30 April 2001

Mr Guy Eastwood
APRA
Policy Research & Consulting Division
GPO Box 9836
SYDNEY NSW 2001

Dear Guy

COMMENTS ON THE BASEL CAPITAL ACCORD

Thank you for the opportunity to comment on the proposals in the new Basel Capital Accord ("New Accord"). While Westpac is generally supportive of this important initiative, we have identified areas in which we believe improvements can and should be made. In an effort to minimise the size of the response, our comments are largely confined to points of substance or issues which appear to have a simple solution.

The main part of our response can be found in the attachment to this letter which deal with each of the individual Pillar 1 risks. Set out immediately below are some general comments on the proposed application of Supervisory Review and Disclosure. Specific Pillar 2 and Pillar 3 issues, which are directly relevant to individual risks covered in Pillar 1, are dealt with in the attachments.

Pillar 2 – Supervisory Review

In relation to the Pillar 2 proposals, Westpac acknowledges that increased supervision is a logical consequence of the move towards greater acceptance of individually based regulatory capital determination. While we do not have any major concerns with the broad principles outlined in the Supervisory Review Process Consultative Document, we do seek assurance that the Pillar 2 process that ultimately evolves will sit lightly on the Bank's existing management and control process. Our obvious concern is that Pillar 2 has the potential to create a parallel risk management and reporting process which generates increased compliance costs.

Pillar 3 – Market Discipline

While endorsing the principle that improved disclosure will be beneficial, Westpac is concerned that the scale and complexity of information that might have to be disclosed if all data underlying the regulatory capital determinations were included would simply add to costs while potentially confusing investors with information overload. We believe that depositors are entitled to expect prudential supervisors to make judgements on what is the key information that should be disclosed rather than forcing a dump of all available information.

In addition there may be areas of proposed disclosure that will be sensitive due to the proprietary nature of the information. Alternative forms of disclosure, which achieve the same level of transparency, will need to be considered unless the Committee grants relief.

Specifically, Westpac believes that the Basel Committee should expand the Pillar 3 section to address or clarify issues such as:

- Frequency of Disclosure Required – Greater distinction between qualitative and quantitative information is required. This will help clarify what needs to be disclosed on an annual basis such as model parameters, risk management framework and background information and what is required on a more regular basis such as quantitative data.

- Costs of Meeting Disclosure Requirements – In addition to the costs of collecting and analysing additional data on a much more regular basis, a direct consequence of the draft paper is that it appears that all information must be audited. Taken literally, this will require a substantial increase in the audit effort across the Bank on potentially a quarterly basis assuming that Westpac opts to use the more sophisticated approaches.

  Westpac believes the value of providing audited data on a quarterly basis needs to be balanced against the expected significant increase in audit costs, and the inevitable disruption to the business on an ongoing basis.

  By way of suggesting a more balanced approach, the Bank believes that the majority of qualitative information could be endorsed more by way of supervisory monitoring and discussion, supported by rating agency checks and balances.

  With respect to the necessary quantitative data, greater value will be obtained by identifying which data, if any, must be audited at every disclosure, and which data can be managed by yearly or half yearly full audit, supplemented by a less intensive "review process" at any interim, unaudited disclosure.

- Appropriateness of web based disclosure – Westpac assumes that banks will be able to meet disclosure requirements by lodging information on their web sites, supplemented by qualitative information (expanded from existing disclosure where appropriate) in Annual Reports and/or half yearly ASX profit announcements. For obvious reasons, we want to avoid an outcome that adds unnecessary additional detail to Annual Reports intended for general distribution when the additional detail will be relevant, if at all, to only a small specialist audience.

If you have any queries in relation to this response, please contact Tony Rich of our capital management team on 9226 1863. You might also want to have a supplementary meeting with the Westpac team working on the Basel response towards the end of May in order to pick up any further developments we have identified. Tony Rich would be the appropriate point of contact if you want to pursue this offer.

Yours faithfully

Philip Chronican
Chief Financial Officer

Attachment A

Credit Risk

We support the general thrust of the proposals for the treatment of credit risk in the New Accord, in that we welcome the move to greater differentiation of the credit risk for each class of obligor in a Bank's portfolio. This is a significant development when compared to the current 1988 Accord.

We particularly support the initiative to allow Banks to use their own internal data for calculating individual risk weightings (the IRB approach) and feel that this will facilitate much more appropriate measurement of a bank's capital requirement.

We also welcome "in principle" the step towards recognition of portfolio effects contained in the "typically granular" baseline risk weights of the Foundation and Advanced Approaches, which are then modified at overall non-retail portfolio level by a granularity adjustment. We believe that a consideration of portfolio effects reflects current best practice.

There are, however, a number of suggestions we would make and concerns which we would like to express in relation to the methodology. Our main points are first summarised in bullet point form and then explained in more detail.

We note that there is a great deal of discussion in the industry leading up to the 31 May deadline for responses to Basel, and we would welcome the opportunity to have continuing dialogue with APRA during May to update our comments as more developments occur.

<u>Summary of Main Points</u>

- According to our analysis, the definition of default and the use of a base Loss Given Default ("LGD") of 50% in the Foundation Approach are mis-aligned and are likely to result in too high a capital charge. For the definition of default as given, we would see the average LGD as about half that used in the Accord. This problem disappears in the Advanced Approach, where banks may use their own estimates of LGD.
- The difference between the treatment of residential property in the Standardised Approach and the IRB Approach for retail exposures is too large. We conservatively estimate that the proposed Standardised risk weight could be at least five times that of the IRB risk weight. This would seem to be a particular issue for the Australian market.
- Despite some billing to this effect, we do not feel that the IRB Approach actually allows banks to use their own models to any real extent. It is an approach which allows them to use their own risk grading models and data on Probability of Default ("PD") , LGD and Exposure At Default ("EAD"), with the form of risk weighting and portfolio model prescribed. We are disappointed that the Committee has not seen fit to allow the use of internal models in their entirety subject to appropriate minimum standards. We fear

that to continue to proceed along the proposed route is unlikely to produce any significant degree of convergence between regulatory capital and banks' own economic capital and to potentially render the New Accord out of date before it is implemented in 2004.

- The prescribed form of risk weighting and portfolio model, based on the work of Gordy and others, although it appears to capture the spirit of the main industry portfolio models, seems to lack the richness of risk factors which these models contain and is likely to be too prescriptive. We would also welcome more transparency on the technical background to the model. This comment applies to both the risk weight formulae and the granularity adjustment.
- The calibration of the risk weighting model in the IRB Approach of the New Accord is of particular concern to us. Our preliminary results show that a move from the Current Accord to the IRB Approach still results in credit risk capital that is substantially in excess of that assessed by our internal models. In itself this is somewhat disappointing, but it also leaves little room to move if the risk weight formula is re-calibrated, other regulatory capital charges are introduced or our portfolio composition changes over time.
- The final form of the model for retail exposures on an expected loss (EL) basis needs to be decided before we could comment finally. This is important to us, because we currently capture our retail data on an expected loss basis and retail exposure is a sizeable proportion of our portfolio.
- Some of the minimum requirements need to concentrate more on substance over form e.g. as a particularly striking case, the minimum requirement that the name of the person who assigned a rating forms part of the minimum database seems hardly appropriate to us.
- The disclosure requirements relating to credit need to take account of the extent to which some of the information is relevant to stakeholders, the additional cost to banks in preparing this information for public disclosure and the commercial sensitivity if not all banks are required to disclose equivalent information, depending on the stage of the Accord to which they are adhering.

Standardised Approach (Para 21 ff)

Westpac would endeavour to move as rapidly as possible to the IRB approach for credit capital, and we shall therefore not comment extensively on the Standardised Approach here. There are, however, several points of note.

Overall Capital Implication

First, despite the added precision of the Standardised Approach, our preliminary calculations indicate that there is unlikely to be a substantial shift in credit capital requirement for us from the Current Basel Accord to the Standardised Approach. Savings obtained through lower weightings for higher rated corporates tend to be offset by such things as the treatment of off-balance sheet instruments. This outcome would be

a concern for us if we were temporarily obliged to use the Standardised Approach, given that additional capital for operational risk is to be required.

Risk Weightings for Banks (Para 30)

We would expect and recommend that APRA adopt Option 2 for bank weightings under the Standardised Approach. The differentiation between banks inside the same country implied by rating would seem to us to be very significant.

Claims Secured by Residential Property (Para 37)

While it is acknowledged that there is intended to be significant incentive in terms of capital relief for moving from the Standardised to the Foundation Approach, we feel that residential property is an instance where the differing treatments are just too large for such a substantial product. Our preliminary calculations show that the risk weighting for residential property under the IRB Approach for retail is (conservatively) likely to be in the region of 10% compared to 50% under the Standardised Approach.

We do not believe that this degree of difference is justified for a product which is such a large component of the Australian market.

Claims Secured on Commercial Real Estate (Para 38)

We agree that overall commercial real estate does not justify other than a 100% weight. However, we currently segment our exposure into specialised (e.g. hotels, hospitals, schools) and non-specialised (e.g. shops, industrial premises, warehouses) commercial real estate and feel that a lower risk weight could be justified for non specialised CRE which is generally readily saleable.

Collateral under the Standardised Approach (Paras 38, 76)

We believe the definition of collateral under the Standardised Approach is too narrow. The New Accord should provide some relief where exposures are significantly over collateralised even if the collateral consists of business assets or commercial real estate (e.g. where lending value is say 150% or more of loan value).

<u>IRB Approach for Corporates, Banks and Sovereigns (Para 150 ff)</u>

Overall Capital Implication

In a preliminary run of the PD/LGD based IRB risk weighting functions against our own data, we found that the IRB Foundation approach gives a degree of regulatory credit capital reduction which is broadly consistent with the size of the increased charge for operational risk mooted in the New Accord. This is not

particularly encouraging, given the additional requirements of the IRB approach, but we stress that this is preliminary.

Under the current calibration of the IRB risk weights, there is potentially a substantial capital relief for middle graded corporates (BBB area). Although this is somewhat offset by the higher weights for lower corporate grades (BB, B area), the net result is a reduction, due to the characteristics of our exposure distribution. However, we are very aware that this result could be dramatically affected by a shift in the calibration of the risk weights.

We are concerned that this calibration may not be stable under changes by Basel and over time, and a fuller disclosure of the methodology and the process for the final calibration of risk weights is therefore needed before we could be confident of this approach to RW.

Transparency of Risk Weight Methodology

More generally, we find that there is a lack of full transparency surrounding the analytical background to the risk weighting functions. Although the formulae are not difficult to apply in the presence of the correct data and to calibrate against a bank's own portfolio, the theoretical under-pinnings of the functions are not clearly justified in the Accord. The methodology appears to be based on the work of Gordy and others and is designed to capture the spirit of some of the main industry credit portfolio models if not their full capability. It would be safe to assume that many banks, particularly those with the capability to move to the Foundation and Advanced approaches, have the necessary in-house expertise to understand all the relevant theory and the calibration process. We feel strongly that this needs to be placed before the industry in the exact form in which it is used in the Accord for critical evaluation.

Floor of 3 Basis Points on Probability of Default (Para 180)

We believe that the floor of three basis points is unnecessary. Long run rating agency data supports the fact that PD's for high rated companies are very low and we believe that this should be recognised. Moreover, it is inconsistent that there is no floor for sovereigns, where we believe that the right approach has been adopted.

Methodology for Recognition of CRE and RRE Collateral (Paras 208 and 212)

We believe that the methodology for the recognition of physical collateral in the Foundation Approach is very conservative, with LGD's between 50% and 40%. As outlined below, under the reference definition of default, the actual average LGD we experience is approximately 24%. As well as indicating that the Foundation Approach capital may be too high, this would also indicate that by moving from Foundation to

Advanced IRB we could see a large reduction in our risk weighted assets. This would appear to be contrary to the intent of the New Accord.

Maturity (Para 226)

Maturity has been conservatively set as the maximum remaining time in years that the borrower is permitted to take to fully discharge its obligation. This does not take any account of prepayments, which can be substantial, and significantly shorten the remaining tenor of the portfolio, particularly in middle market and small business loans, where prepayments are common.

Subject to appropriate validation, banks which have data on prepayments should be able to apply a discount to contractual tenors. We submit that any bank which is actively managing its interest rate risk should be able to estimate prepayments with a reasonable level of certainty.

Allowing banks to use estimates of prepayments will also help to alleviate the Committee's concern that the maturity adjustment may lead to restrictions in the level of longer term finance.

There is also research indicating that loans that fail actually fail early in their life and are unlikely to go to full term. In "The High Yield Bond Market: A Decade of Assessment, comparing 1990 with 2000 – August 2000", Altman (NYU Stern School of Business) presents data which indicates that for bond issues defaulting in 1999, 67% defaulted within three years of issuance. This would also support a discount from applying full contractual tenor.

Definition of Default (Paras 272 and 466)

There are two issues with the definition of default that is used in the New Accord.

- *Inconsistency with Industry Practice for Scheduled Loans*

The definition of default set out in paragraphs 272 and 466 is not strictly consistent with industry practice for scheduled loans. In particular the definition of past due 90 days or more requires amplification.

For loans that are not subject to amortisation, such as bullet repayment or overdraft facilities, the definition is adequate. However, for banks lending in the consumer and small business sectors, a large portion of loans are subject to amortisation. It is usual then for 90 days in arrears to be defined as being in arrears 3 payments or more (where payments are monthly).

Typically LGD analysis will be defined in the above terms. The impact can be substantial, with an LGD calculated on a straight 90 days past due being substantially lower than that calculated using a 3 payments in arrears definition. A large number of

loans are rehabilitated with no loss even though they may have taken more than 90 days to catch up on one or two missed payments.

- *Alignment of PD and LGD*

According to our analysis, the definition of default used will capture a large number of defaults that are short term technical defaults with very low LGD's. This will result in a much lower LGD number than the 50% used as the benchmark in the IRB Foundation Approach. If we use the reference definition of default, as set out in paragraph 338, our equivalent reference average LGD currently stands at 24%. Quite apart from the implications for capital under the Foundation Approach, if this number is applied in the Advanced IRB Approach, it will result in a much larger LGD reduction in moving between the two approaches than we believe is envisaged in the New Accord .

We should remove short term "technical defaults" from the analysis. In middle market and small business it is quite common for customers to be outside arrangements pending negotiations for increased funding for periods in excess of 90 days. Our internal studies indicate that this effect can be substantial, with an average LGD of 24% when the reference definition of 90 days in arrears is applied versus 35% when "technical defaults" (defined as regraded to fully performing within 180 days with no loss) are removed from the analysis. These figures are based on our database of around 26,000 defaults from 1992 onwards.

We note that ratings agencies also have a relatively strict definition of default. For example, restructures that are not considered by Moody's to result in a diminished financial obligation would not be considered a distressed exchange default (refer FOW's "Financial Products Magazine", 28 Mar- 3 Apr 2001, p 4). Defaults of a technical nature only, which are quickly rectified, are not usually considered defaults. Even for larger businesses, it is not unknown for customers to be in arrears on bank loans, but not actually default on public debt – for example, Burns Philp Limited, which was externally rated, was never classified as a default by S&P but would probably have satisfied the technical 90 days in arrears definition in respect of bank debt. However, as debts were restructured and loans reclassified as performing, we would not include this in our LGD study.

This becomes particularly important if a bank is using default probabilities sourced from external sources such as Moody's and Standard and Poor's, as we do. For LGD purposes, the default definition should be consistent.

Data Collection and IT systems (Paras 284 and 285)

In respect of data collection and IT systems, we expect that regulators will be willing to look through the requirements and value substance over form. Where an institution has data supporting an element of the approach which is not in the strict form required in the New Accord but is adequate to support the desired conclusion, we recommend that it should be allowed.

The requirement that banks hold detailed data on rating decisions and rating histories (paragraph 285) is seen as possibly being too onerous. We capture financial data on customers and can build a history of actual grades assigned, but the requirement to capture other key data is too broad as it is difficult to define what this data might be and therefore the requirement is potentially too open ended. For example, maintaining data on the person / model which approved the grade is not essential, although a history of changes to the models should be kept.

Stress Tests used in Capital Adequacy (Paras 300 and 361)

This requirement is difficult to quantify and it is difficult to see what value the stress tests add. Where a bank uses a credit portfolio model set at a high enough confidence interval there would seem to be little point in conducting stress tests unless reasonable probability distributions are included in the test. These distributions are included in portfolio models in any case. If the portfolio model correctly captures risk, changes in the risk mix of the portfolio will be reflected in the capital requirement and thus obviate the need for extensive stress testing.

Frequent Revaluations (Para 319)

The requirement that banks frequently revalue real estate collateral (paragraph 319) does not reflect current practice for some classes and types of loans. For example, loans secured by residential or commercial real estate that are on an amortising basis would not normally be revalued on an annual basis, but rather in the event of a payment default or other credit event. Review processes within the industry nowadays are more "event driven" rather than cycle driven. Provided control procedures are strong this should be adequate.

<u>IRB Approach for Retail Exposures (Para 422 ff)</u>

Overall Capital Implication

We note that the IRB retail exposure risk weight methodology is less well developed than that for corporates, banks and sovereigns, with still some degree of uncertainty as to the best way forward. Of the two approaches proposed, the EL approach would make more sense for us, since this is the way in which we store our retail data.

Because of the uncertainty surrounding the EL approach, an estimation of the potential overall capital implication of the IRB approach for retail is very difficult. However, some preliminary work which uses some of our data on PD and LGD for housing indicates that the risk weight for such a product under the PD/LGD approach could be under 10%. This would imply a substantial capital reduction, since housing is a large part of our portfolio. However, this reduction should be seen in the context of our comments earlier on the overall potential capital reduction in moving from the Current Accord to the IRB Foundation Approach,

where we indicated that this may be only broadly commensurate with the mooted additional capital required for operational risk.

Risk Weight Functions

Again, we would welcome more transparency in the derivation of the risk weight RW in the proposed PD/LGD case.

In regard to the EL approach, we note that a desire to again apply the constrained form of the non-retail risk weight model as a quantification of the distribution tail forces the proposed decomposition into PD and LGD for EL. The functional form of the risk weight then becomes the same as the first case, with a multiple (1/LGD) of EL replacing PD in the risk weight formula This seems to achieve little, since given that only EL is known, no new information is being added. Moreover, any formula which makes an assumption about LGD and then "backs out" PD from the loss data series will magnify the reliance on the independence of PD and LGD. In fact, we feel that it may be better to deal with the loss data series directly and at least use that series' history to add information on its variance. One then does not proceed along a PD/LGD route, but either uses a more sophisticated approved internal portfolio model which utilises the loss data directly or proceeds in a more simple manner.

As an example of a simpler approach, a distributional assumption can be attached to the loss series directly and used to produce an estimation of a confidence interval, which can then be adjusted to reflect portfolio diversification.

For example, given parameters EL and UL estimated for a loss series L_i (i= 1,…,n) as follows:

$$EL = (\Sigma L_i)/n \text{ and } UL^2 = [\Sigma(L_i - EL)^2]/(n-1)$$

then a lognormal assumption on the loss series produces a risk weight of :

$$RW_R = 12.5 \text{ x } \exp[\ln(EL) - ½\,\sigma^2 + F\sigma]$$

where $\sigma^2 = \ln(1+(UL/EL)^2)$, exp denotes the exponential function, ln is natural log and F is the appropriate confidence factor from the unit normal distribution e.g. F = 2.58 for 99.5% confidence, 1 tailed.

We appreciate that such an approach may not capture the full effect of the tail of the retail portfolio distribution in the way that the PD/LGD approach does, but on then other hand we would ask whether this form of approximation is any worse than that implied by the PD/LGD approach in this case.

This is an area on which we continue to do further research.

The Granularity Adjustment (Paras 503 ff)

Our preliminary calculations indicate that the granularity adjustment in its current form would result in little change to the risk weighted assets in our non-retail portfolio. As in the case of the IRB risk weights, however, we are concerned about the stability of this result over time and find the granularity adjustment potentially not precise enough compared to a full portfolio model. For example, from our experience, the Herfindahl Index is at best an approximate measure of diversity. The reference to a technical paper explaining the methodology in this case is, however, welcomed, albeit that the paper appears to be unpublished, and we would encourage the same level of disclosure for the risk weight methodology.

In general, we are concerned that an attempt to "unbundle" portfolio risk into a baseline risk weight (4% of which is intended to cover the effect of granularity) plus a granularity adjustment may not be a very effective substitute for the types of portfolio models which many banks are now using. For example, our portfolio model adjusts in an integrated fashion "up front" for lack of granularity, by associating much larger baseline capital factors to larger transactions. We believe this to be an essential feature of a full portfolio model.

We believe that the use of internal models by banks, with all the associated minimum requirements, should extend to the use of credit portfolio models. The proposed framework is too prescriptive in not allowing this.

Disclosure Requirements (Para 652)

We broadly support the thrust of the disclosure requirements outlined in paragraph 652, but we do question the level of the disclosure requirements for the IRB approach outlined in this paragraph. A significant portion of the requested data appears to have little practical relevance to external stakeholders. Further, this data may be commercially sensitive and useful to our competitors. There will also be some cost associated with the auditing of the information that is to be placed in the public domain and this needs to be balanced with the usefulness of the information.

Given the commercial sensitivity of some of the detailed quantitative disclosures suggested, we would want to ensure that a level playing field existed. Thus we would suggest that disclosure be conditional on all other market participants in the local market being prepared to disclose the same level of information.

In addition, the default data requested under section (c) would need to be summarised, particularly in periods with low default rates and for smaller institutions, to avoid the possibility that individual customers could be identified through the information reported.

Operational Risk

The Operational Risk Consultative Document represents an important step in the development of a more risk sensitive approach to understanding and improved management of operational risk. However, as has been widely discussed both by the various regulators, industry groups and individual banks, the consultative paper is recognised as work in progress and as such there are a significant number of issues requiring further clarification before the Accord can be finalised. As these issues are fundamental to our ability to measure the potential impact of the Accord on Westpac, we believe it is essential that Basel acknowledge the issues raised and respond in a further published consultative paper.

A number of the issues in relation to Pillar 1 have been widely addressed both by industry groups such as ISDA, IIF and BBA and discussion within the risk press. Westpac strongly supports the issues as outlined by ISDA and will not repeat the detailed discussion on each of these points. However, there are two areas that are of primary importance to Westpac and worthy of specific mention:

Calibration of Capital Charge

- We are concerned that the overall level of capital being attributed to operational risk appears excessive as set at approximately 20% of minimum regulatory capital. Given the definition within the Accord, the level of loss is significantly greater than that determined by our own loss modeling. A more appropriate level based on this modeling would be approximately 10% of minimum regulatory capital. This potential overstatement of capital required is further compounded by:
  - An underlying assumption of a direct linear relationship between the level of operational risk in a business and the size of the business (eg income, assets, transactions), and hence the level of capital required. This assumption fails to take into account the importance of control environments and the benefits of economies of scale.
  - Potentially significant elements of double counting of capital between credit risk losses and operational risk losses, given current definitions.

Qualitative Factors

- The second primary area of concern is the absence of qualitative factors that are integrated into the measurement of required capital. Understanding, managing and mitigating risk is fundamentally more important then merely quantifying risk. Of equal importance is the recognition that culture must be seen as complementing process in the management of operational risk. Fundamental to driving both improved operational risk process and culture is the concept that business units own operational risk. While qualitative factors are considered in a bank’s ability to qualify for stages 2 and 3 of the proposed capital charges, to create the right incentive to more effectively manage operational risk, qualitative criteria need to be built into the capital calculation methods. For the accord to ignore the potential impact of using capital allocation to drive a strong control culture seems to represent a major omission from an accord that is targeting a more risk sensitive approach. We believe that the

qualitative criteria should be done within each of the 3 approaches to capital assessment. Illustrative criteria for each approach could be as follows:

- Basic Approach – modify capital levels based on a percentage multiplier based on internal/ external audit results, regulatory review results and the ability to demonstrate adequate controls over specified key risks.
- Standardised Approach – a percentage multiplier based on the results of an auditable self-assessment regime that considers both risk and controls levels. The concept of self-assessment is a well-known and accepted risk management tool.
- Internal Measurement Approach – calculate a risk sensitivity of each business and the individual strategies being pursued, by using a combination of self assessment, KPI volatility and loss quantification as a consequence of using an economic profit regime. Westpac assesses its overall performance and the performance of individual senior management (linked to remuneration) based on economic profit. Economic profit is a risk adjusted performance measure that provides strong incentives for management to manage in a risk-adjusted sense and to drive an appropriate risk culture.

Other Pillar 1 issues

- The floor concept intended to limit the level of relief gained from using a more sophisticated approach appears to have no basis and is a disincentive for banks to develop above average operational risk systems
- It is critical that the beta and gamma factors outlined for the Internal Measurement Approach are reviewed and specified and that the qualifying criteria is expanded to include the level of historic data required to adopt this approach
- Westpac also believes that the definition of operational risk in the New Accord should be amended. Expected losses, by their nature, are either provided for explicitly as part of non lending loss provisioning or implicitly included in the pricing structure of the bank's products. The definition should therefore be amended to reflect that operational risk capital should be held for unexpected losses only.
- The New Accord mentions the use of insurance and outsourcing as potential risk mitigation techniques which could result in capital relief, however no details are provided. The bank believes that there is room for the New Accord to expand on this area.

Pillar 2 issues

With regards to any Pillar 2 issues relating to operational risk, the Bank is awaiting the release of the "Operational Risk Sound Practices" guidance before any commentary is made in this regard.

Pillar 3 issues

There is no apparent purpose/use for increasing market disclosure around operational risk related losses and operational risk capital per business line. This information is not likely to be comparable across businesses and is unlikely to be valuable to either shareholders or industry analysts. The primary user (regulators) will already be conducting regular "supervisory reviews" over the capital framework of banks (Pillar 2).

Market Risk

The market risk guidelines relating to Mark to Market valuation of financial instruments propose that banks should use the more conservative side of the bid/offer position unless the institution is a significant market maker and therefore deemed able to close out the position at mid market. Westpac believes that there are a number of product areas where the Bank is not a significant market maker yet is still able to Mark to Middle as the Bank can access liquidity at mid market values. Accordingly, Westpac proposes that this proposal be modified to enable mid market valuations in “liquid” markets. The definition of “liquid” markets would be determined by the institution but would have to be substantiated if required and would be covered under the supervisory provisions under Pillar 2.

The guidelines relating to valuation adjustment reserves also appear overly conservative. The proposals suggest that minimum requirements should be put in place for unearned credit spreads, close out costs, operational risk, early termination, investing and funding costs, administrative costs and, where appropriate, model risk. Westpac believes that this appears to be a case of excessive provisioning and that the operational risk and funding cost elements in particular can be eliminated while still providing sufficient protection.

Westpac has previously held discussions with APRA in relation to the treatment of positions hedged by credit derivatives. The New Accord allows a partial offset for these instruments in areas where APRA has not allowed any offset to date. While we remain committed to the position that a full offset is the appropriate treatment of these instruments, we recognise the proposed treatment in the New Accord as a step in the right direction.

Interest Rate Risk

We support the proposal that interest rate risk in the banking book is best dealt with under Pillar 2 (i.e. prudential supervision) rather than via an explicit charge. We are concerned however that the focus of Pillar 2, which appears to be mostly directed as detecting excessive risk taking, fails to also reward those banks that have and continue to invest considerable time and money in developing advanced systems and techniques to quantify and manage interest rate risk. Westpac believes that the Pillar 2 regime covering interest rate risk held in the banking book should incorporate a means of reflecting relative interest rate risk between banks (adjusted for these factors) into their respective Tier 1 target ratios.

The requirement to disclose the impact of a change in interest rates against economic value also appears inappropriate. A change in interest rates will have an impact on the market value of a bank and accordingly the economic value. The disclosure of this information (which may indicate a significant variation in economic value) could be misleading to investors as it suggests that Westpac is not effectively hedged whereas it is more properly interpreted in terms of its impact on the Bank's share valuation. The disclosure of the impact of a change in interest rates against earnings (which is currently disclosed) is a more accurate indicator of the potential impact of interest rate changes on a bank's regulatory capital position. Further, different banks worldwide tend to have different interpretations of economic value. Westpac believes that as a minimum, if this requirement is not removed, then a standard definition of economic value should be introduced.

Asset Securitisation

Westpac recognises that where a bank takes on risks through its involvement in a securitisation transaction, the ADI should hold capital commensurate with those risks. It also supports initiatives to align the regulatory capital requirements with the underlying economic risk. However, Basel's conservative approach to securitisation and synthetic securitisation has resulted in a number of inconsistencies for securitised exposures vis a vis other exposures of a similar nature. These inconsistencies create a disincentive for a bank to become involved in securitisation (as either an originator, investor or sponsor).

To ensure that securitisation continues to be available as a risk management tool for ADI's, Westpac recommends Basel apply a consistent approach across similar risks. For banks applying the Internal Rating Based Approach, this means allowing the securitisation related exposures to be assessed within a bank's Internal Rating Based model, in line with similar non-securitised exposures.

Westpac also recommends revisions to the proposed disclosure in the Statutory Accounts, in particular liquidity facilities, to avoid inappropriate focus on these exposures as compared with non-securitised exposures of a similar nature.

Westpac believes any potential concerns relating to structural or moral risk associated with securitisation are addressed adequately through the proposed operational requirements and disclosures made within the issuing documents. This is evidenced through the effective operation of APRA's existing guidelines APS 120, which already contains clean sale requirements and penalties for breach.

The imposition of a 100% LGD for securitisation exposures does not align the capital requirement with the economic risk in many instances. In the case of highly rated senior securities (AAA or AA), applying a 100% LGD under the Internal Rating Based Approach will produce a higher capital charge than that achieved under the standard model (28% vs 20%) and a capital charge double that required for non-securitised exposures (eg corporates at BRW of 14%). This is significantly higher than Westpac's internal capital allocation for AAA rated exposures.

The adverse capital treatment is compounded for liquidity facilities provided to the securitisation vehicles. These facilities rank pari passu with the AAA rated note holders in the event of a wind-up, contain restrictions on their ability to be drawn down and have priorities in relation to repayment from cashflows. These features combine to create a strong credit position but banks applying the foundation approach must apply a 75% EAD and a 100% LGD. This results in capital charge far in excess of the underlying economic risk position (75% x 28% x 8% = 1.7%) again, a level far higher than Westpac's internal estimates.

Westpac recommends allowing banks to calculate a LGD within its Internal Rating Based Approach in the same manner as for non-securitised exposures. In a number of instances the proposals apply differing treatment for originator vs investors vs sponsors. While

these are predominately part of the standard model, Westpac objects to this approach and its potential extension to the Internal Rating Based Approach.

Each facility is provided on an individual basis and documented separately. Obligations are clearly disclosed and the underlying risks are the same regardless of whether the facility provider is an originator, sponsor or investor.

Westpac supports the approach currently taken by APS 120 requiring individual documentation, transactions to be undertaken on market terms and conditions and disclosure regarding the extent of the facility, to ensure exposures can be treated as third party.

Where a bank retains an equity interest, Westpac supports the two-legged sliding scale approach to the extent it involves determining an amount of capital held on balance sheet against the underlying assets and then assessing how much credit risk on the portfolio has been transferred to quantify the capital released. Where a retained first loss position (l) is less than the on balance sheet IRB capital requirement (r), an amount of capital should be released ($r - l$).

However, Westpac does not support the concept that the total amount of capital allocated to a securitised portfolio should be in excess of the balance sheet requirement (ie. where $l > r$, the aggregate amount of capital should be capped at r). The aggregate amount of credit risk on the underlying assets does not increase as a result of securitisation.

For investment in unrated holdings, Westpac recommends banks be able to utilise the Internal Rating Based Approach to determine a capital charge. This could be achieved through either calibration against other rated tranches, looking through to the rating of assets in the underlying portfolio or an adaptation of the sliding scale approach, depending on the specific circumstances of the transaction.

Retained first loss positions of synthetic securitisations should attract the same capital requirement as that of a traditional securitisation, calculated utilising a sliding-scale approach capped at the on balance sheet Internal Rating Based Approach capital requirement. Limiting the size of first loss tranche to expected loss will prevent transactions where a portion of unexpected loss, but not all, is transferred when such transactions are still of benefit to banks.

Requiring the sale of a minimum amount of senior risk to gain capital relief on retained super senior risk exposures, may make transactions uneconomic and prevent transactions that have positive risk transferal of the lower levels of risk. Arbitrage is prevented as the retained exposures are assessed as part of the Internal Rating Based model. The Bank does not object to the other criteria specified in paragraph 82.

Westpac supports Basel applying consistent approach to CRM section and refers APRA to our CRM submissions. The structural criteria specified in paragraph 86 (specifically two rating agencies and a portion of AAA securities to be issued to the market) again may create a disincentive to transfer risk via synthetic securitisation.

Westpac opposes the introduction of a capital charge for securitisation to address implicit or residual risks such as moral risks. These are adequately addressed by the operational risk requirements proposed in paragraph 90.

The Bank also seeks modification of the disclosure requirements for the Statutory Accounts, in particular those covering liquidity facilities. It is inappropriate to disaggregate these liquidity facilities from other exposures of similar risk as it would produce misleading impression as to the overall risk profile of the bank. A requirement to disclose by deal could also require Westpac to disclose confidential competitive information. Westpac suggests disclosing the information to APRA on a confidential basis.

Credit Risk Mitigation

Westpac notes that the proposals are generally supportive of credit risk mitigation techniques, particularly those relating to credit derivatives. Under APRA's current approach, underlying exposures that are hedged by buying protection are re-weighted from their existing level to the risk weighting of the protection seller. Hence the market has generally been limited to banking counterparties if one was managing to regulatory capital. The introduction of a ratings based approach (any of the three approaches mentioned in the New Accord) would have all "AA" or better corporates weighted at 20%. Thus the universe of counterparties expands to include well-rated companies such as reinsurance companies, which is major positive aspect.

However, Westpac believes that the weighting replacement approach fundamentally over estimates the residual risk. We feel that a better approach would recognise that the major risk is one of replacement cost together with the absolute minimal dual default risk. Thus we would recommend that once an exposure is hedged by way of a credit default swap (and there should be some minimum qualifying conditions as to what constitutes a hedge) then the underlying exposure should be reduced by 100%. Against the counterparty an exposure representing the potential future replacement cost i.e. marked to market plus future price volatility, should be recorded. Internally we record this future potential exposure based on the grade of the counterparty. A minimum of 5% for counterparties with an external grading of A- or better, 10% for BBB+ through BBB-, and 40% of the contract value if the counterparty falls below investment grade. We have an absolute prohibition on buying protection from sub investment grade counterparties.

Returning to the new proposals, the negatives include the varying treatment of guarantees and credit derivatives. For guarantees, the straight replacement approach applies when the provider is a Sovereign, Central Bank or Bank. For credit derivatives where the counterparty is AAA or AA, a weighting adjustment formula is applied that increases the effective weighting for all underlying exposures other than AAA and AA. For example, if the underlying exposure was rated BBB (100% weighting) and hedged with a 20% weighted counterparty, the adjustment would increase from 20% to 32%. Single A rated underlying exposures would be re-weighted to 24.5% in this example. It is noted that conservatism and concerns in relation to untested documentation drive this discriminatory approach between guarantees and credit derivatives. If this bias is a factor in the initial guidelines then we would hope that it would be reviewed annually taking into account developments in the credit derivative market.