World Council of Credit Unions, Inc.

FAX

To	Mrs. Daniéle Nouy	**From**	Dave Grace
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☐ **Urgent** ☐ **For Review** ☐ **Please Comment** ☐ **Please Reply**

Dear Mrs. Nouy,

Attached are comments from the World Council of Credit Unions on the New Accord. As an enclosure to this letter we are also including comments from national level credit union organizations in the United States, Canada and Australia. The original copy of these letters is also being send this evening via courier. Please contact me at 608-231-8494 if you have any questions.

Sincerely,

Dave Grace

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"Quality Credit Unions for Everyone"

World Council of Credit Unions, Inc.

May 30, 2001

Mr. William J. McDonough
Chairman, Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002
Basel, Switzerland

Dear Mr. McDonough:

World Council of Credit Unions (WOCCU) welcomes the opportunity to comment on the latest round of the Basel Accord. Worldwide credit unions have over $550 billion in assets with over $450 billion in savings and $60 billion in capital. Even the largest credit union in the world, with $16 billion in assets, is small in terms of assets relative to global banks. However, as retail-focused financial institutions, credit unions worldwide are servicing more than 105 million members and are an integral part of ensuring sound financial systems. Credit unions' offering of services is characterized by a high degree of industry cooperation, and efficiency is facilitated through cooperatively owned second-tier central credit unions. Central credit unions enable small credit unions to efficiently manage liquidity and participate in national financial markets.

WOCCU is the apex trade association and development organization for the international credit union movement. It represents 38,000 cooperatively owned not-for-profit credit unions in 87 countries, serving over 105 million owner-members worldwide. As a voice for the international credit union community, I submit for your consideration the following comments on the *New Capital Adequacy Framework*.

Areas for Review

Introductory Remarks

1) WOCCU continues to support the three-pillar approach that the Committee has developed and is in favor of a more risk sensitive framework for capital adequacy. While the latest version of the Accord is more "credit union friendly" than the June 1999 consultative documents, we believe there is much work to be done to ensure that small cooperatively owned financial institutions can operate within a framework that matches their risk profiles. Although we acknowledge, as does the Committee, that the proposed framework is targeted at internationally active banks, experience with the current Accord and its application in over 100 countries motivates us to ensure that the Accord "...is suitable for application to banks of varying levels of complexity and sophistication."

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2) Claims on Banks
The Accord currently does not clearly identify what is considered a bank and what is considered a corporate. Although it should be self-evident for the purpose of the Accord that credit unions are considered banks not corporates, there have been cases in the recent past where market participants have considered credit unions corporates. To eliminate this confusion, we strongly suggest that the term *depository financial institution* be used instead of *bank* or, at a minimum, that the term *bank* be further defined to include other depository financial institutions, such as credit unions. Although on the surface this may appear to be a minor clarification, the large difference between un-rated banks (50 percent) and un-rated corporates (100 percent) using the standardized approach to assigning credit risk makes this clarification even more important than in the past.

3) Use of External Credit Assessments
WOCCU recognizes and supports the use of external credit assessments for determining risk weights to financial institutions. However, less than 0.1 percent of credit unions internationally have an external credit assessment, and we anticipate that most would have trouble in obtaining a qualified rating due to their size and cost constraints. As a result, most credit unions will be un-rated.

Our concern with the reliance on external credit assessments is related to the potential negative impact this may have on liquidity markets. In the case of credit union systems where a national or provincial central credit union provides liquidity services to its member-owners, this would mean significant increases in capital for the central credit unions that exclusively serve credit unions. For example, in Australia, loans to credit unions from the national central credit union would now have to be capitalized at 50 percent (one greater than the sovereign) as opposed to the current 20 percent. This would require an increase of approximately AD$23 million in capital for the central credit union even though the member-owner credit unions, which are well capitalized nationally at 14.7 percent of risk-weighted assets, will have the same risk profiles.

In cases where credit unions choose to access bank liquidity markets, we anticipate it would be more difficult for them to access liquid funds as a result of being un-rated. We encourage the recognition of maturity in the assignment of ratings to short-term interbank loans and ask the Committee to re-introduce the six-month maturity, or a series of windows, as opposed to the new three-month maturity that was introduced in the January 2001 revision. In addition, we feel that the use of residual as opposed to original maturity would more accurately reflect the risk of short-term claims.

We encourage the Committee to refine the framework for assigning risk weights to depository financial institutions to properly address the needs of small financial institutions. We believe that an institution's risk profile as measured by it activities and its capital position is a better determinate of its risk than a firm's financial ability to obtain a qualified external credit rating or a de facto one minus its sovereign.

4) Retail Exposures
WOCCU welcomes the separate classification of retail exposures in the Internal Rating Based (IRB) approach. In response to questions posed by the Committee on pages 21-23 in the *Overview of The New Basel Capital Accord,* we provide the following comments:

- It is commonplace for credit union regulations to consider all lending under a given value (e.g., $50,000) to be personal lending.

- WOCCU supports the implementation of the second option, utilizing expected loss data for assessing risk to a retail segment of the portfolio, as opposed to separately identifying the probability of default and loss given the default.

5) Operational Risk
WOCCU is supportive of using gross income as the anchoring reference to the balance sheet for determining operational risk, assuming there are standardized accounting practices. However, we view this as most useful when tied to an organization's orientation, i.e., retail versus wholesale, where wholesale organizations present greater systemic risk in the assignment of a capital charge, as the Committee recognizes in the standardized approach. For example, an institution, for the purpose of calculating operational risk, could be considered a retail financial institution if 85 percent or more of its gross income is derived from retail financial activities.

6) Coverage of the Accord
Although WOCCU supports the application of stringent capital requirements for credit unions in all markets, supervisors should recognize the uniqueness of financial cooperatives' retail orientation, pooled liquidity management systems and ownership structure in the application of the Accord.

Closing Comment on Capital
Although the stated purpose of the revised Accord is to neither increase nor decrease capital levels, but rather to make them more risk sensitive, our concern is that the introduction of the IRB approach and external credit assessments will lead to absolute or relative increases for small retail institutions compared to large banks without a corresponding change in risk.

In closing, we strongly recommend to the Committee that the framework of the New Accord not penalize low-risk retail financial institutions, such as credit unions, that generate a large number of small loans funded by local savings and deposit accounts. Such a penalty would have the opposite effect of what we believe the intention of the New Accord is: building safe and sound financial systems in the interest of the public at large.

I would like to thank you for the opportunity to provide these comments and I look forward to future interactions with the Committee to ensure that the New Accord is suitable for the international credit union community.

Please contact me directly if you would like further clarification or discussion of these points.

Sincerely,

Arthur Arnold
President & CEO

Enclosures

CUNA & Affiliates
A Member of the Credit Union System

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Daniel A. Mica
President & CEO

May 1, 2001

Basel Committee On Banking Supervision
Bank for International Settlements
CH-4002 Basel, Switzerland

Dear Sir or Madam:

The Credit Union National Association (CUNA) welcomes the opportunity to comment on the current round of proposed revisions to the Basel Accord. CUNA is the national trade association that represents the United States' more than 10,600 credit unions, which collectively have 80 million members and over $450 billion in assets. Over 90% of U.S. credit unions belong to CUNA and its state league organizations.

CUNA commends the Committee for its willingness to solicit and consider the comments of the world's credit unions. In that regard, I encourage the Committee to give particular consideration to the comments of the World Council of Credit Unions, which is the lead organization representing credit unions at the international level.

CUNA applauds the improvements that are contained in the current Basel proposal. The three pillars of the framework: Minimum Capital Requirements, Supervisory Review Process, and Market Discipline, functionally expand the scope of the Accord. The addition of the internal ratings-based approach as an option, but not as a requirement, provides for greater flexibility in determining capital adequacy while sparing those typically smaller institutions that have standard and lower-risk balance sheets from having to adopt more complicated methods.

Whereas CUNA believes the Basel Accord is appropriate for many financial institutions around the world, including credit unions in many countries, I do not believe it would be feasible to place U.S. credit unions under the Accord. Credit unions in the U.S. operate under a statutorily imposed capital regime known as Prompt Corrective Action (PCA) which includes both a pure leverage requirement and risk-based net worth requirement. The National Credit Union Administration (NCUA, the supervisory authority for federally insured credit unions in the United States) is the agency responsible for implementing the statutory mandate on capital requirements.

NCUA interprets the legislation as requiring them to explicitly account for interest rate risk in the determination of a risk-based net worth requirement, i.e., analogous to the first pillar of the proposed Basel Accord. Because Basel assigns interest rate risk to the second pillar, NCUA does not believe that adoption of the Basel Accord will meet its statutory requirements. The system NCUA has devised for determining risk-based net worth requirements explicitly includes

both credit and interest rate risk in the calculation. Because credit unions are required to comply with the Prompt Corrective Action leverage and risk-based net worth requirements, it would be counterproductive to impose the additional compliance burden on U.S. credit unions of also having to meet the standards of the Basel Accord.

If at some point in the future, the Basel Accord is further revised to treat interest rate risk in the first pillar, CUNA may recommend that NCUA consider it as a substitute for the current Prompt Corrective Action rules. In any event, I plan to suggest that NCUA review the final version of the revised Basel Accord for ideas the agency may be able to incorporate into its rules.

I wish the Committee every success in finalizing the improvements to this very central component of international financial supervision. If you have any questions about the implications of the proposal for credit unions, please contact me or Arthur Amold of the World Council of Credit Unions.

Sincerely,

Daniel A. Mica
President and CEO

cc: Arthur Amold, President and CEO
World Council of Credit Unions

May 24th, 2001

Basel Committee Secretariat
Bank for International Settlements
Basel, Switzerland.
CH 4002

Email: EMAILMASTER@bis.org

Dear Sir or Madame:

RE: Consultative Paper issued January 2001

In response to your request for comment on the consultative paper for a new capital adequacy framework issued by the Committee in January 2001, the Canadian credit union system hereby submits the following comments.

Background of the Canadian Credit Union System

Canadian credit unions located in the provinces of Alberta, British Columbia and Ontario are required to comply with capital adequacy regulations based on modifications of the Basel Committee on Banking Supervision's 1988 Capital Accord.

Each province has a body, referred to as a "credit union central", which, among other things, acts as the manager of liquidity for its respective member credit unions. The assets of a credit union central consist, therefore, of highly-liquid securities, secured loans to their member credit unions, and a limited portfolio of commercial loans. Credit union centrals are generally regulated by both the Canadian federal government and also the government of the province in which they are located.

Credit unions are generally consumer lenders, making personal and residential mortgage loans, and have small commercial loan portfolios. A credit union's business is primarily based within the geographic region in which the credit union is located, and domiciled entirely in Canada. Credit unions are regulated by the laws of the province in which they are located.

Concerns Regarding the January 2001 Consultative Paper

We have chosen to comment on four areas:

1. The lack of a definition of what constitutes a "corporate" and what constitutes a "bank";
2. The Canadian credit union system's preferred option for risk weighting a bank;
3. The need for further recognition of the limited liquidity and credit risk of an organization, the major purpose of which is to provide liquidity;
4. The need for further recognition of the low risk associated with loans made by a liquidity provider to those financial institutions to which it provides liquidity; and
5. The second option for risk weighting exposures to banks.

1. Definition of "Bank" and "Corporate"

There is no clear definition of what constitutes a "bank" and what constitutes a "corporate". It should be clear that both credit unions and credit union centrals are included in the definition of "bank" rather than the definition of "corporate".

2. Preferred Option for Risk Weighting a Bank

The two proposed options for risk weighting a bank (we assume this term includes a rated credit union) are: (i) based on the sovereign in which the bank is incorporated less one category, or (ii) based on the independent rating assigned by an external credit assessment.

The Canadian credit union system's preference is for a bank's rating to be independent of the country in which it is incorporated. As a result of the global diversification of bank assets, the credit assessment of a bank is not so much dependent on its sovereign's risk as on the quality of its own assets, which will likely include assets located in many different sovereigns of varying credit ratings.

This preference does, however, cause problems for credit union centrals and credit unions which do not have an independent rating assigned by an external credit assessment. A risk weighting based on the sovereign in which the credit union central or credit union is incorporated is, in the system's view, appropriate in this instance since a credit union central or credit union confines its operations to a single sovereign. The Canadian credit union system proposes that the supervisor be given the authority to apply both options in his or her jurisdiction, as he or she believes it appropriate.

3. Treatment of a Credit Union Central

As already discussed, the natural asset base for a credit union central is highly liquid because the credit union centrals are the liquidity managers for their respective member credit unions. At the present time, deposits or commercial paper of a credit union central held by a credit union would generally be risk weighted by provincial rules at 0%. Deposits or commercial paper of a credit union central held by a bank would generally be risk weighted by federal rules at 20%. In the view of the Canadian credit union system, a preferred risk weighting of 0% is appropriate for deposits or commercial paper of a credit union central held by a credit union because of the extremely low liquidity and credit risk associated with such an institution. There should be a minimal capital cost to holding highly liquid investments, typically deposits with an initial term of one hundred days or less and callable on demand, in a financial institution the purpose of which is to provide

liquidity to the investor/depositor. The Basel Accord should recognize that investment in a low risk credit union central be provided at no capital cost.

4. Loans by a Credit Union Central to its Member Financial Institutions

A portion of a credit union central's assets will be comprised of loans to the credit unions to which it provides liquidity. These loans may consist of both lines of credit and also term loans of varying lengths. Virtually all credit unions have no independent credit rating, and therefore, depending on its treatment and the term of the claim, would receive a risk weighting of 100%, 50% or 20%. It is the view of the Canadian credit union system that this is inappropriate, and that a credit union central should be permitted to use the internal rating based ("IRB") approach on loans to those institutions to which it provides liquidity even if it otherwise uses a standardized approach. These loans are well-secured, typically with a general security agreement and an assignment of book debts. Credit union centrals have experienced virtually no losses on these loans. It would create perverse incentives if a bank using the IRB approach could assign a lower risk weighting to loans to a credit union, and thereby maintain less capital against that loan and make the loan at a lower cost, than could the credit union central which provides that credit union with liquidity but unfortunately cannot use the IRB approach referred to above.

5. Risk weights for banks – second option – some technical comments

It seems strange to us that the second option for banks (including rated credit unions), which is based on the external credit assessment of the bank, does not distinguish between A and BBB and unrated, each of which is weighted at 50%. We believe that an A rating should be weighted more favourably than the other two, most likely somewhere between 20 and 50%.

We note that risk weights for short-term claims may be claimed when the *original* maturity is three months or less. We would like to make two points about this. First, it is our recommendation that residual term to maturity be used and not original term because the same credit with the same term remaining should rank equally, all other things being equal. Second, we recommend that one year, rather than three months, be used as the yardstick because most of the market uses under one year as the yardstick for short term obligations.

As a general statement regarding the proposals in the consultative paper, the Canadian credit union system supports the Committee's efforts to focus capital requirements on the risks inherent in the assets under management, rather than on balance sheet measures which do not take account of risk. The majority of Canadian credit unions are required to meet, either in addition to or instead of a risk-weighted capital adequacy test, a simple leverage test of $1 in capital for every $20 in total assets. This is an arbitrary test which does not capture the true risks which the Committee has tried to address in the consultative paper. The Canadian credit union system recommends that supervisors and credit unions work towards the replacement of the leverage test with a risk-weighted assets test based on the Committee's proposals.

If you have any questions regarding our few comments, please feel free to contact me by telephone at (416) 232-3439 or by e-mail at rogersg@cucentral.com . Thank you for your consideration of our comments.

Yours truly,

Gary Rogers
Senior Vice President & CFO

RESPONSE TO PROPOSALS FOR

A NEW BASEL CAPITAL ACCORD

CREDIT UNION SERVICES CORPORATION

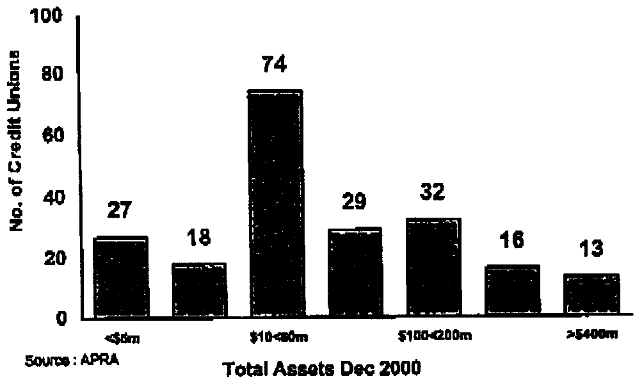
MAY 2001

RESPONSE TO PROPOSALS FOR A NEW BASEL CAPITAL ACCORD

1. BACKGROUND

1.1 CUSCAL is owned by 185 of Australia's 209 credit unions. In international terms, a credit union, even the largest, is small. The asset distribution of credit unions is not even: the top ten credit unions represent 42.8% of assets, the top 20, 64.1%. The chart below illustrates their distribution.

DISTRIBUTION OF CREDIT UNIONS BY SIZE



1.2 While the number of credit unions has been declining (through merger) since the early 1980s, credit unions remain an integral part of the Australian finance sector providing an alternative source of financial products and services to consumers. Credit unions' provision of financial product s and services is characterised by a high degree of co-operation. Their participation in national financial markets is facilitated through industry owned centrals, of which CUSCAL is the largest. This arrangement, ie co-operative participation of local credit unions and a national central, is a feature of credit union Movements and co-operative banking groups around the world. Through these arrangements, relatively small local credit unions participate in national financial markets and are able to share and transfer risk on an industry basis.

2. INTRODUCTION

2.1 CUSCAL welcomes the review of the 1988 Basel Capital Accord and supports the mutually reinforcing three pillar structure promoting the theme of increased risk sensitivity in capital planning. The principle that financial institutions should have robust internal systems for identifying, measuring and managing risk is sound and fits well with the holistic approach to prudential supervision.

2.2 CUSCAL also supports the intention of the Basel Committee to create a set of principles which "are intended to be suitable for application to banks of varying levels of complexity and sophistication"[1] and to retain the minimum ratio of capital to risk weighted assets including operational and market at 8%. [2]

2.3 Whilst supporting the general principles of the New Capital Accord, CUSCAL has several concerns about the potentially adverse impact of the New Accord if the principles are not applied with sensitivity to the diverse and co- operative nature of the credit union movement.

[1] Para 8 Overview of The New Capital Accord
[2] Para 9 Overview of The New Capital Accord

2.4 CUSCAL's response to the proposals reflect our unique position as both an ADI in our own right and as the central banking and industry advocate body for the majority of Australia's 209 credit unions.

2.5 There are five main issues which are of concern to credit unions. They are:

2.5.1 That larger financial institutions should not gain a regulatory advantage over smaller institutions because the nature of their operations prescribes a more sophisticated approach to risk management and they have the funds and capacity to develop sophisticated models under internal rating based (IRB) approaches;

2.5.2 The potential disadvantage to credit unions posed by the use of external ratings agencies in determining risk weights;

2.5.3 The disproportionately high risk weighting on mortgage secured housing loans relative to the risks presented by these loans;

2.5.4 The potential impact of a specific charge for operational risk and the blunt instruments proposed for measuring such risk.

2.5.5 The nature, cost and effectiveness of disclosure requirements

3. INTERNAL RATING BASED APPROACHES

3.1 CUSCAL agrees that financial institutions should be encouraged to develop models which accurately measure and monitor the risks to which they are exposed. The sophistication of these models should be commensurate with the complexity of the organisation and the nature of the risks inherent in the organisation. For example, small financial institutions which provide basic retail deposit products and manage a loan book comprised largely of mortgage secured assets and a small exposure to unsecured personal loans is unlikely to require complex statistical models to measure and monitor risk.

3.2 The absence of sophisticated models does not necessarily indicate a deficiency in the risk management of these institutions and should not lead supervisors to impose more onerous capital requirements on this basis. Nor should such arrangements provide regulatory relief to larger institutions where the nature of their business dictates a higher degree of sophistic ation in the measuring and monitoring of risk.

3.3 CUSCAL strongly supports the notion that strong capital ratios should be complemented by robust internal risk measurement and management systems. However, if the IRB approach is seen to reward the development of substantial quantitative models, this has the potential to actually increase risk in certain institutions who may be tempted to redirect their limited management resources towards pursuing quantitative models in the hope of gaining regulatory relief. Where such activities do little to alter the real risk profile of the business the improvement to risk management processes is questionable.

3.4 A stated intention of the BIS Committee is that the overall capital of the industry would not increase. If sophisticated risk management models brings about regulatory relief to larger institutions, the burden of capital across the industry would shift with credit unions being required to hold a greater proportion of the industry capital - disproportionate to the le vel of risk they present to the system.

3.5 Credit union risk needs to be understood within the context of the credit union system. The high level of co-operation among credit unions has important implications for risk management. An individual credit union's risk profile cannot be fully understood without both an understanding of the industry based risk management systems that it participates in, and an understanding of the structure of the industry as a whole.

3.6 While on its own, a credit union might have difficulty managing the risks that attend its small size (such as geographic or industry sector concentrations, or lack of balance sheet diversification), participation in industry structures offers it a considerably expanded range of risk management options.

3.7 Examples which demonstrate the range of industry based risk mitigation techniques provided through CUSCAL to its members are:

- liquidity support (stand-bys, overdraft facilities)
- balance sheet management (securitisation and wholesale funding)
- emergency liquidity and solvency support (CUFSS)
- risk management and capital advisory services

3.8 This system-wide context for understanding the risk profile of individual credit unions is likely to become more important over time. While the levels of credit union aggregate capital are very healthy (risk weighted 14.7%), the shift in loan portfolio towards housing finance (now exceeding 60% of loan assets) masks a slight proportional decline in reserves. More importantly, continued strong competition and declining margins have resulted in suppressed industry ROA (0.63%). Efforts to address this situation focus on reducing the industry's cost base (81% exp/inc) and increasing non-interest income.[3] Structural changes may also be required to meet these competitive pressures.

3.9 These developments imply rising and more complex combinations of operational, reputation and legal risks for credit unions, and the management of these will be a challenge for credit unions and for supervisors. From CUSCAL's perspective, understanding combinations of risk at the level of the credit union system will become increasingly important for CUSCAL's own risk management, and for that of individual credit unions. Similarly, APRA's sensitivity to the changing risk environment will be essential to the successful implementation of the Basel supervision principles.

4. USE OF EXTERNAL RATINGS

4.1 CUSCAL acknowledges that recognising the ratings of external agencies within the standardised risk weight system will give greater precision to the Accord by recognising the diverse creditworthiness of different corporates and ADIs. This initiative will have considerable impact on banks that have exposures to other ADIs and this is of particular concern to CUSCAL and credit unions.

4.2 Although CUSCAL enjoys an excellent credit rating (AA-) from Standard and Poors, no single credit union in Australia has a credit rating and, it remains unlikely that any credit union would be successful in doing so. One of the difficulties for ratings agencies is that historical default data for prudentially supervised ADIs is virtually non-existent. Additionally, ratings agencies have traditionally had difficulty coming to grips with the unusual characteristics of co-operative banking and credit unions.

4.3 The formal inclusion of the ratings of external agencies within the risk -weight tables has potentially far-reaching consequences for credit unions and for CUSCAL. For instance, an increase in the risk-weight of loans outstanding to credit unions (which are un-rated) from the current 20% to 50%, would result in an increased capital charge of approximately $23 million to CUSCAL. Conversely, a fall in CUSCAL's own credit rating would result in an increased capital charge to credit unions of approximately $43 million.

4.4 Of greater concern to CUSCAL is the likely effect on credit unions' access to liquid funds. Although the liquidity requirements of most credit unions are met by CUSCAL,

[3] All figures quoted as at December Quarter, 2000.

credit unions sometimes choose to source standby lines and other facilities fr om Australian banks as part of their liquidity risk management strategies. A move to risk weight claims on ADIs according to their external credit rating, or a default of 50% for un-rated ADIs, will make it less attractive for banks to offer these facilities to credit unions and will therefore restrict credit unions' access to liquid funds.

4.5 The adverse reaction experienced from banks when credit unions came under the depositor protection provisions of the Banking Act demonstrates that banks are not inclined to rely on the credit worthiness of individual credit unions if they perceive there is a diminution of collateral in relation to the facility provided.

4.6 CUSCAL therefore views the proposal to include external credit ratings in the risk weight tables for ADIs with some concern and caution. If the effect of introduction on unrated credit unions is to unduly restrict their access to credit, this would clearly be undesirable from both a commercial and a prudential standpoint. The proposal to recognise short maturity for claims on banks with a more favourable risk weighting would go some way to assist small ADIs seeking liquidity support facilities but twelve months would be a more realistic time frame.

4.7 There are some attractions in the approach outlined Option One, where claims on banks are allocated a risk weight one higher than that applying to the sovereign in which the bank is incorporated. This approach at least has the merit of ensuring that there is some recognition for the quality of prudential supervision in that jurisdiction. There is a strong argument that the risk-weights should recognise the value of high quality regulatory assurance. Under Option 2, it is possible that credit to a well- run prudentially supervised ADI in Australia might be weighted as having the same approximate credit risk as household credit secured by a mortgage. While Option 1 may be difficult to implement in relation to internationally operating banks, it may be more appropriate for ADIs with purely domestic operations.

5. HOUSING LOANS

5.1 A risk weight of 50% assigned to mortgage backed housing loans is inconsistent with the level of risk attached to such loans in Australia. Whilst there is insufficiently detailed data regarding defaults on mortgage backed loans, accepted commercial intelligence (based on experience) is that this type of lending is among the safest investment for an ADI. Rarely do borrowers default on such loans and in the event that they do, the value of the collateral more than covers the outstanding loan, particularly in the majority of Australian capital cities.

5.2 Partly to take advantage of the low risk nature of the home lending, credit unions in Australia have significantly increased their activities in the this market segment over the past five years. Housing loan balances outstanding for the industry have virtually doubled to $11,267m between December 1995 and December 2000. This represents an average annual growth rate of just under 15% which is around the same rate of growth recorded for the market overall. Credit unions now have more than 60% of their lending portfolio in housing loans and housing lending has replaced personal lending as the dominant business activity in credit unions.

5.3 If support cannot be gained for a reduced risk rating or national discretion, an approach similar to that outlined in the Committee's supplementary paper "Criteria in defining exceptional treatment of commercial real estate lending" would appear to provide a model which could be applied to residential m ortgage lending. By establishing rigorous collateral and valuation requirements along the lines set out in the paper, discounted risk weights for residential housing could be supported internationally.

6. OPERATIONAL RISK CHARGE

6.1 CUSCAL supports a distinct capital charge for operational risk and has always encouraged credit unions to take account of this type of risk in capital planning. However, CUSCAL also agrees with the sentiments expressed in the technical paper that there is much work to be done before the concept of a capital charge representing operational risk can be effectively implemented.

6.2 The role of capital is to protect depositors and ultimately the payments system from risk. While the Accord does leave the ultimate capitalisation decision to the Board of each ADI, there is limited discussion in the Accord of the appropriate level of risk aversion and the role played by central banks and ADI boards in the determining these levels.

6.3 It is argued that regulatory goals should have a strong focus on the protection of the payments system and as, a secondary consideration, provide a base level of risk aversion, or risk floor for ADIs. As the majority of the sophisticated approaches presented in the Accord revolve around some form of confidence interval statistical methodology, there should be explicit recognition of the confidence level required by the regulatory framework as a risk floor.

6.4 The models presented for calculating an operational risk capital charge rely on successfully identifying the components of operational risk and correctly assigning a probability to various events. There are two significant flaws in this: one, it is possible that not all operational risks will be identified and two, the correlations between the risks are not adequately accounted for.

6.5 An alterative is to employ a top down approach to capital allocation and calculate total capital based on earnings volatility. This would then allow the application of a residual approach to estimating operational risk. The basis of such an approach is that credit risk and market risk assessments are relatively straightforward for most banks and can be calculated on data already collected, the difference between these capital charges and total capital calculated using earnings volatility is operational risk.

6.6 The advantage of this approach is that operational risk can be readily identified and calculated in the absence of data, which the Committee acknowledges few banks collect. It also captures strategic and reputational risks which are currently excluded from the definition of operational risk.

6.7 The concepts and principles underpinning the earnings volatility methodology are well accepted in the finance sector and CUSCAL has been developing a model using the residual approach to assess the efficiency of capital allocation within the organisation. Although application of the model is in the early stages, the potential for it to be a powerful and relatively direct strategic decision making tool looks very promising.

6.8 In addition to questioning the nature of the methodologies presented for assessing operational risk, the detail of the standardised methodology appears somewhat confused and creates the potential for misleading results. Specifically:

6.8.1 The 20% value seems to have been extracted from internal economic capital allocations that could be expected to differ from regulatory capital;

6.8.2 The small sample size from which the 20% was derived and the inference that "one size fits all" disregards the diverse nature of balance sheet s and operational risk components;

6.8.3 There is high dependency on accounting output that can vary between ADIs and in some cases may be manipulated;

6.8.4 The focus for retail balance sheets is again placed on asset size as the key risk indicator. This does not appear to be any advance on the original risk weighted assets approach.

6.9 The more sophisticated Internal Measurement Approach outlined in the technical paper does well to start the process of identifying risk factors but provides little assistance in ensuring that all risk factors are covered.

6.10 Additionally, the real benefit to be extracted from such modelling is lost through the application of generic industry expected loss factor (γ) and subjective Risk Profile Index (RPI) factors. Both these variables are to be set by the Supervisor removing them from the control of the ADI which has the best capacity to measure/estimate them. The combination of the γ and RPI factors effectively conceals the confidence level required of these models. Identifying these confidence interval requirements are an important part of the debate on the effectiveness and intentions of the proposed accord.

6.11 It is difficult to see how the proposals presented in the New Accord can be implemented without raising the overall minim um capital adequacy ratio above 8%, especially if the risk rating on mortgage lending remains at 50%.

6.12 In relation to credit unions, the models presented to not account for the risk mitigation afforded by membership of an industry body which provides services such as compliance assistance, IT support, wholesale securitisation programs, etc. This was discussed earlier in section 3.

7. NATURE AND COST OF DISCLOSURE

7.1 CUSCAL generally supports a cautious approach to the use of disclosure and market discipline with deposit taking institutions. Without listed or traded capital, and too small to attract the scrutiny of professional analysts, market discipline on most individual credit unions is not likely to be improved by excessive market disclosure.

7.2 Moreover, the degree of disclosure currently required under Australian legislation and the fact that credit union shareholders are owners as well as retail depositors means that the manner of disclosure should be careful in order to increase confidence rather than add confusion.

7.3 Notwithstanding those concerns, CUSCAL supports the Paper's suggestion that institutions should be required to disclose in some detail the quantitative and qualitative data that supports a description of its risk profile. CUSCAL also s upports disclosure of data related to capital adequacy. CUSCAL would have reservations, in the Australian context, about disclosing the level above regulatory minimum formally required of each institution by regulators.

7.4 In addition, CUSCAL believes there may be much more sense in the credit union industry in promoting disclosure of industry wide risk and risk management information. Standard and Poors already regularly publish a credit union industry analysis, and further development in this area could support further maturing of the relationship between the industry and financial markets.

8. CONCLUSION

8.1 Whilst CUSCAL is broadly in agreement with the thrust of the Accord, there are a number of concerns which arise from the taking concepts and principles designed around the operations of large internationally operating banks with complex structures and product lines and applying them to very small domestically operating financial institutions with simple structures and product lines. In particular, CUSCAL considers that:

8.1.1 Larger financial institutions should no gain a regulatory advantage through the use of sophisticated risk management models

8.1.2 Credit unions should not be disadvantaged by the absence of a rating from an external agency. In particular unrated institutions should have a risk

weight no more than 50% and short maturity (12 months or less) be one risk weight lower.

8.1.3 Criteria be developed which will allow the risk weighting on mortgage backed housing loans to be reduced;

8.1.4 Further work be done on the nature and detail of operational risk measurement tools to ensure the calculation of an efficient capital charge. Such work to recognise the role of an industry central in risk mitigation for individual credit unions.

8.1.5 The nature, cost and effectiveness of disclosure in relation to small ADIs be considered in the context of the disclosure requirements already in place.

Comments and questions on the contents of this submission may be directed to Karin Hawkins, Public Affairs, Credit Union Services Corporation, phone +61 2 9333 7579, or e-mail khawkins@cuscal.com.au.

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April 30, 2001

Dave Grace
Manager
World Council of Credit Unions, Inc.
5710 Mineral Point Rd.
Madison, Wisconsin 53701-2982

Dear Mr. Grace,

Thank you for providing U.S. Central with the opportunity to contribute to the World Council of Credit Unions, Inc. (WOCCU) comments on the latest round of the New Basel Capital Accord proposal (New Accord). U.S. Central supports the New Accord concept of a risk based capital structure.

As you know, United States credit unions are not currently subject to the Basel Capital Accord. In addition, they would not automatically be subject to the New Accord. However, there is one area where the New Accord could potentially impact U.S. Central as well as certain other non-United States domiciled credit unions.

Intrinsic to the determination of the appropriate risk weighting category is the characterization of the type of issuer of an investment. In this regard, a claim on a credit union is not addressed. Predicated on our experience with the current Basel Accord, a claim on a credit union could be characterized as a "claim on a corporate" rather than as a "claim on a bank".

If a non-United States domiciled credit union would be subject to the New Accord, their ability to invest in shares of another credit union, including a corporate credit union, would be adversely affected by risk weighting such as investment as a "corporate claim" rather than as a "claim on a bank".

We believe that it is appropriate for claims on a credit union to be included in the category of "claims on banks" for purposes of the New Accord. As the WOCCU fashions its comment on the New Accord, we urge you to consider requesting that the New Accord be modified, perhaps even in a comment to the effect that claims on credit unions constitute claims on banks for purposes of the New Accord.

Once again, thank you for the opportunity to contribute to the WOCCU response to the New Accord.

Sincerely,

Dan Kampen

Dan Kampen
President/CEO