements and contracts between lenders, project sponsors and other interested parties that creates a form of business organization that:

- will issue a finite amount of debt on inception;
- will operate in a focused line of business; and,
- will ask that lenders look only to a specific asset to generate cash flow as the sole source of principal and interest payments and collateral.

Our analytic framework looks at the following issues: project level risk, sovereign risk, business and legal institutional development, *force majeure* risk, and credit enhancements. Assessing project level risk requires six steps:

- evaluate the risks presented by the project operational and financing contracts that serve as the basis of the project enterprise;
- assess the project's technology and performance;
- analyze the project's competitive position;
- determine the risk that various counterparties present to the project;
- appraise the project's legal structure; and
- evaluate the financial risks.

Generally sovereign risk will cause the host country's foreign currency rating to constrain the project rating. Acts or policies of the sovereign may affect the project's ability to acquire the hard currency needed to service its foreign currency debt. In many instances, the business and legal institutions needed to enable a project to operate effectively do not exist in emerging market countries. Hence, institutional risk may prevent a project from reaching the host country's foreign currency rating.

The potential for *force majeure* risk distinguishes project-financed transactions from corporate finance or structured finance assets because of their singular vulnerability. Consequently, *force majeure*, if unallocated away from the project, will limit most projects to the 'BBB' category or below.

Various credit enhancement products that may mitigate project level risks, sovereign risk, and institutional risk, among others, may elevate some project ratings. Targeted insurance products may prevent a project from going into default for specific reasons. But unlike financial guarantees, enhancement packages provided are generally not comprehensive, either for reasons of cost or because such providers are not chartered to provide comprehensive coverage.

Ultimately, a project debt rating identifies the various risks, analyzes their respective magnitude and likelihood of occurrence, and assesses their effect on the project's ability to operate and to pay debt service. Because project finance is supposed to be non-recourse to the sponsor, the sponsor's reputation, its creditworthiness, or both, rarely influence the rating. Moreover, projects should be structured so that the only risk to project cash flow should come from the project itself and not from the sponsor. As a corollary, project management should have very little discretion in the operation or financial management of the project.

Subordination

Standard & Poor's strongly supports the concept of economic subordination, where the facility is unsecured and the bulk of the borrower's assets are used to secure other loans. We recommend that recognition of this economic subordination be incorporated in the approval process for IRB systems in all countries where the legal systems would pay the senior debt last in this circumstance. This will also hold in some jurisdictions for holding companies that raise debt, while the bulk of the realizable assets and available cash flow are at the level of the operating subsidiaries.

IV. Asset Securitisation[2]

Standard & Poor’s supports the Basel Committee’s overall view of the risks inherent in asset securitisation for both originating and investing banks. We agree that there needs to be a generally more conservative treatment of capital allocation for residual risks retained or purchased risks in securitisation transactions than has existed heretofore. Recommended disclosure requirements, too, can only enhance market transparency and deepen understanding of these transactions by all market participants. Given the complexity of the transactions, however, the degree of risk transfer and its capital implication may vary materially from transaction to transaction, and is a matter of judgment. In an attempt to make rules that encompass all jurisdictions and structures, Standard & Poor’s is concerned that the proposals, as set out, may be too severe for structures that fall into these categories in form but not in substance.

A natural consequence of trying to categorize all existing transactions is that these regulations will be rapidly superceded by market practice, given the ongoing innovation in this field. By its very nature, asset securitisation thrives on regulatory arbitrage. These factors, together with the complexity of asset-backed analysis by type of asset, legal jurisdiction, structural features, choice of credit enhancement and sophistication of cash flows, make Standard & Poor’s skeptical that the IRB Approach can be effective in the determination of capital adequacy for asset securitisation.

Standard and Poor's has reviewed considerations of implementing both the Standardised and IRB Approaches for securitisations, and will continue to provide information to the existing Basel-related taskforces established to finalize this effort.

Standard and Poor's believes that the reliance on external credit assessments of structured securities, especially for investing banks, is viable, and that ratings of structured securities could be mapped to risk buckets in a framework substantially similar to that presented in the Standardised Approach for other exposures. The mapping problems would be, as with the Standardised Approach, complex, but appear manageable. As a practical matter, ratings coverage of the structured market is extensive. While the rating performance history of structured securities is briefer than that for operating companies, Standard and Poor's research demonstrates that default probabilities of structured securities are similar to, and converging with, the ratings performance of operating companies. (See default studies on structured securities) The recovery history on defaulted structured securities is also limited, given the short history and the limited number of defaults, especially from higher rating levels. However, the establishment of a framework that provides for the secured nature of senior positions, and the subordinated position of junior tranches, could be developed. Standard and Poor's anticipates that its ratings on junior tranches of structured securities will increasingly correlate with post default recovery value. We have shared our criteria on subordinated tranches recovery assumptions with the securitisation taskforce.

Standard and Poor's is concerned that the IRB Approach as it applies to structured securities, even for the analysis of the risks retained by the originating or sponsor bank, will entail considerable complexity and have the potential for significant

[2] Standard & Poor’s has had an ongoing dialogue with members of the Basel Committee Subcommittee on Asset Securitisation. As a result, this section represents only our conclusions, and does not replicate all the comments provided to the Subcommittee on the asset securitisation section of the New Capital Accord.

diversity in application. The approach also appears to place material and complex requirements on supervisors to evaluate structured securities on a transaction by transaction basis in considerable detail to determine capital premiums and premium allocation. However, if supervisors determine capital premiums judgmentally across diverse systems, Standard and Poor's agrees that a formulaic approach could support greater consistency of treatment.

Standard and Poor's cautions against the use of implied ratings, as inferred by regulators, in cases where only the senior tranches of a securitisation are rated. The complexity and diversity of these transactions, as well as the information and analytic requirements necessary to adequately assess the behavior of the cash flow under a variety of asset performance and contractual conditions, may limit the accuracy of implied ratings. Nonetheless, Standard and Poor's will continue to make its criteria and methodologies publicly available to facilitate this process, should the Committee adopt an approach that requires regulators to determine implied ratings. As a practical matter, Standard and Poor's anticipates that our criteria and methodologies with respect to rating structured securities, and other sectors, will be useful to banks and regulators in mapping internal risk assessments with risk buckets, and in conjunction with a mapping process that could help validate internal risk rating systems in the absence of extensive risk rating performance history.

Within the Standardised Approach, a matrix of ratings together with a recognition of the seniority of the rated tranche should be used to determine the risk weighting for the transaction. The seniority of the tranche rated needs to be incorporated in the rating in order to take into account the difference in recovery prospects of senior versus subordinated debt instruments.

Standard & Poor’s agrees with the Committee that the residual first loss, regardless of its form, e.g. excess spread, excess servicing income, or residual stock, should be assigned a full capital deduction. This capital charge however, should not exceed the capital charge that would be determined under the new guidelines should the assets not be securitised. Broadly, Standard and Poor's believes that securitisation facilitates financial intermediation, and believes that, other than reducing or eliminating regulatory capital arbitrage, the new framework should avoid creating economic disincentives to securitisation. Standard & Poor’s also recommends 100% capital against higher risk tranches that have a significant probability of suffering loss in a stressed scenario, such at those rated in highly speculative categories. Credit ratings on individual tranches of securitisations do not normally provide information about the size of a ‘first loss’ since the latter varies by asset class, ratings sought, individual structural techniques and the underwriting standards of the asset seller. Standard & Poor’s recommends that the entire notional amount of securitisations, where all reasonably expected credit losses are to be absorbed by the issuer, whether through withholding of excess servicing income or any other mechanism, be risk weighted at the appropriate level for the assets involved. The capital that would then be required would almost certainly be equal to or greater than the amount of any first loss residual, so that the approach of deducting the first loss piece (or requiring 100% capital against it) would not be inconsistent. However, a ratings based approach to other rated portions of the transactions retained may reduce the level of capital required.

Standard & Poor’s concurs that some capital charge is appropriate for liquidity commitments. Standard & Poor’s generally supports a framework that bases the capital charge on the credit risk inherent in the obligor’s assets that could be funded, adjusted for credit supports, on the expected size of the exposure, and, if possible, on some assessment of the probability of funding. To the extent banks have provided

extensive liquidity support to structured commercial paper conduit programs, Standard and Poor's believes that there is considerable diversity in the credit risk exposure taken by liquidity banks. In many transactions the liquidity bank has been provided with significant protection against loss, consistent with AAA and AA levels of protection, by the financing's structure and credit support. In others, the risk imbedded in liquidity support provision may be greater. Standard & Poor's believes a general rule, without regard to the structure and its protections may tend to penalize banks with significant protection and benefit, from a regulatory capital perspective, banks with greater risk exposure.

Basing capital held against credit risk in asset securitisations on a rating from a single rating agency encourages bank originators and investors to select the agency offering the highest rating and not necessarily the most accurate. In order to avoid placing competitive pressure on rating agencies to relax their criteria or assign the highest rating, we recommend required detailed disclosure of performance data on all rated transactions. This would permit regulators, banks and investors to judge the appropriateness of the ratings assigned over time. This disclosure would have the added virtues of further encouraging market transparency, and encouraging liquidity in the secondary market.

Synthetic Securitisation

Standard & Poor's supports the Committee's view that synthetic securitisation can replicate the economic risk transfer characteristics of securitisation. However, clear guidelines are required regarding whether senior risk should be required to be transferred in order to qualify for a clean break treatment. If senior risks are required to be transferred, at the very least, market transparency is improved. In addition, the Committee considers whether it makes a difference if an originator holds both the senior risk and the first loss positions, and sells only a relatively small mezzanine risk piece. Again, clear guidelines will be required here as the more risk positions the bank retains, the less risk it will have likely transferred. The danger is therefore that if a bank retains both the first loss and the senior risk position in a synthetic securitisation, it will receive capital relief for virtually no risk transference.

The proposals also consider a number of structural criteria that would need to be met in order to obtain a preferential capital charge. Standard & Poor's would generally support this recommendation as all these criteria either serve to limit risk retention or enhance transparency. These include: ensuring the absence of early amortization or other credit performance contingent clauses; the issuance of a substantive amount of AAA rated notes (not usually the case currently) to subject the transaction to market discipline; the pledging of eligible collateral to the beneficiary bank (already seen in some transactions); ensuring that sponsoring banks do not reassume any credit risk through credit derivative or other means; ensuring that credit derivative documentation follows generally accepted market practices; and requiring a legal opinion to ascertain that the synthetic securitisation structure works as specified to the supervisor and the market.

Disclosure

Currently disclosure about securitisations has generally been minimal. While the proposals therefore represent a significant improvement, there is some inconsistency in the requirement for public disclosure on certain quantitative and qualitative

information to gain preferential capital treatments, and on the other hand, for that disclosure to be limited to statutory accounts rather than the public reports. Standard & Poor's believes this information should also be made available in public reports to enhance market discipline and transparency. In addition, it would also be beneficial for originators and sponsors to disclose data by transaction and to disclose transaction names, as well as asset types securitised. It would also be helpful for originators to disclose income earned or lost from transactions. While securitisation can distort the level of risks present in a bank's balance sheet thereby making counterparty risk assessment harder, it can also distort banks' earning streams. By requiring disclosure of income and losses emanating from securitisation transactions borne by the originating bank, a truer profile of a bank's risk profile can be gauged.

V. Operational Risk

The Committee's proposed calibration techniques and capital allocations for operational risk appear conceptual. This is not surprising, given the newness of measuring such risks. The Committee's difficulty in quantifying operational risk is very transparent, as is its need for continuing its dialogue with the industry to resolve several key open issues, including the verification of specific calibrations and risk estimates for all three approaches, the basic indicator approach (BIA), standard approach (SA) and internal measurement approach (IMA). Standard & Poor's is a strong proponent of assessing the level of operational risk as part of determining the overall creditworthiness of a financial institution, and in general concurs with the Committee's concept that building block or business line approaches for measuring operational risks are necessary, depending on the level of an institution's complexity and activity volumes.

We share the opinion that at present the capacity to develop independently certain calibrations and criteria detailed in the consultative paper is impeded by many factors, the most significant being consistent, industry-wide operational loss data. The sophisticated models that employ such data, for example the Operations Value at Risk (OpVaR) or Loss Data Approach, are both extremely sensitive to the data set that is fed into them. Thus, the design and definition of the data set that is collected (for example, whether it is based upon bank-only experience or broader industry experience, the period of time over which the data is available, whether "outlier events" are rejected, or whether there is a minimum size threshold) will determine the outcome of the models. In addition, because the real focus of operational risk should be the low probability but high impact events, this presents certain mathematical challenges in that one cannot assume a normal distribution curve. Given the constraints and uncertainty surrounding the availability and quality of data, Standard & Poor's will remain cautious over the long term in accepting any of the sophisticated models.

The New Capital Accord is somewhat circular in its reasoning in setting a calibration for operational risk based on the minimum regulatory capital calibration. Banks vary in the proportion of their risks that is represented by operational risks. Those with a heavy emphasis on asset management, for example, where the risks are predominantly operational, should devote a greater proportion of their capital to them. In any case, predicating the operational capital charge on the credit and market risk charges is not logical. The consultative paper is candid in disclosing that the 20% factor was based on a close consultation with the Industry Technical Working Group on Operational Risk (ITWGOR). Standard & Poor's believes that the average proportion of economic capital that is consumed is in fact closer to 30%.

The Committee’s proposal for operating risk measurement creates onerous regulatory and supervisory issues. The qualifying criteria and measurement factors for business line approaches will be extremely challenging for supervisors to develop and implement on a consistent and uniform basis. Direct supervisors are charged with making independent assessments of risk management systems for all institutions that they regulate. The speed and flexibility of changing certain domestic regulatory frameworks, as well as the ability to gather and maintain sufficient supervisory resources to meet the tasks outlined by the consultative document’s Pillars, is also questionable. Within the European Union (EU), the challenge is again in unifying supervisory approaches among national supervisors, as well as harmonizing supervisory and industry transparency to level the playing field. Therefore, it is likely that the development of both the details of regulating and measuring operational risk will remain industry-driven by a narrow range of institutions, while the process of educating and convincing regulators of the appropriate quantitative and qualitative measures for managing operating risks will most likely fall to a wider spectrum of industry leaders.

The New Capital Accord provides a vehicle for encouraging enterprise wide risk management, which theoretically should lead to coordinated risk assessment and management decisions across the institution. Standard & Poor's is both encouraged and concerned by the Committee’s introduction of a ‘continuum concept incentive’ for capital allocation for operational risk, which requires banks to qualify in order to use more sophisticated approaches in determining capital charges. While the New Capital Accord mentions using a floor concept without specifics, which is designed to limit the reduction in capital held when a bank moves from a less sophisticated to a more sophisticated risk measurement approach, such as move from the SA to the IMA, Standard & Poor's remains cautious in giving too much of a capital incentive to institutions using untested sophisticated modeling.

The Committee provides an embryonic x-ray view of capital allocation measures for operational risks. It is likely that these approaches for operational risk measurement will need to evolve prior to the New Capital Accord’s implementation. The capital charges for operational risks will need to pass through a period and series of trial and error measurements over several years, prior to their being relaxed from the initial minimum thresholds for the industry, as well as for individual banks. Not dissimilar to both credit and market risk models, the operational risk allocation models developed under the New Capital Accord will need event stress testing for validity. In theory, Standard & Poor’s believes that as an institution’s operational risk profile increases so does the need for better risk management systems and measurements. While the different approaches for allocating capital presented in the proposals range from basic to very sophisticated loss distribution data, not all financial institutions will need to develop sophisticated operational risk modeling techniques. The costs of developing such systems are not justified by the level of complexity of the likely operational risks, nor the potential capital saving.

Parts 3 and 4: Market Discipline and Disclosure

Standard & Poor's fully supports all aspects of the proposals that add to the level of information available to financial markets, counterparties and investors on all aspects of a bank's risk profiles. We also fully support the concept that the use of the IRB Approach be contingent upon a number of criteria including appropriate disclosure. Similarly, in the area of credit risk mitigation and asset securitisation, banks that wish to receive capital benefits should fulfill certain disclosure requirements to provide sufficient information to markets about the impact of these techniques and transactions. In particular, we support continued discovery via disclosure of the performance of the unrated assets within banks' portfolios. Further, we would recommend that the Committee, and notably the practitioners implementing the New Capital Accord, be open to a reconsideration of the treatment of unrated assets as a function of their future performance.

Conclusion

Standard & Poor's looks forward to providing the Committee with any additional information or background on the issues raised in our response, or any other data or work we have available that might be helpful to the Committee in its research.

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