SWEDISH
SECURITIES DEALERS
ASSOCIATION

Mme NOUY

STATEMENT OF COMMENTS

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The Basel Committee on Banking Supervision
The Bank for International Settlements
CH-4002 Basel

European Commission
Av. de Cortenberg, 107
B 1049 Bruxelles

Finansinspektionen
Box 7831
SE-103 98 Stockholm

Finansdepartementet
SE-103 33 Stockholm

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)

Swedish Securities Dealers Association (SSDA) has got the opportunity to comment upon the proposals which the Basel Committee on Banking Supervision and the European Commission Services have presented in the documents mentioned above (and in the Basel Committee's supporting and supplement documents). SSDA has as members investment firms; i.e. banks

BIBLIOTEKSGATAN 3, 2TR, P.O. BOX 1426, SE-111 84 STOCKHOLM
TELEPHONE: +46-8-679 78 79 TELEFAX: +46-8-611 61 37
WEB: www.swedsec.com

and securities companies, but will confine this statement of comments to aspects relevant to securities companies first of all. For comments relevant to Swedish banks, please refer to the position paper from the Swedish Bankers´ Association and their comments to which SSDA fully agrees.

As the proposal is most comprehensive and some detailed proposals still are pending from Basel and the EU Commission Services SSDA believe more time should be dedicated to the consultation process. This opinion has also been expressed in a letter dated 21 May 2001 to the Chairman of the Basel Committee from the American Bankers´ Association, Canadian Bankers´ Association, Japanese Bankers´ Association and the European Banking Federation.

<u>*General Comments*</u>

- The Basel proposal as well as the Commission Services´ consultative document is to a great extent formulated in rather unspecific terms and thus has to be further elaborated to give proper guidance for a harmonised adoption within EU member states.
- Nevertheless, at the same time the proposals suggest very sophisticated methods for risk weighting. Some of these methods seem to be most academic and theoretical and thus of little practical value because the methods suggested need to be based on standardised historical data about default cases and other critical incidents, data that today does not exist in a standardised form.

- SSDA is not convinced that operational risks, as suggested in the proposal, are to be met by capital charges in the first place. Strict control of the quality of management, operations, systems and routines within the institutes are means that SSDA regards to be a more effective approach to master operational risks.
- Securities companies, with insignificant credit risk exposure, will be struck by a much higher, in some cases multiplied, total capital charge than before due to the suggested 30 % charge on gross income for operational risks. This will hamper their ability to compete with the banks, which according to the proposal may be able to transfer some capital charges from the credit risk portfolio to the area of operational risk.
- The suggested 30 % charge on gross income for operational risks is claimed in the proposal to correspond to about 20 % of the total capital charge. This assumption does not apply to securities companies with limited capital charges on their credit risk portfolio. On the contrary, securities companies will, according to the proposal, be charged for their operational risks to a much larger extent than 20 % of the total capital charge.
- SSDA is not convinced that the present 8 % target of total capital charge on the financial industry will remain without an increase if the proposed changes of the regulatory capital will be carried out. The reason for this is, that the proposed capital charges on operational risks are not likely to be compensated by a decrease of the capital charge on credit risks as assumed in the proposal. At least this statement will be valid for institutes with small credit portfolios like the securities companies.

- As the Basel Committee proposal does not include securities companies, it may well be that the negative consequences securities for companies mentioned above may be overlooked by the EU Commission Services when transforming the Basel proposal to amendments of the Regulatory capital for credit institutions and investment firms.
- SSDA urge the Commission Services to make thorough surveys of the forecasted effects of the proposal on the financial market an that the Commission makes special provisions in order to preserve the competitive equality between banks and securities companies as regards the business line of investment services (see section 10 and 12 in the EU document).

Specific Comments

Pillar 1: Minimum Capital Requirements

Credit Risk

SSDA refers to the position paper given by Swedish Bankers´ Association and their comments to which SSDA fully agrees.

In addition to the position paper given by Swedish Bankers´ Association, SSDA points out that Swedish securities companies - according to the Securities Business Act (1991:981) - may be authorised to lend cash against pledged collateral for the facilitation of investment services to investors. Such an authorisation also permits securities companies to receive cash on deposits from customers. Securities companies with this kind of authorisation are obliged to take collateral for all lending. Normally, securities companies take pledged

securities, deposited in a custody account with the securities company, as collateral and thus are exposed to credit risk with a specific type of risk mitigation.

The proposed rules for risk mitigation from the Basel Committee are two; the simplified and the comprehensive approach. SSDA is concerned that the simplified method, which probably will be applied by several securities companies with authorisation to lend cash to investors, does not admit risk mitigation for collateral such as "Main index equities" or "Other equities listed on a recognised exchange".

Operational Risks

SSDA is not convinced that operational risks, as suggested in the proposal, are to be met by capital charges in the first place.

The reasons for this are; firstly the problems of assessing the relevant capital charge to operational risks. Secondly, SSDA finds that capital charge for operational risks will be lacking incentives for the institutes to reduce their operational risks. At least this will be the case when the two simplest methods, i.e. the Basic Indicator Approach and the Standardised Approach, are applied. Strict control of the quality of management, operations, systems and routines within the institutes is deemed by SSDA to be a more effective approach to control operational risks.

Should capital charge be introduced for operational risks, SSDA will underline that securities companies, generally being smaller organisations than the banks with less management resources and risk calculation data bases, through regulatory capital provisions within EU will be compelled to apply the more simplified methods for calculation of capital charge for operational risks. The proposed 30 % on gross income charge for the Basic Indicator Approach (se Basel Committee Consultative Document on Operational Risk, IV 23) is unwarrantably high and will lead to a considerable increase of the cost for capital adequacy amongst the securities companies.

The present total regulatory capital charge in Sweden for a securities company - according to the Capital Adequacy and Large Exposures in Credit Institutions and Securities Companies Act (1994:2004) - has a floor of 25 % of the fixed costs. It is obvious that a charge of 30 % on gross income for operational risk only, i.e. apart from any credit risk or market risk charges will exceed the present floor of 25 % of the fixed costs.

As examples of the effects of the proposal, two of the largest securities companies in Sweden, being members of SSDA, will encounter an increase of the present capital charge with a factor 3,3 and 5,5 respectively based on the proposed 30% charge for operational risk! SSDA has been informed that also in other countries within EU similar increase rates have been calculated. For obvious reasons such capital charge increases can not be accepted by the financial industry. No doubt, by imposing a new capital charge of this size on an important group of intermediaries their ability to carry out their securities

business will indeed be hampered. Taking into account the important contribution to securities services delivered by securities companies and the fact that very little analysis of the effects of the proposals on such intermediaries and on the financial market as a whole has been undertaken, no decision should be made at this stage to introduce new capital charges on operational risks based to the proposal.

It should also be pointed out that this increase would be most noticeable in securities companies with no credit risk portfolio as they will not be able to take advantage of any relief from the proposed methods for decreased capital charge for credit risk.

Also, little evidence has been published in the proposal that the regulatory capital charge for operational risks would be restricted to a 20 % share of the total capital charge. Obviously, this proportion will not be the case when the Basic Indicator Approach is adopted as SSDA above has pointed out.

SSDA urge the EU Commission Services to reconsider the proposal and undertake careful surveys of the effects on the financial market and on the financial institutes, in particular on securities companies and their competitiveness with banks, before any decisions are made to amend the present regulatory capital provisions.

Pillar 2: Supervisory Review Process

Principle 3: Supervisors should expect banks to operate above the minimum regulatory capital ratios and should have the ability to require banks to hold capital in excess of the minimum.

Under section 49 and 53 is stated that supervisors are able to require (or encourage) banks to hold capital in excess of the minimum Pillar 1 requirement. The basis for such requirement of extra capital charge can be grouped under three headings: those factors relating to risks considered under Pillar 1 (Minimum Capital Requirements) that are not fully captured by the Pillar 1 process; those factors not taken into account by the Pillar 1 process; and the factors external to the bank.

SSDA consider this principle being most doubtful due to the arbitrariness this gives to the supervisors to decide the final capital charge on banks and, if EU includes this provision in the new directive, also on other institutes. The major objective with the new Basel proposal is to capture - by means of renewed regulation - all risks against which capital has to be hold by banks and other institutes. If, on the other hand, the thought behind this proposed provision is to give the supervisor an instrument for punishment of "outlier banks" it would, according to what SSDA believe, be most inappropriate. If punishment has to be administered to institutes reluctant to meet the capital adequacy requirements or to diminish their risk exposure, penalties should be administered in another form than as extra capital charges.

Pillar 3: Market Discipline

General Considerations

The Basel proposal imposes a very profound public disclosure procedure on the banks. The thought behind the proposal seem to be that public disclosure could act as an effective control beside of the supervisory control on the institutes.

SSDA points out that it can be questioned if such extensive public disclosure should be imposed or if alternatively a more extensive disclosure should be confined to the supervisory authorities.
SSDA also underlines that the disclosure requirements should be in parallel with the development of other international disclosure standards such as the IASC standards.

The reason is that different disclosure standards may introduce ambiguity in-between various standards. Another reason is that the cost for disclosure and reporting procedures will be prohibitive if not confined to minimum requirements.

SWEDISH SECURITIES DEALERS ASSOCIATION

Per-Ola Jansson	Lars Nordström