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BANKIERVEREINIGUNG
ASSOCIATION SUISSE
DES BANQUIERS
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DEI BANCHIERI

Basel Committee on Banking
Supervision
Bank for International Settlements
Centralbahnplatz 2
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St/ce

Comments on The New Basel Capital Accord

Dear Sirs,

The Swiss Bankers Association (SBA) welcomes the opportunity to present its views on the second consultative package on the New Basel Capital Accord issued for comment by the Basel Committee on Banking Supervision in January 2001.

Please find enclosed our position paper. We would like to thank you in advance for taking our views into consideration.

Please do not hesitate to contact us should you have any questions or requests.

Yours faithfully

SWISS BANKERS ASSOCIATION

Dr. U.P. Roth   Dr. M. Staub

Comments (35 pages)

cc
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Swiss Bankers Association (SBA)

Comments on The New Basel Accord by the Basel Committee on Banking Supervision (Second Consultative Package from January 16, 2001)

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0. General Comments

The Swiss Bankers Association (SBA) welcomes the opportunity to comment on the second consultative package for the New Basel Capital Accord issued for comment on January 16, 2001. The SBA thanks the Basel Committee on Banking Supervision for the opportunity to present its views.

As pointed out in our comments dating from April 5, 2000 on the first package, our association admits that there is a need for a thorough revision of the Basel Capital Accord of 1988. The SBA basically agrees with the idea that the suggested New Basel Capital Accord will be able to tackle a lot of the weaknesses associated with the 1988 Accord. In principle, the SBA welcomes the underlying strategy of the proposals and basically agrees with the proposed structure of the three pillars. Particularly, **our association supports the aim of aligning capital adequacy regulation more closely with underlying risks, i.e., with introducing more risk sensitivity into the existing framework.**

From a general point of view, the SBA also welcomes the idea of a menu approach providing banks (and their supervisors) with several options for the assessment of capital adequacy. In our perspective, it is important that regulated banks be provided with incentives to continuously improve their risk management. This can be accomplished if qualitative improvements in banks' methods to identify, measure and control different categories of risks are rewarded by quantitative reductions in the amount of required capital.

Our association also welcomes the goal of more differentiated banking regulation taking into account the differences between institutions as well as between banking groups. Switzerland is an example of an extremely heterogeneous banking industry where banking groups and individual banks vary heavily in the nature of their businesses and, correspondingly, their risks. There is, therefore, no economic rationale for a concept of "one size fits all".

Of course, the SBA appreciates the approach of a systematic dialogue between the Basel Committee and the involved industry. The importance of "getting the details right" cannot be overstated since the banking industry will have to operate under the new system for quite some years to come. However, the consultation period until May 31, 2001 has in our view been extremely short given the extent and complexity of the second package as well as the potential impact of the New Accord on the whole banking and financial industry. **Therefore, the SBA considers it to be important that the revision of the Accord be**

finalised over the coming months in close dialogue with the industry and that there be the opportunity to continuously comment on aspects that are open at the moment and that will hopefully be made more concrete in additional consultative documents.

a) Main Concerns

As a bottom line of our position, the SBA has three areas of main concern that it would like to mention here as well as to comment in detail in the rest of this position paper.

As a first point, our association is convinced that capital charges throughout the New Basel Capital Accord tend to be too high. This is especially true regarding some fields of special interest like, e.g., mortgage lending. These aspects will be commented on in detail later. But the problem is more general.

On the one hand, **calibration has to be criticised**. Unfortunately, the quantitative impact study runs in parallel with the consultative period and will not allow a third round of consultation. In particular, the SBA doubts whether the banking industry really has had the time to properly evaluate and test the quantitative impact of the suggested revision in an adequate way. Calibration of risk charges in the field of credit as well as operational risks would have required systematic simulation and testing. In this context, the SBA is especially interested in hearing about the main results of the second impact study soon.

On the other hand, the SBA wants to emphasise that capital requirements in the interest of bank customers as well as systemic protection have in any circumstances to be based on concrete risk considerations. **Thus the approach pursued by the Basel Committee to condition the new framework on the past level of capital in the banking system in our view is problematic per se. At least, it has to be kept in mind that even if the revision left the overall amount of capital unchanged on average, the New Accord would give rise to important redistributions of capital requirements across banking groups.** For example, whereas, banks engaged mainly in asset management or private banking will have to hold additional capital to cover operational risks, they will hardly benefit from reductions on the credit risk side. In order to soften these aspects of competitive (in)equality, it is crucial first to at least provide banks with the opportunity to choose from menus of different approaches. Second, the final version of the New Accord as well as national implementation will have to make sure the availability of simple and easy to understand and to use standard procedures for relatively small banks.

As a second main concern, the SBA does not clearly see in what way the New Accord will ensure a level playing field. It wonders whether one of the revision's prominent goals to enhance competitive equality can really be achieved.

- **The Basel Accord has been developed for banks and although it may be applied in some jurisdictions, notably in the EU, to all financial institutions, it will not apply to all systemically relevant financial insitutions.** In this respect, the New Accord does not introduce any progress. The need for a generalisation to all systemically relevant financial intermediaries not only arises from competitive concerns but also, and even more importantly, from the need to promote the safety and soundness of the financial system, which is another explicitly stated goal of the suggested revision.

- Furthermore, **inequalities can be located even amongst regulated banks.** The implementation of Pillars 2 and 3 at a national level will inevitably introduce **new differences in the regulatory treatment of banks across jurisdictions**. Firstly, the Pillar 2 related reviews are carried out by national regulatory agencies where it is very unlikely that different regulators will review banks' internal risk control and capital management practices in exactly the same or even in a comparable way. Secondly, national supervisors are unlikely to be able to enforce Pillar 3 with the same intensity across institutions and across jurisdictions. Local practices are going to persist unless the markets put a premium on disclosure.

Taken together, the above arguments imply that from an international perspective, it is highly questionable at the moment whether the proposed New Accord will adequately achieve its stated goals to ensure the safety and soundness of the financial system as a whole and to guarantee a level playing field. This is mainly because the second consultation document is assigning quite some discretionary power to national supervisory authorities, for example in the field of the Standardised Approach to credit risk or regarding operational risk. As far as can be judged at the moment, the SBA also has some serious doubts concerning the degree with which Pillars 2 and 3 can be expected to be properly implemented in different countries, mainly because some national regulators have not decided yet how broadly Basel II should be applied to the banks in their jurisdictions. With regard to Pillar 2, the SBA believes that the criteria upon which bank management will be judged by supervisors need to be more explicitly specified and harmonised across jurisdictions.

As a third main point, the SBA is highly concerned about the Basel Committee's approach to operational risk. Capital adequacy as a means to reduce operational risk is

questionable per se. Empirical evidence demonstrates that ensuring appropriate control mechanisms and a well-functioning risk management might be more promising in fighting operational failures. Even if one accepts the position that capital charges are to be required for operational risks, some highly relevant methodological issues arise. Amongst other things, we would like the Accord to take into account the facts that:

- The loss absorption capacity of a bank, i.e., the sum of capital and pre-tax income (and not capital charges only) is relevant when facing adverse hits. This consideration obviously applies to all risks faced by banks, being market, credit, operational or other risks and, therefore, constitutes ag eneral criticism of the Accord.
- Operational risk has a different nature from other types of risk. In contrast to market and credit risk, operational risk is not being priced on markets.
- Operational risk requires a different approach than the one to market and credit risk, which has to be more focused on tracking its changes over time than on identifying its absolute level.
- Data on operational risk events are highly context-dependent. The use of historical and external data for modelling purposes is thus very questionable.

In sum, the conceptual basis for the proposed approaches to capital charges is relatively weak. In the light of the many methodological problems and difficulties of definition that we are going to discuss, we suggest refraining at the moment from requiring explicit quantitative capital charges for operational risk. The SBA recommends that effort and resources of both regulators and the industry are devoted to the development of an appropriate regulatory treatment of operational risks. If necessary, the SBA further recommends de-coupling the Committee's internal deadline for operational risk from the one for credit risk such that consensus and clarity on the approaches to operational risk capital charges can be reached.

b) Scope of Application

The SBA feels clarifications are required as to which parts / Pillars of the Accord are applicable to: (i) the banking group as a whole, (ii) banking activities alone, (iii) securities and other financial subsidiaries, (iv) insurance subsidiaries, (v) significant minority-owned equity investments in non-insurance financial entities, and (vi) significant investments in commercial entities. The SBA assumes that the Accord's provision under Pillars 1, 2 and 3 are not meant for entities for which banks' investment is deducted from capital. Also our

association assumes that the provisions on credit risk, Pillars 2 and Pillar 3 should not be applied to insurance subsidiaries, if banks' investment is not fully deducted from capital.

Moreover, the SBA feels that paragraph 6 of "The New Basel Capital Accord" requires clarification regarding: (i) the criteria used to adjust the amounts of minority interests that may be included in capital in the event the capital from such minority interests is not readily available to other group entities as well as (ii) whether the criteria also apply to minority interests within the banking group. The SBA suggests not deducting group internal minority investments from capital.

The SBA feels that paragraph 9 requires clarification regarding the treatment of a bank holding several insurance companies with regard to: (i) surplus capital, (ii) capital shortfall as well as (iii) deduction of banks' investment in such subsidiaries from capital. Practical aspects make a consolidated treatment complex. Therefore, the SBA suggests employing aggregation. Also, it believes that a capital shortfall of a deconsolidated insurance subsidiary should only have to be deducted from the parent bank's capital if there is a legally binding and enforceable obligation of the bank to "bail out" such a subsidiary. Our association suggests explicitly including this specification.

Furthermore, the SBA believes that paragraph 18 requires clarification as to the deduction of investments in deconsolidated entities with regard to: (i) the split between upper and lower Tier 2 capital, and (ii) the deduction rules when sufficient Tier 2 capital is not available.

1. Pillar 1: Minimum Capital Requirements

1.1 Credit Risk

a) General Aspects

The SBA admits that the proposed New Basel Capital Accord eliminates several weaknesses of the 1988 Accord and that it offers a much more flexible and menu-driven approach.

Especially, the SBA welcomes the fact that the Basel Committee has modified the criteria for applying the Internal Ratings Based Approach such that banks other than just the sophisticated and internationally active ones are also allowed to use internal

ratings. The SBA acknowledges that by creating both a foundation and an advanced Internal Ratings Approach, the Committee's proposal is offering a great deal of flexibility.

However, our association is convinced that banks must be allowed to apply the Standardised Approach, the Foundation Internal Ratings Based Approach and the Advanced Internal Ratings Based Approach simultaneously, respectively, in a parallel fashion. This is only logical given the different degree of sophistication required by different business lines.

Moreover, it should be possible not only to use ratings from external rating agencies, but also ratings from other banks (if the national supervisor accepts these). Many banks let other banks use their country and credit ratings. This should not be rendered impossible by the New Accord.

On a conceptual level, the Basel proposal does neither take into account diversification effects nor does it consider the role of earnings in absorbing losses. Expected earnings absorb losses in the first instance and risk control is about the control of (excessive) earnings volatility. Thus, the key difference between banks' best practice and the regulatory approach (i.e., the fact that banks consider expected earnings and capital as a defence against losses, while the Committee only takes capital into account) does not necessarily imply that the approaches should converge. What it does indicate, however, is that an internationally active financial firm, characterised by a well-diversified income stream, which is experiencing significant losses, will typically face funding and liquidity difficulties long before insolvency is an issue, i.e., long before its capital is put at stake. This should be of key importance to the Committee.

In other words, the framework proposed for credit risk – including expected losses and unexpected loss components – results in double counting of capital requirements. Expected losses are "reserved" for through pricing and specific provisioning and should therefore not result in additional capital requirements. Also, general (capital) reserves for expected losses are not allowed under accounting rules (e.g. US GAAP). The SBA therefore suggests ensuring consistency between the Accord and the international accounting standard requirements, e.g., excluding the expected loss component from the definition of credit risk and aligning Pillar 3 requirements on these standards.

Finally, still regarding general issues in the field of credit risk, the SBA feels that with the current calibration there will not exist adequate incentives to move to more sophisticated approaches.

For example, the benefit from the Advanced IRB approach, as compared to the Foundation IRB Approach, is capped at 10% from implementation date until 2006, where banks qualifying for this approach will have to carry out, presumably on at least a quarterly basis, a double calculation for both approaches. This procedure contrasts with the situation in the operational risk area, where the concepts are still at a very early stage of development compared with credit risk, but the Committee envisages a much more aggressive timetable to implementation. Moreover, the 10% figure appears to be entirely arbitrary.

The capital incentives of the Foundation IRB Approach relative to the (new) Standardised Approach are intentionally set at 2%-3%. No rationale is given as to why the benefit differential in moving along the spectrum should follow such an incremental path rather than for instance a linear path or other proportions.

More specifically, the incentives to move from the Standardised Approach to the IRB Foundation Approach are not straightforward for the following reasons:

- Higher risk weights in the rating range from AAA to BBB- for the Standardised Approach basically favour banks using the IRB Foundation Approach; however, for ratings below BBB-, risk weights significantly favour banks using the Standardised Approach (example based on corporate exposures). On a systemic level, this would push the least sophisticated banks into the high risk activities from which the more sophisticated banks would retreat.
- The larger list of eligible risk mitigation and lower weighting of eligible risk mitigation favours banks using the IRB Foundation Approach.
- The eligibility requirements for using the IRB Approach, and particularly the Advanced IRB Approach are very restrictive (e.g., the adoption of the approach across all exposures) and call for significantly higher costs of operations which could be prohibitively high for smaller banks.
- Also, the coarseness of risk weights in the Standardised Approach will increase the procyclical moves of capital requirements, thereby rendering capital management more difficult for the less advanced banks using this approach. The SBA suggests reducing the gaps between risk weights when moving from one rating class to another, e.g, by introducing more granular rating classifications.
- The suggested treatment of undrawn commitments bears little incentive to move from the Standardised to the IRB Approach. Under the Standardised Approach (*Standardised Approach to Credit Risk* document, paragraph 49), "the credit conversion factor for business commitments with original maturity up to one year will be 20% (...). The credit conversion factor for commitments with original maturity over one year will

continue to be 50%." Under the Foundation Approach (*Internal Ratings Based Approach* document, paragraph 110), "...the Committee proposes to measure EAD on commitments and similar revolving credits as 75% of the off balance sheet amount. The 75% figure works in the same way as a credit conversion factor in the standardised approach.(...)" the SBA believes that the larger factor (which is equivalent to a 1.5 multiplier in risk weights) under the IRB Foundation Approach looks anomalous. Unlike the Standardised Approach, maturity is not taken into account under the IRB Foundation Approach. Therefore, our association suggests reviewing the calibration of the risk weight under the IRB Foundation Approach in order to at least ensure a similar treatment of undrawn commitments as under the Standardised Approach. The SBA also suggests providing for a maturity adjustment under the IRB Foundation Approach.

As a last general observation, the SBA would like to point to the fact that in the context of the supranational derivative exchanges within Europe, different weighting schemes are applied by national supervisors. Our association suggests treating the corresponding derivative exchanges like AAA-banks. Alternatively, we recommend including a category as "Claims on Derivative Exchanges". Exchanges with regulatory schemes equivalent to, e.g., Eurex - particularly with well-defined margin requirements - should be excluded from capital requirement rules since the corresponding risks are mitigated by the rules of the stock exchange itself.

b) Specific Remarks

Standardised Approach

Compared to the 1999 proposal, the Committee has reduced the weight for corporates rated A+ to A-. However, it has also substituted the granularity suggested in June 1999 (AAA to AA-; A+ to A-; BBB+ to BBB-; BB+ to B-; Below B-; Unrated) with the following categories: AAA to AA-; A+ to A-; BBB+ to BB-; Below BB-; Unrated. The consequence is that it has increased the charge for corporates rated BB- to B- (before 100%, now 150%). Low-grade corporates continue to be better off unrated than rated. Furthermore, the difference between the highest risk weight under the Standardised Approach (150%) and the highest risk weight under the IRB Foundation Approach (625%) is significant. The Committee should explain the reasons for this significant difference. More generally, the SBA believes that granularity of ratings continues to be insufficient.

Option 1 attributes to claims on banks risk weights based on the weighting applied to claims on the sovereign in which the bank is incorporated. The weight applied to the bank would be one category less favourable than that applied to the country. Our concerns refer to the crude nature of this link between the creditworthiness of a sovereign and the creditworthiness of domestic banks. In some circumstances, the existence of such a crude link could even run against improving the soundness of banks because capital requirements would have to be adjusted according to sovereign downgrades or upgrades, independently from the bank's performance and out of phase with the need to access international credit lines.

The Committee argues that for claims on banks, national supervisors will apply one option to all banks in their jurisdiction. Here, the criteria adopted to level the playing field appear to be arbitrary. The Committee should either provide a rationale for this choice or allow each bank to adopt its preferred method. Relying on geographical criteria might also conflict with consolidation rules for the capital calculation within internationally active banks. Lastly, it could prevent any meaningful comparison across banks and jurisdictions.

In particular, the SBA wishes to stress the fundamental importance of the regulatory equity requirements for mortgage lenders in Switzerland. According to a study of the European Mortgage Federation, over 98% of mortgage loans in Europe remain on the banks' balance sheets and are capital intensive (i.e., 50% or 100% weighting). This is in stark contrast with the US, where more than 50% of mortgage loans are removed from the balance sheet through securitisation.

The mortgage lending business plays an important role, primarily at Swiss domestic banks. Mortgages at Cantonal Banks amount to 81%, at Regional Banks to 89% and at Raiffeisen Banks at 91% of the total of loans to customers. As mentioned in the Explanatory Note, the goal of the Committee is to ensure for international banks that overall capital requirements will neither be higher nor lower than in the current regulation. Banks with large mortgage portfolios will be the losers in this scenario.

The weighting of residential and commercial mortgage loans is therefore of crucial importance to most of the Swiss banks.

Mortgage collateral reduces credit risk by reducing the loss given default. The **SBA therefore recommends reducing the weighting of mortgage loans in a differentiated way, depending on the quality of the properties and the loan-to-value ratio.**

Furthermore the SBA recommends accepting the risk reducing effect of mortgage collateral also in corporate lending.

The SBA is not sure where **lombard (collateralised) lending** fits into the proposed procedures for credit risk capital calculation. The rules for lombard lending are crucial for a large number of Swiss banks, however. Since lombard lending is not explicitly covered by the current draft of the Accord, **specific issues (regarding a robust risk management process as well as quantitative aspects, i.e., eligible collateral and standard supervisory haircuts) have to be clarified at the national implementation level.**

Basically, this lending activity is characterised by diversified baskets of collateral assets combined with conservative haircuts and daily revaluation and margining. This results in a very low risk lending activity. Asset Management banks applying conservative haircuts, ensuring diversification of assets and high quality risk controlling procedures have encountered few or no credit losses from that type of business in the past.

The SBA assumes, however, that this lending activity is covered to some extent in the standardised approach by the general collateral procedures defined in paragraphs 64 to 111 of the New Basel Capital Accord and paragraphs 88 to 173 in the "Standardised Approach to Credit Risk" document. In these sections, the Committee distinguishes between a simple approach and a comprehensive approach.

The **simple approach** is not applicable to the lombard (collateralised) lending activities performed by Asset Management banks since this is a retail type of business. The implementation of tools to calculate credit charges for all individual positions within the collateral basket would be too complex and not feasible.

The **comprehensive approach** is characterised by **haircuts** (for exposure, collateral and currency mismatches) applied to the market value of collateral in order to protect against price volatility. Haircuts can be computed by means of a standardised approach (supervisory haircuts) or by means of proprietary estimates. There is, however, uncertainty regarding the holding period assumption: The standard supervisory haircuts as well as own estimates are based on a holding period of 10 days, whereas in the paragraph on "secured lending transactions" (New Basel Capital Accord, paragraph 99), however, a holding period of 20 days is defined (given daily mark to market).

Since a lombard loan is collateralised by a diversified portfolio, the applicability of the list of eligible collateral as well as the standard supervisory haircuts under the comprehensive approach have to be reconsidered at national implementation level.

Credit Risk Mitigation

The comprehensive approach is characterised by a **floor w**, designed to encourage banks to focus on and monitor the credit quality of the borrower in collateralised transactions and to reflect the fact that, irrespective of the extent of overcollateralisation, a collateralised transaction can never be totally without risk. In other words, no amount of overcollateralisation will reduce capital requirements to zero unless w itself is zero. The level of w will be zero for certain very low risk transactions, while all other collateralised transactions - including the lombard (collateralised) lending performed by Asset Management banks - will receive a w of 0.15.

The SBA's concerns relate to the purpose as well as the level of w. Its level appears to be entirely arbitrary. The Committee offers no clues as to the motivation behind the choice of that particular level, except that the Committee seems to suggest that the residual risk consists of the extent to which the enforceability of the documentation used has been upheld in practice. In the light of this, it seems that the Committee imposes the floor w in order to cover against legal risk or, at any rate, some sorts of operational risk. The SBA believes that the Committee should tackle risks other than credit risk by means of operational risk capital charges and not by means of artificial floors. Such floors boil down to setting capital adequacy irrespective of the risk-sensitivity principle. Therefore, the floor w is likely to generate incentives for collateral mismanagement or redistribution as well as to duplicate capital charges (operational risk). The **SBA suggests dropping the w factor.**

Internal Ratings Based Approach

Firstly, the SBA would like to raise some **issues regarding definitions**. The criteria listed under the definition of **retail exposures** (paragraph 156), particularly those referring to the low-value of individual exposure and the large number of exposures, will depend highly upon the size of the individual institution considered. Reliance upon such criteria would therefore open the door for regulatory arbitrariness and further erosion of the level playing field. Two options can prevent such undesirable developments: (i) considering criteria such as either a low degree of product / service complexity or the degree of sophistication / standardisation of risk assessment of the counterparties instead of the

value of exposure, or alternatively, (ii) fixing an amount for the maximal USD equivalent value of exposures classified under retail exposure which would be identical for all countries in the Accord. The SBA would prefer the first option.

Also, the risk characteristics of **project finance exposure** (paragraph 157) justify a distinct treatment from the other asset classes defined. Current practice, however, does not generally use a methodological setting comparable to the risk assessment techniques used with the other types of exposures. Of course, the SBA offers its collaboration with the Basel Committee also in this field.

On a conceptual level, there is no practical need for a detailed common **default definition** under IRB across all entities. It is much more important that such a definition is consistent with internal loss data and / or the market practice as set by rating agencies. The SBA would, therefore, suggest having a much more general definition of default, covering what counts as a loss and some indicative events that could be counted as default, subsequent to an internal assessment. The focus should be on completeness (e.g., that no material historic loss is not assigned to a default event in the database) and accuracy (e.g., that each event in the database is accompanied by a material loss measured either by the final workout cost or, in the event the workout is not complete, provisions and cost to date) of the database used as a basis for IRB.

Moreover, the definition of default is not consistent between corporate and retail exposures. This inconsistency results from differing second bullet points of paragraphs 272 (corporate exposures) and 466 (retail exposures). The formulation in paragraph 466 ("...any reaging of a facility (e.g. extending the life of a mortgage to reduce monthly payments) is regarded as a default event, so long as such reaging is undertaken in distressed circumstances to mitigate a default event") appears impractical for daily business and could potentially lead to arbitrage between the retail and the corporate portfolio. The SBA suggests using completely identical default definitions in paragraphs 466 and 272. If this option for rewording were not considered, additional clarifications would be required as to the treatment of exposures going into recovery watch list, but not being provisioned for. The SBA would assume that such exposures should not fall under the definition of default.

Concerning eligibility, the SBA is concerned about the requirements for the adoption of the IRB Approach across all exposures (paragraph 159 and 160). Our association believes that different parts of a banking group should be allowed to use different approaches. Different business areas require modelling techniques to be tailored to business features and to be

commensurate with available resources. Therefore, the SBA suggests allowing for a mix of approaches – combining Standardised and IRB Approach – subject to supervisory validation. The SBA also suggests clarifying the criteria that make business units significant as well as explicitly excluding insurance business units of a banking group from the IRB rollout requirements.

As far as the treatment of collateral is concerned, the Internal Ratings Based Approach provides for several risk mitigation instruments such as collateral, on-balance sheet netting, guarantees and credit derivatives (paragraphs 197, 230, 231). There is, however, no recognition of risk insurance or marketable physical collateral such as leasing objects (e.g., aeroplanes, cars, ships, trucks and others) and tradeable commodities/goods. These are widely-used risk mitigation instruments, which are critical for conducting various businesses such as leasing, trade finance, etc. Not recognising these risk mitigants would undermine the bases of such activities. Therefore, the SBA suggests recognising the listed instruments as eligible risk mitigation instruments under both the Foundation and Advanced IRB Approach.

Concerning the Advanced Approach, the suggested standard supervisory haircuts (paragraph 88) require clarification. Under the comprehensive approach to collateral, haircuts may be calculated using a standardised approach. However, the standard supervisory haircuts supplied are for eligible collateral only. Haircuts are not supplied for other forms of exposure, which are also needed to calculate the adjusted value of the collateral.

A further comment refers to the suggested criteria to ensure meaningful differentiation of risk in the context of minimum requirements for corporate exposures. The consultative document suggests that in the rating grade structure there should be a meaningful distribution of exposure across grades and no excessive concentrations in any particular grade (paragraph 242). The SBA agrees, of course, with this requirement. But the Committee goes on to require that no more than 30% of the gross exposures (before on balance sheet netting) should fall in any one borrower grade (paragraph 242). If, for example, a bank - due to its loan strategy - has more than 30% of its loans in the AA-range, this does not allow drawing very meaningful inferences about the quality of its rating system. The **SBA recommends a more flexible use of the criterion for the rating grade structure.**

Still in relation to the minimum requirements for corporate exposures, with regard to the completeness and integrity of rating assignments, the SBA wonders whether requiring that

the process by which a borrower is independently reviewed must be documented really resists a cost/benefit-analysis in every individual case. Especially regarding retail positions there should exist a much simpler procedure (paragraph 245).

Generally, the time horizon over which the rating is considered and the definition of PD as a one year PD do not seem to match. The Committee explicitly states that the rating (assessment) horizon is a different concept than the time horizon associated with risk quantification or the assigning of PDs to grades. However, this raises a consistency issue in the sense that it is not clear how ratings with a multi-year horizon should be reconciled with one-year PDs. Moreover, the data concept for one-year PDs is not clearly stated. The SBA would appreciate more clarity on this topic.

More specifically, and with regard to the criteria and orientation of the rating system (assessment horizon), the SBA basically agrees with a one-year horizon for risk quantification (assigning PDs to grades). It also agrees that banks should initiate a new rating if material new information on the borrower comes to light (paragraph 246). However, it doubts whether, in the case of higher-risk borrowers, a review of the borrower and the grade to which it is assigned can be carried out more frequently than once a year. In practice, a higher frequency will often be problematic since the data necessary as input to sophisticated models will in many cases not be available during the year (paragraph 263).

For the minimum requirements for PD estimation, banks are asked to review their PD estimates on a yearly basis at a minimum (paragraph 275). The SBA suggests enlarging this period to, e.g., two to three years. The same argument applies to LGD estimates (paragraph 345) and essentially to paragraphs 356, 381, 395 and 471.

With regard to stress tests for the assessment of capital adequacy, our association believes that requiring to conduct stress tests at least every six months (paragraph 300) is exaggerated, especially because the relevant economic data will often not be available for such short time intervals. Instead, the SBA recommends conducting stress testing once a year only. In the same context, the SBA thinks that periodic testing of model outputs against outcomes on an annual basis in the process cycle of model validation is - at least for many important cases - not realistic (paragraph 305). Here, the SBA also suggests enlarging the corresponding interval to two to three years. An analogous reasoning applies to stress testing processes for evaluating estimates of LGD (paragraph 361) as well as EAD estimates (paragraph 373).

With respect to the minimum requirements for the estimation of LGD within the Advanced Approach, the SBA agrees that estimates must be based on a minimum data observation period ideally covering a complete economic cycle and must be no shorter than a period of seven years. However, the SBA's feeling is that during the first few years after implementation of the New Accord, this period should be shortened to a time series of, e.g., five years only (cf. paragraph 283) and that corresponding simplification is called for.

Asset Securitisation

The Committee is proposing to underpin asset securitisation with regulatory capital. The SBA has a number of concerns with respect to this initiative. While the intention to subject securitisation to regulatory capital requirements in order to tackle the practice of capital arbitrage is to be welcomed, the SBA recommends a fine tuning of the approach in order to adequately discriminate between cases of "good" securitization on the one hand, performed for liquidity and genuine credit risk management purposes, and "bad" securitisation on the other hand, pursued purely for regulatory capital arbitrage purposes.

Asset securitisation is a promising business area for banks, with key liquidity and credit risk management aspects. Moreover, it generates transparency - a by-product of securitisation that should be of key interest to regulators. Therefore, it is important that any capital charges imposed do not discourage good securitisation practice. More concretely, while the SBA supports the disincentives to provide any kind of implicit support in the event of a subsequent deterioration of the credit quality of the securitised portfolio, it believes that the penalties foreseen for banks doing so are excessive.

Furthermore, the SBA notes that the onerous capital treatment for originating banks and servicing banks sponsoring their own securitisations represents a strong incentive for them to arrange for third party credit and liquidity support. The SBA also notes that more restrictive requirements for structuring, clear distinctions between origination, servicer obligations, liquidity support, credit enhancement and enhanced disclosure requirements are likely to result in more transparency.

However, the SBA believes that there is scope for clarifying how banking groups with various legal entities will be treated with regard to these developments, particularly if one of its business units provides implicit support.

1.2 Operational Risk

a) General Aspects

As pointed out in the general comments, capital charges for operational risk represent one of the main concerns of Swiss Bankers Association. In the light of recent history, operational risk most certainly represents an internationally relevant issue for banking regulation. **Our association generally accepts the view that in order to protect bank customers and the financial system, the measurement and management of operational risk may make sense. However, the SBA feels that the area of operational risks is by far less concretely presented in the New Basel Capital Accord than are other areas as, e.g., credit risk. Overall, we therefore strongly recommend that the capital requirements for covering operational risks be more clearly defined.**

Besides issues of definition and clarity, the SBA also has some serious doubts concerning the methodological approach. For example, the suggested indicators seem to be highly arbitrary and basically lack empirical justification. Hence, it is impossible to assess whether there is any gain in risk sensitivity by progressing from the Basic Indicator to the Standardised Approach.

One of the major differences between the different approaches is that only in the most sophisticated method (Internal Measurement Approach) loss types are specified, i.e., the Committee discloses what risks it is actually targeting under the umbrella term of operational risk. This methodological difference translates into a discontinuity between the first two approaches on the one hand and the third approach on the other. The first two approaches are basically based on business lines whereas the third is based on loss types and, accordingly, is the only risk sensitive one.

In the context of several methodological problems, it would from the SBA's perspective have been desirable to conduct a much wider and thus more representative impact study involving not only a larger sample of banks, but also some more specialised banking groups. **It is the SBA's hope that the second impact study being conducted simultaneously to the ongoing consultation process will be more conclusive in this respect.**

In the event that a specific capital charge for operational risk were to be included in the New Accord under Pillar 1, the SBA would expect the Basel Committee to make all necessary provisions to avoid double counting. More concretely, the SBA would like to

point out that the text of the New Accord implies overlaps between the capital charges against operational risk on the one hand and against credit and market risks on the other. The floor w, which limits capital benefits from credit risk mitigants to 85%, is supposed to cover legal risk and other operational risks. The Committee should avoid double counting operational risks by means of w and by means of another explicit charge through the operational risk charge. Additionally, banks which calculate the market risk capital charge by means of internal VaR models, can incur capital penalties (increase of the multiplier from 3 to 4) by letting inappropriate data integrity and data management negatively affect backtesting results. Again, the Committee should avoid double counting operational risks by maintaining this penalty under market risk and introducing another explicit coverage of losses connected with inappropriate data integrity and data management under the operational risk charge. The SBA urges the Committee to pay due attention to these issues and to eliminate possible double charging by either eliminating these charges from the credit and market risk methodologies or by avoiding their inclusion under the operational risk charge.

b) Specific Remarks

The Basel Committee currently defines Operational Risk as "the risk of direct or indirect loss resulting from inadequate or failed internal processes, people and systems or from external events" (e.g., Supporting Document on Operational Risk, p. 2). The SBA has several comments regarding this definition.

First, the SBA welcomes the fact that strategic risk as well as reputation risk are not included in this definition. Nevertheless, **the exclusion of certain risk categories from the definition of operational risk does not legitimate the implicit assumption that all other possible forms of operational risk should be subject to capital requirements. In particular, business risk should be explicitly excluded, along with reputation and strategy risks.**

Second, **the used definition of operational risks** does not describe operational risks as such, but rather the potential causes of operational risk. Assuming that this type of vague definition of possible causes of a certain risk type constitutes an economically legitimate basis for capital charges is at least a brave hypothesis. The following analogy with market risk illustrates the associated problems. Clearly, the causes of market price volatility and, hence, market risks are decisions of individuals to sell or buy, together with their interaction. Nevertheless, this type of causal "definition" would neither be considered a

robust basis for capital charges on market risks nor would be of great help for banks' market risk management. It appears dangerous to us to build capital charges for operational risks on a definition of operational risks that is focused on its causes instead of nature.

Third, although the formulation of the attempt to define operational risks is grammatically a positive and an enumerating one, the use of the term "Operational Risks" as a residuum for any possible risks that do not directly belong to other well-known risk categories (such as credit risk or market risk) becomes obvious. Stating that operational risks are all the risks stemming from inadequate or failed processes / people / systems is so general that it is nearly tautological. The **SBA definitely suggests that the term "operational risk" be more precisely defined.**

Fourth, in its definition of operational risks, the Basel Committee apparently intends to shield institutions from both direct and certain indirect losses (e.g., Supporting Document on Operational Risk, p. 2). Here also, it is important to have a clear understanding of which loss categories should be included in the calculation of losses coming from operational failure. **Again, the SBA recommends that the Committee defines more accurately what "direct losses" and especially what "certain indirect losses" are.**

Fifth, the Supporting Document on Operational Risk (p. 2) states that there may be other types of losses or events such as near misses, latent losses or contingent losses which should be reflected in the capital charge. In practice, however, banks would typically face great difficulties in identifying, measuring and reporting the hypothetical impact of events of this type. The decision whether to include certain kinds of events for calculating the required capital charge would mainly be based on subjective criteria and would be very arbitrary. **Summing up, the SBA doubts whether it will be possible to satisfactorily include near misses, latent and contingent losses and the like as elements of operational risk.**

Sixth, the definition of operational risks suggested by the Committee explicitly includes losses from external events. In order to avoid that every single risk that cannot directly be attributed to credit, market, strategic or reputation risk has to be considered as operational risk, **the Committee should try to unambiguously define what "external events" are thought to be. And the Committee should clearly state that catastrophic losses are explicitly excluded from the scope of regulatory capital.**

Turning now from issues concerning definition to the proposed methodologies of calculation, the SBA also has some doubts about the possibility of implementation.

Basic Indicator Approach

As far as the Basic Indicator Approach is concerned, the risk sensitivity is very limited. Using gross income as an indicator of operational risks does not properly take into account a bank's field of activities and might lead to a certain volatility of the minimum regulatory capital. The gross income indicator fails to capture the quality of risk management as a primary factor in controlling operational risk. Even more seriously, taking gross income as a proxy for operational risk creates quite perverse incentives. It is in our view crucial that the New Accord attempts to find ways to measure operational risks in a more incentive-compatible way. And, more generally, it is not clear at all why it should be possible to approximate something as multidimensional and complex as operational risk by one single variable only.

As a general point of critique, concerning both the Basic Indicator as well as the Standardised Approach, the SBA strongly objects to the assumed linearity of operational risk. The exposure due to operational risk is clearly not a linear function of the size of a bank. Recently published empirical research seems to indicate that the size of operational risk loss bears little relation to the size of the institution. Whereas the relationship between size and the magnitude of operational risk might be a positive one on average, this relationship is surely not directly linear. The SBA believes that the larger a bank, the smaller the percentage of capital charge that should be applied.

Abstracting from this general line of critique, the factor α (30%) has apparently been calibrated in such a way that the capital charge for operational risks is about 20% of a bank's total capital requirement. Besides our concerns regarding the quality of the proxy as such, the SBA strongly doubts whether this calibration represents (i) the current percentage banking institutions hold on average for operational events and (ii) the importance of operational risks relative to credit risk in a realistic way. **In our view, calibrating the charge for operational risk to 20% of the total charge is much too high. This perception has been empirically confirmed by preliminary calculations performed at Swiss banks.**

On the one hand, if the Committee's perspective is that the 20% calibration choice comes from modifications of capital requirements for credit risk, then our point is that the

calibration is very arbitrary. Calibration should result from concrete risk considerations instead of strategic reasoning with respect to the maintenance of the overall capital level. This is where the imprecision of the operational risk definition comes in to create problems of consistency. From a conceptual point of view, the intention to proportionally link - even only for initial calibration purposes - the operational risk charge with the capital charge for credit and market risks runs against the rationale for revising the Accord. One of the main purposes of the revision is precisely to increase risk sensitivity and, specifically, to depart from the proportional link established in 1988 by saying that the 8% capital charge implicitly covered operational risks as well.

If, on the other hand, the Committee's argument is that the calibration has been chosen in order to be compatible with current industry standards, our response would be that the outcome of 20% seems to have been significantly dependent on the sample of banks taken into account together with their specific fields of activity as well as with their specific definitions. The Committee is referring to a figure that stems from a survey on economic capital allocation for risks other than market and credit risk (operational risk constituting a fraction of those), performed some years ago amongst a restricted set of firms. Reflecting economic (and not regulatory) capital allocation to other risks (and not simply operational risk), this study cannot be taken as an indication of the appropriate level of regulatory capital allocation for operational risks.

In sum, the SBA would like to express the desire that in future calibration exercises the factor α will be calculated in a more representative way and be based on a more representative sample of banks.

Another aspect deserves attention. Under the Basic Indicator Approach, banks have to hold capital for operational risk equal to a fixed percentage (α) of gross income, defined as the sum of net interest income, net non-interest income (before deduction of operational losses). This reference to the ability to deduct operational losses is puzzling in the sense that the necessity to deduct operational losses requires the ability to identify these losses. If, however, they can be identified, then the bank is likely to be able to qualify for an advanced method. If, on the other hand, these losses cannot be identified, then there is the real danger that a bank could reduce its regulatory capital requirement by inadvertently incurring larger and larger operational losses. **In sum, the Basic Indicator Approach is totally lacking empirical underpinning and its risk sensitivity is extremely doubtful.**

Standardised Approach

The arguments sketched above analogously apply to the Standardised Approach, which also operates with relatively arbitrary risk indicators and lacks empirical foundation. **Again, the SBA thinks that the calibration process aiming at defining the β factor should be extended to include a wider range and more representative sample of banks, e.g., also including banks mainly active in the asset management business.**

Of course, one of the main challenges regarding the Standardised Approach will be the identification and definition of clearly differentiated business lines. Moreover, and to some extent paradoxically, the categorisation of banks into different business lines or business units also needs to allow for a certain degree of flexibility such that banks may define these lines and the appropriate betas in agreement with the relevant regulator.

Generally, the SBA is convinced that the new capital adequacy framework should guarantee that for banks allowed to use the Standardised Approach the capital charge to cover operational risks is always lower than the one calculated using the Basic Indicator Approach. Otherwise, the incentives to meet the specified quantitative and qualitative criteria for using the Standardised Approach will clearly be lacking.

Besides the above aspects concerning incentives, it is the SBA's view that it is imperative that also risk mitigation efforts should be rewarded by smaller capital charges for operational risks. In order to avoid replacing an operational risk simply by a counterparty risk, the SBA recommends that the Committee specifies the objective criteria to be met for risk mitigation efforts to be taken into account for the calculation of operational risk capital charges.

Internal Measurement Approach

Concerning the Internal Measurement Approach, most of our concerns above apply in a similar fashion. The **SBA considers it to be important that there be incentives to move from the Basic Indicator to the Standardised Approach and - for some sophisticated and internationally active banks - on to the Internal Measurement Approach.** As already pointed out, these incentives can best be provided when adequate reductions in the capital charge can be achieved by improved risk management.

Given that it is the supervisors' intention to reward good risk management practices, the SBA is surprised not to find direct capital discounts for prudent and sound risk management practices. In our view banks should be given direct capital discounts for sound risk management practices such as:

- top management focus on risk governance
- issuance and enactment of policies and frameworks for operational risk management
- adequate organisational structure and dedicated staff on risk management
- financial investment on risk management infrastructure (including MIS)
- appropriate risk reporting across the hierarchy of the organisation (including various relevant risk committees for risk review, limits approval, credit management, escalation and oversight)
- effective operational risk methodologies

Whilst the SBA welcomes the principle of risk transfer and insurance being endorsed by supervisors, it would also like to see direct capital discounts for effective risk mitigation. For example, supervisors could consider a direct capital discount, e.g., a reasonable percentage of the insurance / risk transfer coverage, especially for contracts that cater for low probability / high impact events. This percentage deduction could then take into account the potential lack of standardisation of operational risk insurance contracts. Over time, when both the industry and the regulators are more comfortable with insurance / risk transfer, this discount factor may have to be adjusted.

Concluding on operational risk, the SBA wants to emphasise once again that it is highly concerned about the proposed methodological approach:

- In relation to the Basic Indicator and Standardised Approaches, the problem is not that approximations are used to measure operational risk. The problem rather is that it is not made explicit and clear what should be approximated at all. Without having a workable definition of operational risk events and a mechanism to segregate operational risk losses from credit and market risk losses at hand, the consultative documents conclude on how to measure operational risk for regulatory capital purpose.

- Regarding the Internal Measurement Approach (and a possible Loss Distribution Approach), the Committee suggests a measurement methodology similar to the methodology currently used / suggested in the fields of market and credit risks. The SBA is concerned that the use of such methodologies for operational risks has not been

conceptually analysed with enough intensity and rigor. It recommends further work in co-operation with the industry, not constrained by an arbitrary and over-tight deadline, in order to achieve an industry-wide consensus on this isse.

To conclude, the SBA suggests:

(i) trying to make the definition of operational risks more precise, particularly as far as the Basic Indicator and Standardised Approaches are concerned, and,

(ii) allocating the necessary time and resources to the dialogue between the Committee and the industry to generate a consensus and sound conclusions on the Internal Measurement Approach.

If the efforts undertaken within the available timeframe prove insufficent to deliver the desired outcome, the SBA would recommend a temporary delay in imposing explicit quantitative capital charges for operational risk under Pillar 1 and instead implementing a qualitative treatment of operational risks within Pillar 2, basically along the lines developed for the treatment of interest rate risk in the banking book. Concentrating on the qualitative aspects of operational risk management could be more realistic than demanding rigid quantitative charges at this early stage.

In other words, the SBA admits that - in principle - introducing capital charges for - at least some categories of - operational risks may make sense and may be economically justified. However, our association has serious concerns about the underlying methodology of the suggested approaches. Whereas the SBA admits that the Internal Measurement Approach goes in the right direction, we would like to reiterate that the Basic Indicator Approach as well as the Standardised Approach both are at a very preliminary, immature stage and suffer from quite some methodological arbitrariness.

In particular, the SBA does not accept the hypothesis of a linear (i.e., proportional) relationship between indicators of the size of a banking institution on the one hand and the degree of operational riskiness on the other. Instead, our association strongly pleads in favour of using a degressive (or capped) (instead of linear) functional form in any formula for capital charges aimed at operational risk. Given the vague nature of the proposals and the fact that the second Quantitative Impact Study is still being carried out, it is not at this stage possible to offer more constructive suggestions.

Of course, the SBA, together with the Swiss banking industry, would be happy to cooperate with the Basel Committee in redesigning the corresponding approaches and we look forward to seeing the results of the second Impact Study as soon as possible.

2. Pillar 2: Supervisory Review Process

a) General Aspects

As far as the second pillar is concerned, our association basically welcomes at least some aspects of reinforcement of the supervisory review process in the context of capital adequacy. This pillar has, of course, the virtue of offering great flexibility in the design of regulation and supervision and permits to further differentiate between institutions of different size, riskiness and systemic relevance. The SBA would like to point out, however, that the implementation of Pillar 2 in Switzerland can also be expected to be associated with major quantitative as well as qualitative resource problems.

Our association understands that – as the Accord is not specifically addressing insurance risk – Pillar 2 would not cover insurance subsidiaries of banking groups. The SBA also assumes that Pillar 2 will not cover non-consolidated majority-owned securities and other financial subsidiaries. The SBA would suggest making this explicit in the New Accord. Also, it would urge the Committee to consider the limitations of harmonisation of sectoral rules and avoid placing insurance subsidiaries belonging to a banking group at a competitive disadvantage against other insurance firms. Moreover, the SBA recommends taking into account positive effects of earnings diversification.

The SBA agrees with the strategy to treat interest rate risk in the banking book under the supervisory review pillar of the new framework due to the considerable heterogeneity between banks in terms of the nature of underlying risks as well as the processes for monitoring and managing them.

Of course, the SBA would like to cooperate with the Basel Committee also with respect to Pillar 2.

b) Specific Remarks

The SBA welcomes the fact that the Committee has decided to make Pillar 2 more concrete by specifying four main principles. Although the SBA agrees with the principles in principle, it would like to draw the Committee's attention to several points of interest.

Principle 1: The SBA agrees that banks should have a process for assessing their overall capital adequacy in relation to their risk profile and a strategy for maintaining their capital levels. **However, this principle should be implemented in such a way as to adequately differentiate between banks of different type and size.** As an example, paragraphs 601 (credit risk methodologies), 602 (internal risk ratings) and 603 (analysis of credit risk at the portfolio level) in the New Basel Capital Accord might go too far for most small and medium-sized banks.

Principle 2: The SBA also agrees with the idea that supervisors should review and - at least to a certain degree - evaluate banks' internal capital adequacy assessments, as well as their ability to monitor and ensure their compliance with regulatory capital ratios. However, the **SBA would like to emphasise that this type of review and evaluation has to be kept at a very limited level so as not to interfere directly with regular business decisions of bank management.** Secondly, the SBA would like to stress that banking supervision in Switzerland is to a large degree exercised by the Swiss Federal Banking Commission via licensed auditing firms. **This kind of a well functioning dualistic supervisory framework must in any case remain possible under the New Accord.**

Principle 3: Whereas the SBA agrees that supervisors should have the possibility to expect banks to operate above the minimum regulatory capital ratios, it objects to the supervisor fixing the degree of the additional safety cushion. Again, the **SBA suggests letting banks themselves choose the amount of economic capital they want to hold in addition to what is required by regulation.** Additional capital requirements as formulated under Principle 3 in its current form are not acceptable because (i) what is to be considered adequate is left at the discretion of regulators, (ii) Principle 3 asks for additional capital for risks that should already be covered under Pillar 1, and (iii) it includes capital requirements for business cycles, strategic developments etc. which were intentionally excluded under Pillar 1. Without clear guidance and agreement on these aspects, banks will run the risk of an undefined additional capital charge that cannot be properly calculated and that will vary from country to country or even from institution to institution. **Therefore, it is our firm opinion that this principle will need a thorough review both in general and in detail.**

Principle 4: Our association basically agrees that supervisors should seek to intervene at early stages to prevent capital from falling below the minimum levels required to support the risk characteristics of a particular bank and should require rapid remedial action if capital is not maintained or restored. Nevertheless, it has to be pointed out that **neither the criteria for early intervention nor the concrete actions to be taken by the supervisor are very clearly specified.** There remains considerable room for national interpretation that could give rise to significant distortions. **Consequently, the SBA considers it very important that supervisors must take care to carry out their obligations in a highly transparent and accountable manner,** as stated in paragraphs 64 ff. of the supporting document on Pillar 2.

Concluding on the above four principles, the SBA believes that the Committee should explicitly promote effective co-ordination amongst national supervisors based on sound rules, for instance the principle of the lead home country supervisor. If this rule (that the Committee has traditionally supported) is chosen, then the home country supervisors should have well accepted consolidated views and oversight approaches for carrying out the activities described under Pillar 2. Insufficient co-ordination by national supervisors of the interaction with sophisticated international banks would unduly increase the burden on the management of these institutions. The SBA is extremely concerned that no provision is made to secure an internationally harmonised practice for exercising the far-reaching authorities among national supervisors. This bears the potential for harming the international level playing field among banks and for giving rise to regulatory arbitrage. To ensure a level playing field, further guidance in this respect should be developed. The **SBA therefore suggests that the Accord spells out detailed operational criteria applicable for all national supervisors when exerting the authorities provided by Pillar 2.**

Furthermore, it is important that precise control criteria for national supervisors be defined in the New Accord in order to avoid excessive differences in national practices. In this context, the SBA respects that regulators will always have and use discretionary power. However, it would expect that this discretion be clearly specified by the New Accord as well as that such powers should (i) only be used in respect of the principle of the level playing field and (ii) be subject to legally enforceable rights of recourse to a court.

Interest Rate Risk in the Banking Book

Concerning interest rate risk in the banking book, the SBA would like to emphasise the following aspects in the Supporting Document entitled *Principles for the Management and Supervision of Interest Rate Risk*.

The SBA is concerned that an aggregation of interest rate risk "... independent of whether the positions are part of the trading book or reflect banks' non-trading activities..." as implied in paragraph 2 and 42 could significantly reduce the power of risk information. Interest rate risk is of an intrinsically different nature in the banking book than in the trading book. In contrast to the banking book, in the trading book, a material position one day can be the exact opposite the next day. The SBA would, therefore, suggest rewording these paragraphs in such a way as to give full consideration to the point made in paragraph 6 of Annex 2.B, i.e., to provide for a separate treatment of interest rate risk in the banking book and the trading book.

With regard to Principle 14 the SBA notes that the criteria based on which supervisory authorities would assess the adequacy of internal measurement systems are not specified. This bears a significant potential for regularity arbitrariness, which again is not conducive to securing an international level playing field in the banking industry. These criteria would therefore in our view need to be specified prior to implementing the New Basel Accord.

On a technical level, a one-year holding period is underlies the definition of the standardised rate shock in paragraph 81 (and in Annex 4). The SBA believes that this does not reflect current practice for the following reasons: (i) market transactions to reshape the risk profile can be transacted in much shorter intervals, and (ii) interest rate risk is reported to senior management on a monthly basis. The standardised rate shock would thus bear an overly conservative bias unduly magnifying the level of interest rate risk. Our association would suggest basing the standard shock on a holding period of 30 days and rewording paragraph 81 b) and Annex 4 accordingly.

Moreover, the SBA is concerned that paragraph 82 (and paragraph 6 of Annex 3), in terms of requirements regarding the level of detail and coverage, would be overly burdensome in relation to the additional risk information generated. The SBA would suggest rewording paragraph 82 in such a way as to: (i) place the benchmark for currency accounting at 10% (instead of 5%), and (ii) require only other material (instead of "any") remaining exposures to be subject to a 200 basis point shock.

3. Pillar 3: Market Discipline

a) General Aspects

As stated in its response to the first consultation package, the SBA would like to stress our sympathy with the proposed approach of enhancing market transparency and discipline. In general, the SBA argrees that disclosure of capital levels, risk exposures and capital adequacy can contribute to enhanced transparency leading to increased market discipline as well as - at least in principle - to an enforcement of the market for corporate control which the SBA expects to have a positive effect on the safety and soundness of the financial system.

Clearly, market participants often have better and more timely information about the state of banks than supervisors do. Therefore, by enhancing market discipline, the available information about the true state of a bank can be improved. Furthermore, a well functioning market for corporate control can strengthen the incentives of depositors and other creditors as well as shareholders to monitor the bank's risk taking more attentively. However, a wide range of practical questions arises.

- First, although transparency normally has the characteristics of a "good" in the economic sense, more information is not always better than less. More concretely, information and transparency requirements have to be considered also in the light of the involved costs to produce the corresponding information. Therefore, **it is in our opinion crucial that implementation costs of Pillar 3 be explicitly considered and anticipated.**

- Second, **the extent proposed for disclosure probably amounts to much more than what the external audience can digest.** The Committee might have been guided by the necessity to provide the market with sufficient information to be able to rightly interpret the capital ratios declared by banks. By so doing, it has lost track of what the market really needs to assess the risk condition of banks and, accordingly, to exercise market discipline. Saturating a broad public with technical information on models can be counterproductive with respect to enhancing market discipline.

- Third, and as already suggested in our position on the Committee's 1999 draft, **the Committee should consistently distinguish between disclosure to supervisors and disclosure to the public.** It should be possible to envisage broader sets of data being openly available to supervisors who have to assess the fitness of internal approaches

for the different levels of sophistication envisaged in Pillar 1. This scrutiny would allow supervisors to act as intermediaries by issuing health checks or benchmark assessments of the internal processes used by different banks.

- Fourth, it is essential to realise that **capital adequacy is not the prime concern of market watchers.** The market primarily wants to assess the quality of earnings and the Committee should recommend market disclosures accordingly. These recommendations should especially allow the market to assess the quality of internal risk management and control processes. They should also allow the market to grasp the actual risk / reward profile of the institution by means of standardised, comparable and comprehensive disclosure of exposures, sensitivities and loss experience related to the targeted risks. Essentially, disclosure should inform on scenario analysis and stress loss management as performed by the institution. The SBA believes that disclosure is an area where the banking community should be encouraged and allowed to lead the process.

- Finally, the framework shows a lack of co-ordination between the international accounting disclosure framework and the regulatory capital disclosure framework. This discrepancy could lead to unintendedly costly and harmful consequences. The **SBA recommends aligning disclosure requirements with international accounting standards.**

b) Specific Remarks

The SBA clearly agrees with the idea that materiality (cf. paragraph 636) should drive decisions on which disclosures are to be made. Mainly in the light of implementation costs, aspects of materiality should definitely apply with respect to core as well as supplementary disclosure. Furthermore, the SBA would like to point to the fact that disclosure requirements as proposed may in many cases, and especially for smaller banks, lead to problems with respect to banking confidentiality. Generally, it should not be possible to make inferences about individual exposures from capital adequacy disclosure.

The SBA does not clearly see additional benefits, for example, in having to disclose

- total unweighted credit exposures before and after recognised credit risk mitigation (paragraph 650.a)

- a more detailed breakdown of exposures by type, e.g., loans, investments, contingent items, repos and types of derivative (in addition to the core breakdown) (paragraph 650.c)
- the required data for estimation of the model and so on for banks using IRB approaches (paragraph 652.a)
- exposures amounts before and after recognised credit risk mitigation (paragraph 652.b)
- the distribution of rating migrations for the last 1, 2 and 3 years for each portfolio (paragraph 652.c)
- total exposures, the amount of exposure secured by collateral and on balance sheet netting contracts, and risk weighted assets excluding and including the effects for collateral / on balance sheet netting (paragraph 656)
- total exposures covered by guarantees / credit derivatives, risk weighted assets excluding the effects for guarantees / credit derivatives
- the capital charge for option positions (paragraph 663.a)

Concerning the frequency of information, the SBA pleads in favor of an adequate degree of flexibility in order to harmonise the rhythm of disclosure with accounting standards as well as with specific national conditions.

Furthermore, the characteristics of the disclosure are not explicitly specified. Therefore, it does not become clear whether the information should be included in shareholder letters, annual reports, press releases or if the release of the regulatory reporting document could also be considered. The SBA would suggest standardising the regulatory reporting formats.

Qualitative Information

It is in our view questionable to make internal strategies, tactics and objectives public. Paragraph 650 b) of "The New Basel Capital Accord" asks banks to publish such strategically vital information in their future plans. Additionally, it appears doubtful whether auditors or regulators are in a position to verify such information.

According to paragraph 652 a), banks must disclose their supervisor's acceptance of their IRB Approach. It should not be necessary to disclose additional qualitative information such as:

- whether own estimation or a supervisory vector for LGD and / or EAD are used

- methods for estimation and validation of PD
- required data for estimation of the model
- responsibility for and independence of the rating process
- relation between internal and external ratings
- the process used for managing and recognising credit risk mitigation

Moreover, since a bank has been reviewed by its supervisor and auditor, the public should be confident that (i) the management of collateral, (ii) the recognition of collateral as well as (iii) the monitoring of the continuing credit-worthiness of protection providers and the administration of guarantees and credit derivatives are handled in a correct manner. Such information, as required in paragraph 655, should not have to be disclosed.

Most accounting standards have strict rules concerning the conditions to be met in order to net on-balance sheet transactions. It can be assumed that the financial statements of banks comply with these standards because external auditors have audited them. Therefore, it is not necessary to disclose the overall strategy of netting as recommended in paragraph 657.

Quantitative Information

Paragraph 650 c) recommends disclosing volumes of credit risk transferred into securitisation vehicles. Such information should be obtained by reading the section dealing with asset securitisation (paragraph 659). Information regarding credit protection purchased using credit derivatives is available in the credit risk mitigation section (paragraph 656).

According to paragraph 656, a bank must provide information on the type of regulatory calculation methodologies that it has selected with regard to the credit risk mitigation techniques. Again, insofar as auditors and the supervisor have approved the methodologies applied, such information should be irrelevant to the public.

Paragraph 658 recommends that banks applying credit risk mitigation techniques disclose the types of eligible collateral by geographical grouping. For banks applying the IRB Approach this information creates no additional benefit to the public. The same paragraph also recommends that banks disclose their main guarantors / protection providers. However, if this information were material, it would have to be disclosed already according to paragraph 650 (significant concentrations of credit risk).

According to the section dealing with asset securitisation (paragraph 659, 660 and 661) a lot of disclosures are required on a detailed transaction level. From our perspective, showing this data only on an aggregated level should be sufficient for the public.

According to paragraph 663, banks are required to disclose movements of portfolios between the Standardised and Internal Models Approach. As long as all assets are classified correctly, which has been approved by both the supervisor and the auditors, such movements should be irrelevant to the public, too.

The disclosure on interest rate risks (paragraph 667 to 669) would be derived from stressing the relevant books under given scenarios. Here, a common definition of such scenarios is needed; otherwise, sensitivities among banks could not be compared. In addition, the shocks underlying the scenarios should be in line with sensitivity analyses already required under various GAAPs (e.g. US GAAP, where at least 10% shifts have to be applied).

Coming back to operational risk, the SBA believes that disclosure in the annual report should be limited to control mechanisms and procedures. Whereas the SBA banks are willing to disclose operational risk data including losses to regulators, rating agencies, our insurance underwriters or large stakeholders, the SBA feels that indiscriminate loss data disclosure will result in imprudent increase in reputation risk for banks, especially if these loss data are not relevant but offer a potential for misuse by the media. Particularly in the case of pending litigation, indiscriminate publication of prudent provisions may be misconstrued as implicit admission of guilt. Another unhealthy development may be the exaggeration and sensationalising of such details by the media. Serious problems would arise when comparing banks in terms of models (data, history, ratings, etc.) such that all corresponding comparisons of models have to be considered as highly questionable. For the above reasons, our association believes that expected operational losses should not be required to be published.

4. Conclusions

From an academic and conceptually relevant perspective, it has to be kept in mind that theoretically as well as empirically the effects of capital adequacy requirements are not unique.

As is well known, of course, in *microeconomic* terms, the literature in this area is highly inconclusive in the sense that the risk reducing effects of capital regulation are not generally accepted. Some theoretical studies even suggest that capital requirements (especially if applied uniformly across banks) may lead to an overall increase in the riskiness of portfolios, partly because banks may face an incentive to substitute towards riskier assets within a given risk category.

Empirically, whereas it is generally acknowledged that capital ratios have internationally increased on average during the ten years following the Basel Accord of 1988, causalities are not clear and hard to prove econometrically. The empirical evidence concerning the corresponding risk impact is mixed. In other words, a systematic relation between the level of capital and the risk of insolvency could not be demonstrated so far.

In *macroeconomic* terms, it is not clear to what degree capital adequacy requirements can and will have pro-cyclical effects. Empirically, some negative macroeconomic effects ("credit crunch") can at least be shown for some countries in some time periods.

The Basel Committee on Banking Supervision has itself directed attention to the above issues in its paper "Capital Requirements and Bank Behaviour: The Impact of the Basle Accord", dating from April 1999.

In sum, these more general considerations do not primarily constitute arguments against capital requirements per se. However, they should in our opinion give rise to a very careful and critical assessment of any measures of regulatory intervention to be taken in the field of capital adequacy.

It is in this sense that the SBA believes that these conceptual considerations enhance its position outlined above and especially our argument in favor of future approaches to capital adequacy regulation that sufficiently differentiate between institutions operating in different businesses as well as between different banking groups.

Again, the SBA admits that the revision of the 1988 Accord has become highly necessary and welcomes the general strategy to make the New Accord more risk sensitive. The SBA supports the idea of placing more emphasis on banks' internal risk management methodologies. With the restrictions given above, our association also welcomes the more qualitative approach as defined in Pillar 2 as well as the principle of including interest rate risk in the banking book in Pillar 2. And, last but not least, the SBA is basically in favour of reinforcing transparency and market discipline via

Pillar 3, where (i) implementation costs as well as (ii) accounting standards have to be carefully taken into account. Besides specific remarks concerning calculation and methodology, the SBA also welcomes the chosen menu approach of the new framework and believes that it generally has to provide banks with well-defined incentives to use more sophisticated and more reliable modelling and risk management techniques.

However, the SBA is of the view that the proposed capital charges are generally excessive throughout the New Basel Capital Accord. Where this is especially the case with regard to specific categories like mortgage lending or lombard credits, it is also true in a more general sense. The SBA has commented in detail on the approach used for calibration. Particularly, it strongly objects to the Committee's approach to condition the New Accord on the past level of capital in the banking system. This approach, in contrast to starting from concrete risk considerations, is hard to defend on economic grounds.

The SBA has also explained its very serious concerns as far as the level playing field, both internationally and between different categories of financial intermediaries, is concerned. In particular, it feels that Pillar 2 has to be concretised in order to avoid harmful regulatory competition.

Finally, the SBA believes that in the field of operational risk the conceptual basis for capital charges, i.e., the suggested methodological approach is rather weak. Whereas our association accepts that operational risks have played and probably will play an important role in the financial sector, the SBA definitely objects to the proposed approach with the proposed calibration. Instead, the SBA recommends a critical review of both the definition of and the methodological approach to operational risk (hit absorption). The SBA will be following with great interest the outcome of the ongoing impact study.

As a last remark, let us emphasise that we think it is of enormous importance that the New Accord be flexible enough to deal with recent as well as future technological developments and products and that it be able to adequately respond to financial innovation.