Swedish Bankers' Association
Svenska Bankföreningen

POSITION PAPER
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"THE NEW BASEL CAPITAL ACCORD" - Consultative Document from the Basel Committee on Banking Supervision (January 2001)

and

"COMMISSION SERVICES´ SECOND CONSULTATIVE DOCUMENT ON REVIEW OF REGULATORY CAPITAL FOR CREDIT INSTITUTIONS AND INVESTMENT FIRMS" (MARKT/1000/01, February 2001)

In this position paper Swedish Bankers'Association states its main comments on the proposals which the Basel Committee on Banking Supervision and the European Com-

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<u>mission Services</u> have presented in the documents mentioned above (and in the Basel Committee's supporting and supplement documents).

Swedish Bankers'Association is a member of <u>European Banking Federation</u>, <u>European Mortgage Federation</u> and <u>Leaseurope</u> and has taken active part in the preparation of their position papers to the Basel Committee and to the European Commission.

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EXECUTIVE SUMMARY

Swedish Bankers' Association's main concerns

Swedish Bankers' Association's most important remark is that the proposed treatment of <u>mortgage loans</u> - in the foundation Internal Ratings Based Approach (IRBA) - is unreasonable. Loans secured by mortgage on property generally have a lower "probability of default" and "loss given default" than most other kinds of loans. Despite this, many mortgage loans will be treated - under the foundation IRBA - in the same way as loans without collateral. Consequently, the proposed risk weights for mortgage loans correspond badly with the real risk. Moreover, it is not logical that mortgages on property are considered as less risk reducing in the foundation IRBA than in the Standardised Approach. Since a large part of all loans in the credit markets consists – both in Sweden and in most other countries – of mortgage loans, many banks will be unwarrantedly punished if they move from the Standardised Approach to the foundation IRBA. If the proposed rules are not changed, they will prevent banks from moving to the foundation IRBA, rather than giving banks incentives to do so.

<u>We disagree particularly with the following proposals</u>:

- In the foundation IRBA, only certain mortgages on property are considered as risk reducing. For eligible real estate collateral, the real estate owning company must not be dependent on the rental income from the collateralised property. - <u>We propose</u>: As all mortgages on property - both residential and commercial - reduce the LGD (Loss Given Default), they must be considered as risk reducing in the foundation IRBA - like they are in the Standardised Approach.

- The banks must have a first claim/first lien on the collateral. – <u>We propose</u>: The rules must allow also other possibilities, as in Sweden and many other countries the legal systems give the holders of second and subsequent mortgages a legal right to carry through a forced sale of the property.

- The proposed methodology for measuring LGD is the C/E (Collateral/Exposure) ratio. – We propose: Since the C/E methodology is not suited for all countries' legal systems, the LTV (Loan To Value) methodology - used all over the world to measure the creditworthiness of mortgage - should be used to measure the LGD.

- The LGD can only be reduced from 50 % to 40 %. – We propose: When the LTV is low, the LGD should be reduced to much less than 40 %.

Swedish Bankers' Association proposes a risk-weight under the Standardised Approach for leasing and factoring of 50 %, considering the low risk level of these products in comparison with the risk level of ordinary bank loans.

Swedish Bankers´ Association is also concerned about the outlined structure for calculating operational risks. The proposed level – 20 percent of the total capital requirement – is far too high and needs to be calibrated from a larger sample of data which does not include strategic and reputational risks. Furthermore, the framework needs an improved incentive structure. Otherwise, most banks would not be able to affect their capital charge for operational risk for many years, since they will lack necessary data to enter the Internal Measurement Approach. In order to change this – and thus to improve the incentive structure – we propose that the Standardised Approach is complemented by factors covering the quality of the institutions´ over all operational risk management, diversification and risk mitigation.

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GENERAL CONSIDERATIONS

Swedish Bankers' Association supports the general structure of the proposals. It is in many respects flexible to further developments in the industry, it contains a good incentive structure and the process of developing a new capital framework has certainly brought the risk management concept further, although a lot still remains to be done. We are particularly in favour of the development of the IRB Approaches and the acceptance of the different risk profile of retail business compared to corporate business. These proposals are very similar to those proposed by the European Banking Federation, of which Swedish Bankers' Association is a member. Despite this general support, we have some major concerns that are expressed below.

SCOPE OF APPLICATION / SCOPE OF CONSOLIDATION

The Basel Committee states in "Part 1. F.: "Deduction of investments in deconsolidated entities will be 50 % from Tier 1 and 50 % from Tier 2".

Swedish Bankers' Association would like to emphasize that in the 1988 Basel Accord it is stated "investments in unconsolidated banking and financial subsidiary companies" should be deducted "from total capital" (Annex 1., C.). In the Accord's paragraph 24 it is stated that such investments should be deducted "from the capital base".

The proposal to deduct 50 % of the investment from Tier 1 (core capital) - in stead of the present deduction from total capital - would imply a serious reduction of the total capital base for many banks, as the (net) amount of Tier 1 capital is decisive for how much Tier 2 capital and Tier 3 capital can be included in the total capital base.

We are surprised that the Basel Committee presents such a proposal without any discussion or arguments (as far as we can see). Moreover, the proposal for a New Basel Capital Accord does not deal with any need to reform the definition of the capital base. Because of this, our opinion is that at present no changes should be made as regards the capital base. Also the European Commission Services are of a similar opinion as they write (in paragraph 30) "a possible revision of the EU-regulations concerning such deductions will be considered within the current review of the Own Funds Directive".

CREDIT RISK – THE STANDARDISED APPROACH

Claims secured by residential and commercial property

The Basel Committee proposes that lending "fully secured by mortgages on residential property that is or will be occupied by the borrower, or that is rented, will continue to be risk weighted at 50 %". Mortgages on commercial real estate "do not, in principle, justify other than a 100 % weighting of the loans secured…The Committee, however, recognises that, in exceptional circumstances…mortgages on…commercial premises may have the potential to receive a preferential risk weight of 50 %…" (for a certain tranche of the loan).

Swedish Bankers' Association has the following views. The Basel Committee's proposal leaves the risk-weight for mortgages mainly unchanged. But banks will face a significant new demand for capital allocation towards operational risks. If the over all capital requirements are not to be raised - as is stated by the Basel Committee - there must be a general reduction in capital requirements with respect to lending. Since mortgage lending is one of the least risky forms of lending, it seems natural to take a further step in reducing the capital charges in this segment. It should also be taken into

consideration that mortgage lending is of fundamental importance for the cost of living for millions of citizens.

In Sweden, residential mortgages historically have shown very low loss figures. In recent years the relation between losses and the book value of residential mortgages is below 0.1% a year. With respect to commercial real estate, lending losses were high in the beginning of the 1990´s, due to extraordinary macroeconomic circumstances and the rapid deregulation of the credit market, but have since then been as low as those of residential lending.

Because of what is said above, we propose a decrease in the risk-weight for residential mortgage lending to 40%. Furthermore, the low risk in commercial real estate lending (office buildings, etc.) calls for a general reduction from 100% to 75% or less. The Basel Committee's proposal for a 50% risk weight for commercial real estate lending under "exceptional circumstances" will probably not be considered feasible in many countries. Our opinion is that the present EU rule of 50 % risk weight for commercial property lending, within certain limits,should be made a permanent rule both in the Basel Accord and in the EU rules - in stead of the "exeptional circumstances" proposal from the Basel Committee.

In the present capital adequacy rules, as well as in the new proposals, the special treatment of claims secured by residential property is limited to "*mortgages*". However, there are also other forms of title to a private home that is used as collateral for a home-loan. Housing co-operatives of different legal nature exist in many countries where you typically buy your flat and pledge the title to the flat to the bank as security for a loan. The owner of a unit/share in such a housing co-operative lives there and does his utmost not to lose the home that he owns. This form of residential lending has a much lower risk profile – and a much lower loss given default - than lending without collateral and should therefore be allowed a risk reduction. We suggest that the risk-weight of 75 % for "lending fully secured by units/shares in residential housing co-operatives" is added in the final capital adequacy rules. Another possibility could be that the national supervisors are allowed national discretion in determining which collateralised residential loans qualify for the 50 % weighting under national regulations.

Maturity

Swedish Bankers' Association supports the Basel Committee's proposal not to incorporate a "maturity dimension" in the standardised approach for credit risks.

Leasing

The Basel Committee and the Commission Services make no reference to financial leasing and thus leaves the risk-weight for leasing unchanged. Swedish Bankers' As-

sociation believes that this, given the low loss figures for leasing, is unwarranted and not consistent with the proposal regarding residential mortgages. In the Association's view a risk-weight for leasing of 50 % is justified.

There are a number of factors that helps to diminish the lessor's risk as compared to that of an ordinary lender. (1) An important feature of leasing is that the lessor is the owner of the leased equipment. This means that the lessor immediately can recover the asset in case of the lessee's insolvency. (2) The lessor is in a better position than the lender in negotiations on continued activities of a bankrupt lessee as the leased asset is normally crucial for the company's further existence. (3) There is a secondhand market for most leased assets which means that the lessor does not need to keep recovered equipment in stock. (4) The lessor is often protected against residual value losses on returned assets through various forms of guarantees with third parties. As a result leasing losses are both low and consistent over the time.

Swedish Bankers' Association recently made a study of leasing losses of the four major bank owned leasing companies as compared to credit losses for their parent banks (excluding mortgage credits) for the period 1990-1999. A graph of the results is shown in Appendix 1 to this position paper. The graph shows credit losses on leasing in relation to outstanding credits for leasing vs. the total banking losses in relation to the outstanding credits for banks. The study shows that leasing losses are constantly much lower than bank losses, for instance in 1999 only one third of the latter. Of particular interest is the fact that leasing in comparison with bank credits did very well during the financial recession period 1991-1994, with a level of losses only one fifth of that of the banks. The figures for the bank owned leasing companies are believed to be representative for the major part of the leasing industry. – The study clearly shows that the risk profile of leasing merits a much lower risk-weight than 100 %.

Factoring

The Basel Committee and the Commission Services likewise do not refer particularily to factoring when considering credit risks under the Standardised Approach. As in the case of leasing Swedish Bankers' Association strongly believes that for factoring, in its in Sweden predominant form, a lower risk-weighting than 100 % is justified.

Factoring in Europe comes in different forms. Whereas in the rest of Europe factoring normally means that the factoring company purchases the receivables, and thereby takes a credit risk, factoring in Sweden as a rule means that the factoring company lends money to this client with the receivables as collateral. The "loan to collateral value" varies with the risk, but usually amounts to about 80 % of the total value of the invoices held as collateral. This means that the risk level is already taken into account when the factoring transaction is made. In addition, the client is normally obliged to take back receivables when the debtor is in default, including of course the credit risk. As a consequence, the risk level of factoring for factoring companies is extremely low.

A study involving some of the Swedish bank owned factoring companies shows that the net losses of factoring (definite losses ./. recoveries) in relation to lending was not higher than about 0.25 % for the period 1991-2000, varying from 1.27 % (1993) to -0.06 % (2000). The average credit loss for the four largest banks in the period 1990-1999 was, according to the earlier mentioned leasing survey, 2.01 %. This is a strong justification for giving factoring a lower risk-weighting than 100 %. As in the case of leasing Swedish Bankers' Association proposes a risk-weight for factoring of 50 %.

CREDIT RISK - THE INTERNAL RATINGS BASED APPROACH (IRBA)

Rules for corporate exposures

Risk weighted assets for corporate exposures

Swedish Bankers' Association wants to emphasize that the benchmark risk weights stated for the foundation IRBA are far too high to give the credit institutions the incentive to move from the Standardised Approach to the foundation IRBA. Impact studies, undertaken by ISDA and others, show that, as an average, the total capital requirements in the foundation IRBA will be much higher than in the Standardised Approach. In order to encourage the institutions to use the foundation IRBA, the calculation of its risk weights must be changed. Capital requirements should be calibrated to cover only the risk of unexpected losses. Expected losses are taken account of in the institute's pricing (interest rate/fees).

Rating grade structure

The Basel Committee proposes that a bank must have a minimum of 6 to 9 borrower grades for performing loans and should assign no more than 30 % of its gross exposures (before on balance sheet netting) to any one rating grade. The Commission Services believe that 6 borrower grades are the minimum and that "there might be a number of special cases within the EU that justify a deviation from the requirement" (the 30 % rule).

Swedish Bankers' Association considers these proposals from the Basel Committee as being unnecessarily strict and supports the views of the Commission Services. Some institutions might very well have a business structure which causes an extensive concentration to one or a few grades, no matter how sophisticated internal rating system they have. A high concentration into one or a few grades is not necessarily an indication that an internal rating system is poor or that the exposures are risky. High concentration into a few grades might indicate low-risk lending, e.g. lending from specialized

mortgage banks. High concentration might also be a business strategy - e.g. focusing on a segment in the market not covered by other institutions.

Minimum requirements for corporate exposures

The Basel Committee proposes very long lists of minimum requirements that a bank must demonstrate to its supervisor that it meets if it wants to use the IRBA for corporate exposures and retail exposures. These requirements are primarily focused on how institutions are expected to - or must - act or organise their work in order to qualify for the IRBA.

Swedish Bankers' Association supports the principle that a bank that wants to use the IRBA shall meet certain requirements. However, we are of the opinion that the focus should be directed towards certain important principles that should be followed and towards the ability of the model to estimate probability of default and other relevant parameters (goal-oriented approach) – but not towards how this exactly shall be achieved. We believe that a goal-oriented approach has several advantages. Most importantly, it would stimulate institutions even more to continuously think in constructive ways and to develop their risk management systems. A system built on detailed descriptions on exactly how an institution shall do, and organise itself, would run the risk of promoting a "tick-behaviour" rather than critical thinking. Furthermore, detailed descriptions might soon become outdated or be ill suited for the particular context and needs of the individual institution. It is also important that institutions have the possibility to take account of their own experience of their own specific situation, organisational structure and risk management culture. This is also important because of legal, cultural and other differences between all the countries in which these recommendations shall be applied. We therefore strongly hold the view that the risk management process is better promoted by focusing on the actual performance of the models used. - Examples of paragraphs in this context in the proposal for The New Basel Capital Accord which we think interfere too much with a bank's organisational structure, are unnecessary or unnecessarily detailed - and therefore should be changed or deleted - are the following:

- Paragraphs 245, 246 and 255: The requirement of "an independent credit risk management unit", "an independent credit unit" and "an independent credit risk control unit" interferes with the organisational structure of the bank. The important thing is that a bank has an organisation that guarantees the separation of the "control functions" from the "business functions".

- Paragraph 248: As pointed out by the Basel Committee in a footnote "Board of directors" means different things in different countries. In some countries, the board of directors takes a much more active part in the decisions than in other countries. Because of this, the requirement does not fit all banks or countries.

- Paragraphs 249-252: These requirements should be less detailed. The rating systems will not be of higher quality just because the requirements for reporting etc. are this detailed. There is a high risk that a bank being organised in a specific way will feel forced to make changes that will have an opposite effect on the rating system and the risk monitoring process.

- Paragraphs 253 and 254: Rules about internal and external audit are unnecessary in capital adequacy rules.

- Paragraph 257: Rules about the quality of staff are unnecessary in capital adequacy rules.

- Paragraph 265: These rules about information regarding the borrower are too detailed and should be formulated in a more general way in order to concentrate on the goal instead of on the detailed factors. The important thing should be that the internal ratings system can segregate risk.

- Paragraph 285: These requirements are far too detailed and should be rephrased.

The Basel Committee states, in paragraph 321, as one on the "additional collateral management requirements" the following:

- "Collateral management should be contained within a distinct operational unit of the bank".

Swedish Bankers' Association is of the opinion that such a requirement interferes too much with the organisational structure of a bank. There must be possibilities for the bank to discuss flexible organisational solutions with its supervisors.

Minimum requirements for estimation of Probability of Default (PD)

Supervisory estimates of Loss Given Default (LGD)

Definition of eligible real estate collateral

The Basel Committee proposes (paragraphs 313-315 in the main document) for the foundation IRBA certain criteria for the definition of eligible real estate collateral. Other kinds of real estate will not be regarded as eligible collateral.

Swedish Bankers' Association wants to emphasize that all real estate must be regarded as eligible collateral in the foundation IRBA – and not only in the advanced IRBA, for which the Basel Committee states that "there is no limit on the types of collateral that may be recognised". Taking mortgage as collateral is more risk reducing than not do-

ing so. It is surprising that mortgage collateral is considered as more risk reducing both in the Standardised Method and in the advanced IRBA than in the foundation IRBA.

Even if a real estate owning company is dependent of the cash flow from rental streams, this does not mean that the collateral, in form of mortgage in its real estate property, is worthless in case of default of the owner/borrower. If, for instance, the rental income for some reason decreases with, say, 15 %, it might lead to default of the owner/borrower. However, the remaining cash flow would be large enough to secure payments to a lender with a pledged mortgage within 75 % of the original value of the property.

Operational requirements as regards real estate collateral

The Basel Committee proposes that several operational requirements must be met if real estate is to be eligible for recognition as collateral for corporate claims. Among these requirements is mentioned (paragraph 320 in the main document) the following:

- "First Claim: the bank should have a first lien on, or charge over, the collateral…no recognition for second or subsequent charges will be provided, and these will be treated as senior unsecured exposures".

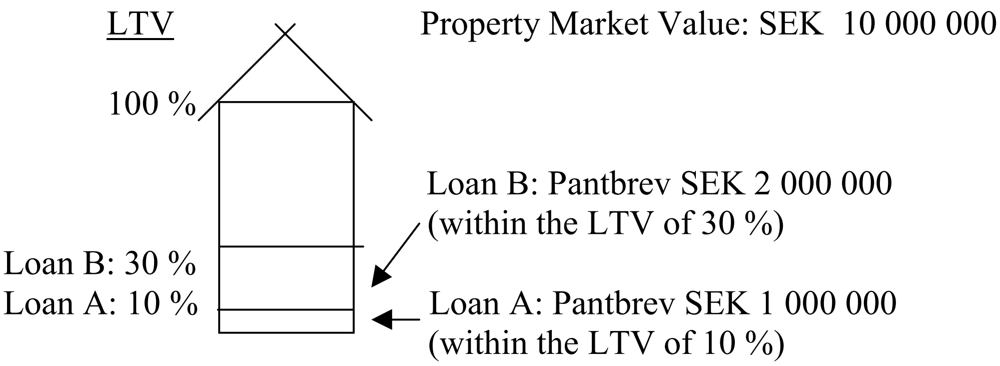
Swedish Bankers' Association wants to emphasize that there is a need for modification of the proposed rule about *first lien.*

In many countries, a mortgage legally means that a loan is secured by registration in a public register giving the holder of the mortgage a priority right of payment from proceeds at a forced sale of the property. This is called a first lien, and the whole value of the property stands to serve the loan. If a second mortgage is registered, the holder of this mortgage will be paid from the proceeds only after that the holder of the first mortgage has been paid in full.

In Sweden and other Scandinavian countries, the legal tradition with respect to mortgages is different. In Sweden, a lender's collateral in a property is guaranteed by one or more "Pantbrev" (=certificate of mortgage) pledged by the owner of the property in question. A Pantbrev indicates the maximum amount in Swedish Kronor (SEK) that can be paid to the creditor holding that Pantbrev in a forced sale of the property. The nominal amount and priority of each Pantbrev is recorded by the official registry of real estate. The same property often provides collateral for more than one loan, and each loan is often secured by the pledge of one or more Pantbrev. Mortgage lending typically is considered fully secured if the Pantbrev is within 75 % of the market value of the property.

For example, a property with a market value of SEK 10 000 000 provides collateral for two loans by the pledge of two Pantbrev of total SEK 3 000 000, of which Bank A has

one Pantbrev of SEK 1 000 000 pledged as collateral for loan A of SEK 1 000 000, and Bank B has one Pantbrev of SEK 2 000 000 pledged as collateral for loan B of SEK 2 000 000, second in priority to the Pantbrev securing loan A (see the figure below).



This legal technique enables banks to grant a "second or a third mortgage" within an established *loan to value* (LTV) framework. In this robust system, founded on an official register where all Pantbrev and their priority are registered, each lender knows how much of the proceeds of the property he and the other lenders are entitled to and in which priority they are entitled to the proceeds. A holder of a "second or a third mortgage" may – as is the case for the holder of a first mortgage – independently from the other mortgage holders carry through a forced sale of the property, provided the sale of the property gives proceeds covering the mortgages secured by Pantbrev with better priority.

It is very important that the concept of first lien in the future capital adequacy rules recognises this type of legal technique, allowing national legislators or supervisory authorities to fit their national system into the more general framework.

Methodology for recognition of real estate collateral

The Basel Committee proposes (paragraphs 208-212 in the main document) that exposures, with eligible collateral, for which the ratio of current collateral value (C) to the nominal exposure (E) is below 30 %, will receive the "loss given default" (LGD) of 50 % for unsecured exposures or those secured by non-recognised collateral. For exposures with a C/E ratio higher than 140 %, LGD will be reduced to 40 %. Exposures with a C/E ratio between these two levels will get a LGD that is a weighted average of the secured and unsecured LGD figures.

Swedish Bankers' Association would like to emphasize that the Basel Committee's proposal means that mortgages by corporates are considered as risk mitigators only in a very limited way – "eligible Residential Real Estate (REE)" and "eligible Commercial Real Estate (CRE)". LGD is stated as basically 50%, and only when "outside" mortgages is at hand, LGD can be reduced to 40%. Considering the general risk reduction allowed in the Standardised Approach, this will lead to increased risk weight when a bank moves from the Standardised Approach to the foundation IRBA.

Swedish Bankers' Association considers this proposal to be both inadequate and far too restrictive. Mortgages should always be considered as risk mitigation.

Swedish Bankers' Association also wants to make the following technical comments. All over the world, the creditworthiness of mortgages is measured within the LTV (loan to value) methodology. The LTV methodology is applied on mortgages both in countries that use the concept of first lien and in other countries.

The methodology by which the C/E ratio is measured is suited only for countries that use the concept of first lien, where the whole value of the property stands to serve the loan. As we have pointed out in the section above, in Sweden and other Scandinavian countries the legal tradition with respect to mortgages is different. Within these legal frameworks, a mortgage in a property is granted for a specified amount and priority, which is registered in an official register. Hence all lenders and potential lenders know the amount and priority, and the creditworthiness of mortgages is measured within the LTV methodology. Also the rating agencies use this methodology all over the world.

Referring to the example above, the C/E methodology - together with the Basel Committee's requirement of first claim - leads to the conclusion that the holder of a second mortgage would not benefit at all from its collateral in the property, in spite of a low LTV of only 30 %, whereas a potential holder of a first mortgage of SEK 7 500 000 with a higher LTV of 75 % would benefit for the whole amount. This is clearly not logical and reasonable. Our suggestion is therefore that the LTV methodology shall be used in the new capital adequacy rules, instead of the C/E methodology.

With respect to the value of a mortgage it is obvious, and also our experience, that the lower the LTV, the lower the LGD. For a low LTV, the LGD is close to zero. Our opinion is that the banks should benefit from this to a much higher extent than suggested by the Basel Committee.

We propose that the LGD for a corporate loan secured by a residential mortgage with an LTV not higher than 100 % should - as a general rule - not be higher than 40%. For lending where the LTV is low - e.g. below 75 % - the loss risk is very low. In such cases, the LGD should, because of empirical data, be reduced to 15 %.

This issue is of large importance. In Europe millions of citizens live in apartments rented from residential corporates. These companies are in many cases owned by mu-

nicipalities or other forms of local government. But also privately owned multi-family houses are common.

Maturity for corporate exposures

The Basel Committee discusses whether maturity should be taken into consideration when calculating credit risk weights. The Committee mentions that there are arguments both for and against such a consideration – but states that there will be no "maturity dimension" as regards credit risk weights in the *foundation* IRBA. The average maturity will be assumed to be three years. This proposal is supported by the Commission Services. However, the Basel Committee is also considering whether inclusion of "the explicit maturity adjustment" - which it proposes for the *advanced* IRBA - should be an option that some supervisors could implement also for banks in the *foundation* IRBA.

Swedish Bankers' Association would like to emphasize that the word *maturity* means different things to different banks. A straightforward 5-year loan of course has a 5-year maturity when being paid out, but, especially in the residential sector, the conditions are more imprecise. Many loans have no definite date of maturity. They are rolled over on a yearly basis. Other loans are for a longer formal period with agreed renegotiation periods, when interest and other conditions are adjusted. Certain loans run with no maturity date but with a right for the bank to demand, at any time, repayment within, for example, 6 months.

We support the Basel Committee's statement that "a shorter maturity increases a bank's flexibility to limit further losses to customers whose financial conditions deteriorate unexpectedly by denying credit, by raising the price sufficiently to compensate for the increased risk…". This means that the important aspect regarding maturity as a risk-reducing factor is how soon the bank can change the conditions for the loan. In the final rules from the Basel Committee and the Commission, this must be expressed clearly.

Hence the definition of maturity in the final capital adequacy rules should, if maturity is chosen as a relevant factor in adjusting risk-weight, allow an interpretation where relevance is given to the intervals of possible renegotiation and other novations of the agreement rather than the formal longest loan-period.

As the important aspect is how soon the bank can change the conditions for the loan, our opinion is that the Basel Committee's proposal to treat all exposures as having an average maturity of three years is far too conservative. Most loans can be renegotiated in a much shorter time than after three years. Because of this, the average maturity should be assumed to be much shorter than three years proposed by the Basel Committee.

We would like to emphasize the Basel Committee's arguments against including long-term maturity in the calculation of risk weights in the foundation IRBA. One important such argument is that higher risk weights for loans with longer maturities would lead to more short-term financing. This would be contra productive to the purpose of the capital requirements, as it would reduce the stability both for the borrowing customers and for the banking systems.

Rules for retail exposures

Definition of retail exposures

The Basel Committee proposes (paragraphs 263-270 in the supporting IRBA document) four criteria for the definition of retail exposures. Among these criteria is the following (in paragraph 268): "…each individual exposure has a low value. The Committee recognises the difficulties involved in setting a single exposure threshold which would fit all countries…national supervisors…may choose to set a maximum value for individual exposures".

Swedish Bankers' Association supports the Basel Committee's statement (paragraph 266) that lending to a small business - even if it is not to an individual person or persons - may be included in the retail exposure treatment with explicit approval of supervisors, provided "that the bank treats such exposures in its internal risk management and risk assessment processes consistently over time in the same way as other retail exposures…This takes into account differences regarding the legal status of small businesses in different member countries". It is also crucial that the retail segment consists of a large number of loans with a homogenous risk profile. These criteria cover all relevant factors and make the criterias about "product criteria" and "low value" unnecessary.

The definition of *small business* is of paramount importance for evaluating the effects of the IRBA. In the pools of small business property lending, there are numerous loans suitable for segmentation and treatment as retail. In many cases a corporate is a small business where the source of repayment is nothing but the cash flow from a property.
Hence the definition of retail should be modified in order to enable this type of business to be treated as small business. The focus on loan size in the definition should be reduced.

Maturity for retail exposures

The Basel Committee states that, for the time being, it has not set out different risk weights for different retail product types. It has chosen the three-year maturity basis for all retail risk weights - but may, during its continuing work, "consider separate risk weights for residential mortgages and for other retail products".

Swedish Bankers' Association is of the opinion that the average maturity should be assumed to be much shorter than three years. As we have emphasized above – under the heading "Maturity for corporate exposures" – most loans can be renegotiated in a much shorter time than three years. This is also true for retail loans.

Minimum requirements for retail exposures

Segmentation by borrower risk

The Basel Committee states (paragraph 445 in the main document): "The bank must segment by credit scores or equivalent. This includes segmentation based on application scoring…". In a footnote to this, it is said "Ongoing or ´behavioural´ scoring…should be used as a basis for reassessing the estimates of loss associated with each segment, rather than as a basis for segmentation".

Swedish Bankers' Association would like to emphasize that some Swedish banks have the experience that in many cases behavioural scoring gives better probability of default estimates than application scoring, not only after some time has passed since the application moment. Because of this, we propose that the capital adequacy rules should not state that segmentation must be based on application scoring. It should be up to each bank to use any scoring method, or to develop their own methods, provided that the method is able to make good probability of default estimates and has been approved by the supervisory authority.

The consequence of the proposed regulation is that the way a bank conducts credit assessment and approval will be indirectly regulated. Setting credit approval rules and policies are core decisions in creating the credit culture, and should therefore not be covered by the capital adequacy rules.

ASSET SECURITISATION

Swedish Bankers'Association would like to point out that the regulations regarding asset securitisation have changed a lot over the last decades and will probably continue to do so in the future, not least as a result of the outcome of the Basel and EU proposals. Securitisations are often large in volume, of long-term character and involves supervisors´ consent. When new rules are introduced, it is therefore of major importance that these only apply to new securitisation transactions – not to old ones.

The treatment of explicit risks associated with traditional securitisation

The Standardised Approach

The treatment for originating banks

(a) Minimum operational requirements for achieving a clean break

The Basel Committee proposes that a clean break has occurred only if "the transferor does not maintain effective or indirect control over the transferred assets". This excludes situations where a transferor is "able to repurchase from the transferee the assets to realise their benefits and is obliged to retain the risk of the assets".

Swedish Bankers' Association of course supports the idea of a clean break and agrees that a clean break does not exist if the transferor has any *obligations* to repurchase assets as clean-up actions in case of financial distress. We, however, hold the view that the transferor should have the *possibility* to repurchase the assets, like a bank has the possibility to by any other assets, whenever this is judged to be commercially sound. A bank should therefore not be excluded from the possibility to repurchase assets just because it has previously sold those assets to an SPV, provided that the purchase is not a clean-up action.

Securitisation under IRB: A Hybrid Approach

The treatment for issuing banks

The Basel Committee suggests (paragraph 59 in the supporting document) that the full amount of retained first-loss positions shall be deducted from capital.

Swedish Bankers' Association thinks that this is unwarranted, as it would mean that the institution would not be allowed to use the outcome of its internal rating system, which is supposed to reflect the actual risk involved.

Implicit and residual risks

The Basel Committee proposes (paragraphs 89 and 90 in the supporting document) rules on how to handle institutions that give implicit support to trusts or SPVs whose underlying asset pool is experiencing credit deterioration. If this is done once, all of the assets within the structure will be treated as if they were a part of the bank's balance sheet. If this is done a second time or more, all the securitised structures the bank has originated will be treated in this way.

Such decisions might have very far-reaching effects for the parties involved. In Swedish Bankers' Association's opinion it should therefore explicitly be made clear in the final version of the rules that such supervisory decisions have to be very well-founded and made only after close contacts with the involved bank. Many securitisations are complicated, as would the judgement be of whether a bank has given implicit support

or not. The bank therefore must have a chance to explain its actions. It is also important that such supervisory decisions are not made just because of minor mistakes by a bank.

OPERATIONAL RISK

General remarks

The Basel Committee proposes a structure that is intended to promote banks' development of operational risk management. This is done through four models – with increasing sophistication – for calculating the capital requirements for operational risk.

Swedish Bankers' Association supports such a structure since it - if well constructed - gives many banks incentives to improve their work in this field. We are, however, deeply concerned about the extensive gap between the "Standardised Approach" and the "Internal Measurement Approach", which will probably prevent a majority of banks from continuing from the first to the second of these two approaches. We therefore suggest that another alternative is introduced. This should in our opinion be based on the Standardise Approach but be developed further to incorporate factors that more accurately capture an individual bank's operational risk. Introducing a quality factor, a diversification factor and a mitigation factor could preferably do this. (We elaborate this proposal further in the following sections.) When institutions improve their operational risk management, they could then be rewarded by a lower capital requirement.

Basic Indicator Approach

The Basel Committee assumes – in the absence of operational loss data – that the capital requirement for operational risk should be 20 percent of the total capital charge. This level of capital has also been the starting point for estimating the provisional multiplication factor α, which is estimated to 30 percent of gross income, and for the calibration of the Standardised Approach.

In Swedish Bankers' Association's opinion this factor is far too important to be estimated from a small sample of banks and their estimation of operational risks – or, more correctly, other risks. A final decision must be based on a more solid ground of empirical observations of operational losses, *i.e.* an estimation of the true loss distribution function. Since such data today are scarce, it is important that a revision is made after a few years in order to arrive at a better estimation of the true risk. In our opinion the 20 percent level should also be abandoned and the capital charge be related to the operational risk in the banking system, which probably is well below this level. This is clearly warranted, since the 20 percent arrived at in the sample included strategic and reputational risk, which shall not be included in the calculation of the capital

charge for operational risk. For the same reasons, the estimate of α, as well as β is highly exaggerated.

Standardised Approach

Swedish Bankers' Association thinks that this approach has been given a sound and logical structure. However, the outcome of this approach is highly dependent upon the calibration of the β-factors. Considering the importance of the size of the total level of the capital charge and the different β-factors, this calibration should be revised regularly in order both to incorporate more complete sets of data and to capture possible changes.

We are also concerned about the extensive gap – as mentioned above – between the Standardised Approach and the Internal Measurement Approach. We therefore suggest that the Standardised Approached is complemented by a more advanced version that includes (1) a quality factor, (2) a diversification factor and (3) operational risk mitigation. A problem with the Standardised Approach is that is does not take account of improvements in the individual bank's operational risk management process, and thus gives the bank possibilities affect its capital charge for operational risk. A quality factor, which would be assigned by supervisors, would make it possible to both punish and reward banks' operational risk management. The quality factor should be based on supervisors' own judgement, from on site visits and discussions with the institution's senior management. The quality factor should reflect the over all subjective opinion regarding the institution's overall risk-profile, control culture, record of overall loss-profile over a longer time period (at least one business cycle). If a quality factor is introduced it is important that operational risk is excluded from the individual evaluation under Pillar II.

A diversification factor is warranted since operational risks in different business lines generally have a very low correlation. When banks reduce operational risk through insurance etc., they should also be allowed to account for this. If these factors were introduced, institutions would have additional incentives to proceed to the more advanced standardised approach since they could be rewarded for their management of operational risks.

Such an advanced standardised approach would have several advantages. First of all it would make a more correct estimation of operational risk. The suggested approach would also facilitate for other institutions than only the very largest ones to enter a more advanced approach. In practice, very few institutions - no matter how effectively they handle their operational risk - would have internal data enough to estimate expected losses based on those data. This approach would certainly also increase the possibilities for, and stimulate, others than only the very largest institutions to develop their management of operational risk.

The Basel Committee proposes that a bank that enters the Standardised Approach shall meet many detailed qualifying criteria.

Swedish Bankers' Association holds the view that these qualifying criteria are set at a too high level for the Standardised Approach - particularly the criteria regarding systematic data collection in all business lines. The balance regarding qualifying criteria between the standardised and the Internal Measurement Approach also needs to be improved. If - as suggested above - an "advanced" standardised approach is introduced, this should also be accompanied by additional requirements compared to the "less advanced" standardised approach. In that case the qualifying criteria suggested by the Basel Committee for the standardised approach could be appropriate for the more advanced standardised approach.

Internal Measurement Approach

The Basel Committee proposes that banks with sophisticated and well developed methods for measuring and handling operational risk should have the possibility to enter a more advanced approach - the Internal Measurement Approach - for calculating capital adequacy for operational risk, provided that the bank meets certain qualitative and quantitative standards. As suggested for the measurement of credit risk, it is proposed that a bank then should base its calculations on internal loss data.

Swedish Bankers' Association has the opinion that the Internal Measurement Approach should be based not only on internal data but also on external data from a large population of banks.

We have some concerns about the proposal regarding the Internal Measurement Approach. The underlying assumption behind this approach is that operational risk can be handled in the same way as market and credit risks, *i.e.* that it – through observations of earlier development of the value of the institution's positions – is possible to calculate a certain level of loss at a certain probability level. For market risk this is easy because data on market prices for almost all kinds of assets are available. For credit risk, market prices are seldom available, but institutions have large loan portfolios and major amounts of loan loss data ("events") that might be used to calculate the probability of a loss event, the loss given in case an event occurs and the size of the exposure. This is, however, not the case for operational risk.

Operational risks are, as the Basel Committee also underlines, of a different nature. Compared to market risk and credit risk, operational risk is less related to transactions, and less objective, and events are often originated within the bank, and not outside management control. At present, loss data is scarce and the knowledge about the causal relationships is limited. Operational risks also concern many different possible low frequency events that maybe occur only once in a hundred years in a particular bank. Moreover, even more frequent events may be too few to make good estimates.

Still, both rare and common events have to be captured statistically and included in a calculation of a bank's true operational risk profile when the operational risk shall be estimated. As a consequence, calculations may not be based only on internal data from the own bank, particularly since a separate calculation has to be done for each single loss type. The internal data available will be inadequate and therefore has to be complemented by external data.

SUPERVISORY REVIEW PROCESS ("The Second Pillar")

The Basel Committee states (paragraph 7 in the supporting document) that, even though supervisors will draw from each other's experiences, it is not the purpose to harmonise the supervisory review process in member and non-member countries.

Swedish Bankers' Association holds the view that this is an area where harmonisation shall be given high priority. Considering today's extensive amount of cross border competition in the majority of financial markets, it is crucial that financial institutions are object to as equal conditions as possible. The same criteria when judging banks' capital adequacy under the supervisory review process, as well as the supervisory measures to be taken into account, should be as harmonised as possible.

The Basel Committee states (paragraph 8) that the main areas that are particularly suited for treatment under the supervisory review process are credit risks not fully captured by "Pillar 1", factors not taken into account under "Pillar 1", and factors external to the bank.

Swedish Bankers' Association welcomes this approach where 8 percent is considered as the "normal" regulatory capital charge, provided that the actual risks are captured under "Pillar 1". If a bank would receives a capital charge above the minimum level, it is important that the supervisor makes regular revisions - at least on an annual basis - of this decision and that it also has to communicate what actions the bank shall undertake in order to get a reduced capital requirement. Although this is self-evident, it should be made clear in the final capital adequacy rules.

Principle 3

The Basel Committee suggests (paragraph 54) that supervisors shall consider external factors such as business cycle effects.

Swedish Bankers' Association agrees that this aspect, in some cases, might be justified. We would, however, be seriously concerned if this means that capital charges could be increased above the minimum level just because of an economic downturn. This could of course increase the pro cycling effects and also be devastating for individual institutions. This would also incorporate an element of double counting since the "Pillar 1" capital charge might already have captured the increased risks. This

should therefore only be considered when it is obvious that the "Pillar 1" capital charge has not fully captured the credit risk.

MARKET DISCIPLINE (”The Third Pillar”)

General considerations

Swedish Bankers´ Association does not in principle disagree with the notion that a new capital adequacy framework shall be supported by additional and changed disclosures on institutions' capital structure, risk management and capital adequacy. This becomes particularly important for institutions that enter the internal ratings based approaches. However, we are deeply concerned about the magnitude of the suggested disclosures and the level of detail, which in many cases would interfere with the principle of materiality. We doubt that disclosing of all the suggested details would be in the interest of users and that it would actually serve the purpose of transparency. In our opinion, a large part of the information asked for is mainly of supervisory character and should thus not be required in disclosures in the annual and semi-annual accounts. An example of this is the disclosures suggested (in Appendix 2, Table 3.3) for each portfolio about many of the "IRB Approach disclosure requirements". In order to serve user needs and the aim of transparency we therefore think that many of the very detailed requirements and the information that is of supervisory character should be deleted or changed.

In the process of reviewing Pillar 3 it is also important that the work is carried out in close cooperation with IASC in order to arrive at a harmonised standard. Otherwise, the banks may end up with regulations and recommendations where they have to disclose huge amounts of information several times about the same things – or almost the same things – from different angles. Except for an unwarranted reporting burden this would not serve users, the aim of transparency and understanding of the institutions' capital and risk situation.

SWEDISH BANKERS' ASSOCIATION
SVENSKA BANKFÖRENINGEN

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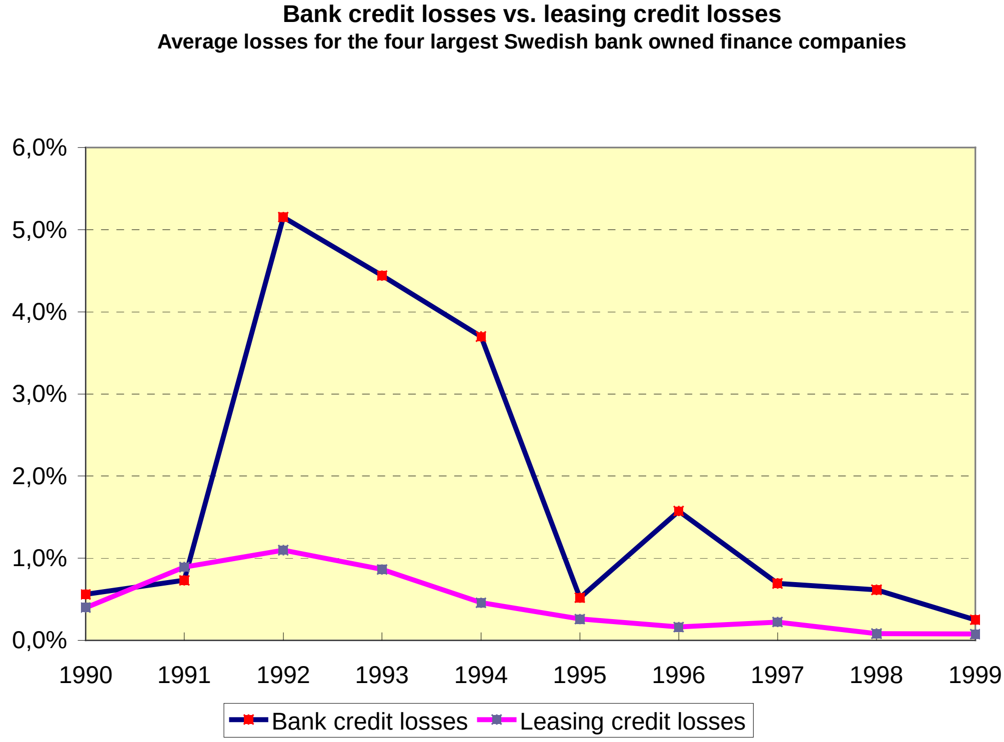
Appendix 1



	Average leasing credit losses
1990	0,4%
1991	0,9%
1992	1,1%
1993	0,9%
1994	0,5%
1995	0,3%
1996	0,2%
1997	0,2%
1998	0,1%
1999	0,1%