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Berlin, 28 May 2001

Comments of the Zentraler Kreditausschuss on the Basel Committee's Consultative Document of 16 January 2001 on a New Capital Adequacy Framework for Banks ("Basel II")

Preliminary remarks

1. General remarks

On 16 January 2001, the Basel Committee on Banking Supervision followed up its First Consultative Document of 3 June 1999 by presenting its Second Consultative Document on a revision of the 1988 Capital Accord. The document lays down guidelines for gearing international capital rules more strongly to the actual economic risk of banking business, particularly lending business. The most important innovations are the broader scope of application and consolidation of the New Capital Accord to cover whole banking groups, the use of internal rating systems as the basis for determining capital charges for so-called risk assets, improved recognition of loan collateral and the inclusion of operational risk in the regulatory capital regime. These innovations are accompanied by a more strongly qualitative supervisory process for reviewing minimum capital adequacy and recommendations to strengthen market discipline through disclosure of information.

Unfortunately, given the scope and the complexity of the new Consultative Document, the deadline set by the Basel Committee for comments by the banking industry – 31 May 2001 – is much too tight. For this reason, it is difficult for the Zentraler Kreditausschuss (ZKA) to properly assess the impact of the proposed rules.

This problem is aggravated further by the numerous open questions that are only touched upon in some cases in the consultative document and by the lack of determination/ determinability of important risk parameters. This goes particularly for the final calibration of internal bank rating

and thus the ultimate size of future capital requirements. For this purpose, data is to be compiled by the banking industry in the course of the coming year within the framework of a so-called Quantitative Impact Study II so that risk weights and capital charges can be determined precisely. The results of this survey are, however, only to be evaluated and presented after expiry of the proposed consultation period. This is why it is particularly important that the consultation process be continued in the form of an open dialogue on these points even after the official deadline for comment has expired and – where necessary – even after adoption of the New Capital Accord.

2. Key criticisms

The new Basel Committee proposals contain in some cases major improvements on the First Consultative Document of June 1999. However, a fundamental rethink is required in many areas and extensive amendment/revision needed so that the New Capital Accord is inherently consistent and does not have any negative competitive implications.

(a) Scope of application/consolidation

We welcome the extension of the scope of application of the New Capital Accord so that banking groups, including the parent holding company, will be fully consolidated. This means an alignment/approximation of the scope of consolidation for internationally active banks with existing EU directives and thus more equality of competition. However, there is still the fundamental difference that the EU rules also include securities firms in the scope of consolidation, while Basel II only applies to banks. To allow full harmonisation of the coverage of supervisory rules, we suggest that the scope of consolidation provided for in Basel II be brought completely into line with the rules applying in the European Union. Besides their proven effectiveness, a further advantage of adoption of the EU rules would be that they are already applied by a majority of the countries represented on the Basel Committee.

(b) Mutual recognition of supervisory decisions

Insofar as the Basel Consultative Document allows national supervisors discretion in implementation of certain requirements[1], the required transparency on the extent to which

[1] See in this connection para. 24, para. 27, para. 39 footnote 15, para. 45, para. 103, para. 142, para. 160, para. 163, para. 254, para. 311, paras. 520 – 523. On the question of the discretionary powers available to national supervisors, see also the remarks on page 17 for further details.

supervisors make use of this discretion should be created for market participants so as to ensure a common level playing field.

The approval and supervision of internal systems for measuring credit risk, but also other risk, e.g. operational risk or interest rate risk, is to fall under Pillar 2 (Supervisory Review Process) of the future Basel Capital Accord. Considerable national discretion is allowed in this connection. This could therefore mean that a situation may arise in which internationally active banks and their subsidiaries face auditing in different countries with conflicting requirements. This would result not only in substantial extra costs; in extreme cases, the use of internal systems already approved by home-country supervisors would have to be dropped in other countries. For this reason, home-country supervisors should be put in charge of group-wide recognition of internal systems. This principle of home-country control has proved successful within the European Union.

(c) Internal ratings-based approach

As far as the requirements for use of the IRB approach are concerned, we feel that considerable modifications are still required.

The key criticism of the Basel Committee’s internal rating requirements is that the risk weights in the IRB approach are much too high. These high risk weights are due in our opinion mainly to the fact that the Committee requires banks to cover not only their actual credit risk (the so-called unexpected loss) with capital but also the risk which banks have already covered via the risk premiums included in interest rates (the so-called expected loss). Moreover, the numerous safety cushions, haircuts and floors imply that all potential crisis scenarios, errors and catastrophes will occur simultaneously with full force. This is, however, totally unlikely. All in all, it is to be feared that capital requirements for corporate exposures will increase on average, resulting in poorer loan terms. This would impose an unreasonable burden on small and medium-sized enterprises in particular.

To the surprise of the German banking industry, the Basel Committee’s Second Consultative Document provides for the inclusion of exposure maturity in the IRB approach. This means that, all other things being equal, a long-term exposure will require up to six times as much capital as a one-year exposure. Because of established corporate financing structures, the percentage of long-term loans in Germany is much higher than, for example, in the USA or the UK. Capital add-ons for long-term loans would therefore seriously affect the international competitiveness of the German banking industry and result in higher interest rates for

borrowers that would not be justified by the risk exposure. We therefore reject such capital add-ons.

Generally speaking, it is very difficult to submit alternative proposals for setting the parameters for calibration of the IRB approach, as the credit risk model on which calibration is based and the way in which the formulae for determining the risk weights are derived are unclear. We therefore call for disclosure of every single calculation step and of all models and methods used. In addition, the results of the Quantitative Impact Study II should be published and the conclusions for calibration of internal rating drawn from these should be explained in detail to the banking industry. We demand at any rate to be given a proper hearing before the final risk weights are set.

The inclusion of equity exposures in the IRB approach is, we feel, a practical way to arrive at a capital requirement geared more strongly to actual risk also where such exposures are concerned. However, the LGD of 100% proposed by the Basel Committee, as against 50% for credit exposures, is much too high and counter-productive in terms of economic policy. The capital requirements should therefore generally be identical with those for corporate exposures.

The rules on partial use of the IRB approach and on the requirements concerning the data history that has to be compiled are, overall, too strict and make it more difficult for German banks to qualify early for an IRB approach for supervisory purposes. They should be allowed to exclude clearly definable business units, e.g. subsidiaries or branches, but also separate retail segments for which establishment of the required data history is impossible or unreasonable, from the IRB approach in general.

We also suggest that, at least until the end of 2006, merely a two-year data history should be stipulated for internal ratings, without any increase in requirements during the transition period. Furthermore, until the end of 2006 as well, banks should only be required to demonstrate that they have been using a rating system for a period of twelve months within the two-year data history so as to facilitate access to more sophisticated methods of risk measurement and to provide sufficient incentive for improvement of internal risk management.

(d) Recognition of collateral

The Basel Committee’s intention to recognise collateral to a greater extent than before in measurement of regulatory capital is strongly welcomed by the banking industry. However, the scope of eligible collateral is confined mainly to so-called financial instruments. This means,

however, that the Committee's proposals only reflect current practice as regards the use of collateral extremely inadequately. The scope of eligible security should be extended to include all collateral "customary in banking business", such as collateral in the form of movable property and real estate liens.

The introduction of a "w factor" as an extra risk buffer alongside collateral haircuts that are planned in any case in connection with the recognition of collateral to capture "residual risks" is not an adequate instrument. This is particularly true because the risks that the Basel Committee believes should be covered by the "w factor" are operational risks. If the Basel Committee were to stick to its intention of introducing a separate capital charge for operational risks, the application of the "w factor" would result in these risks being captured twice.

(e) Operational risk

The Basel Committee has repeatedly stressed that, while the average capital requirement should not rise as a result of the new rules, it should not fall either. The Committee is thus pursuing a "compensatory approach". Expected savings in the area of credit risk are to be offset by a mandatory capital requirement for operational risk. Against this background, calibration of the operational risk capital charge (mainly by fixing the alpha, beta and gamma parameters) will only make sense after the effects on capital in the area of credit risk have been reliably assessed. On the other hand, the Basel Committee's intention of gearing the size of the capital charge for operational risk to a pre-determined "ideal result" of an average of 20% of the regulatory capital required so far appears arbitrary and makes it more difficult to achieve the aim of establishing a risk-sensitive capital regime. Rough calculations also suggest that capital relief of 20% in the area of credit risk is a highly exaggerated figure.

The methods proposed by the Basel Committee for determining the capital requirement for so-called operational risk (e.g. IT risks, fraud, or the like) are inadequate. They are based on indicators that have got nothing to do with the actual operational risk. In this way, wrong risk management incentives would be set. The proposed so-called Basic Indicator Approach, based on banks' "gross income" would mean, absurdly, that earning additional income would be punished by an increased capital charge for operational risk.

The further discussion of the future treatment of operational risk must focus on achieving more risk-sensitive solutions and avoiding a general increase in overall capital. It must at any rate be ensured that the methods for covering operational risk with capital do not create any wrong risk management incentives for banks. It is vital that the rules in the area of operational risk are

worded “openly” enough. Progress in operational risk management methods made on the basis of more accurate loss data should be eligible for inclusion in the New Basel Capital Accord even after it has been adopted.

(f) Market discipline

Pillar 3 of the Basel Committee’s Second Consultative Document reflects in part the trend away from statutory financial reporting towards capital-market-oriented business reporting. The following is particularly noticeable:

The Basel Committee is exceeding its original mandate by unilaterally pressing for banking disclosure that is already being pushed by market participants themselves and international organisations (IASC, IOSCO). There must be no division of disclosure for banks based on supervisory requirements on the one hand and capital-market-oriented requirements on the other.

The disclosure of confidential customer data and sensitive business information to outside third parties negates the practice whereby supervisors are informed fully on a regular basis about the development of a bank’s business and about its credit risk, market risk, liquidity risk and operational risk.

The amount and depth of individual data lead to an “information overkill” at the expense of transparency for most addressees. It is no longer ensured that information is clear and relevant. This makes it impossible even for expert third parties to evaluate information quickly. The principle holding that only significant information should be disclosed is cancelled out by the requirement to disclose approximately 1,000 individual items of data.

PART 1: SCOPE OF APPLICATION

A. Introduction (paragraphs 1-4)[2]

Given the growing integration of financial markets, internationally diverging consolidated capital requirements have become more and more of a competitive factor. We therefore firmly support the Basel Committee's intention of now harmonising the scope of the Capital Accord at international level. Its proposal to extend application of the scope of consolidation to include, on a fully consolidated basis, holding companies that are parents of a banking group is a first step in this direction.

To allow full harmonisation of the coverage of prudential regulation we suggest aligning the scope of consolidation envisaged by the Basel Committee with the rules applying in the European Union. Besides their proven effectiveness, a further advantage of adoption of the EU rules would be that they are already applied by a majority of the countries represented on the Basel Committee.

Definition of a "*banking group*"

The proposed definition of a "banking group" as a "*group that engages predominantly in banking activities*" is unclear and allows room for national discretion. To allow harmonisation of the scope of consolidation, a more precise definition is required. A clear-cut and thus competitively neutral definition of holding companies that are parents of banking groups could be ensured by using the definition of "*financial holding company*" contained in Article 1, no. 21 of EU Directive 2000/12/EC relating to the taking up and pursuit of the business of credit institutions[3].

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[2] Our comments follow the structure of the Consultative Document "The New Basel Capital Accord". The paragraph numbers in brackets refer – unless otherwise indicated – to the main document.

[3] According to Article 1, no. 21 of the EU Directive on the taking up and pursuit of the business of credit institutions, a financial holding company (FHC) is a "*financial institution, the subsidiaries of which are either exclusively or mainly credit institutions or financial institutions, one at least of such institutions being a credit institution*". The term "*mainly*" is to be defined more precisely in the course of the on-going reform efforts at EU level. One possible approach: Proportion of a financial institution's assets accounted for by the financial sector > 50 % ⇒FHC.

B. Securities and other financial subsidiaries (paragraphs 5-8)

Scope and method of consolidation

According to the Basel Committee, majority-owned or -controlled **securities entities** "*should*" generally be fully consolidated if they are subject to regulation that is "*broadly similar*" to that to which banks are subject *or* the activities they conduct are deemed by national supervisors to be banking activities.

The First Basel Consultative Document provided for consolidation (or deduction of the capital) of securities subsidiaries only where the activities of the securities subsidiaries are deemed by national supervisors to be banking activities. The wording in the Second Consultative Document therefore means that the scope of consolidation envisaged by the Basle Committee has been brought more into line with that adopted at EU level. This is, in principle, to be welcomed.

Nevertheless, there is still a considerable difference in the way securities entities are treated under the scope of consolidation provided for in Basel and Brussels respectively: Whilst at EU level the capital rules are directly applicable to securities firms as well, the Basel Committee only actually deals with such firms where they are part of a financial group that contains at least one internationally active credit institution. To ensure a level playing field, the differing scopes of consolidation should be aligned, i.e. the New Basel Capital Accord should apply directly to securities entities as well. To do so, the Basel Committee should, if necessary, bring its influence to bear on IOSCO.

Moreover, formulating the provision on the consolidation of securities entities in the Consultative Document as a "desired" provision ("*should*") and using the vague legal term of "*broadly similar regulation*" seriously dilutes its regulatory thrust. To create a risk-focused, internationally uniform scope of application of the Capital Accord, the Basel Committee must stipulate on a binding basis those activities which generally qualify undertakings for inclusion in consolidated supervision. For this purpose, the list of activities applying to "*financial institutions*" set out in Annex I of the EU Directive 2000/12/EC should be adopted as a tried and tested guideline. To establish a level playing field, stipulation on a binding basis of the circumstances which trigger mandatory full or pro-rata consolidation of a financial institution is also required (pursuant to Articles 52-56 of Directive 2000/12/EC).

The Basel Committee admits that there may be "*instances*" in which consolidation of "*certain securities and other regulated financial entities*" is not feasible or "*desirable*".

This vague wording could be understood to mean that the Basel Committee provides for broad **national discretion** in this connection. The Committee should only waive inclusion in consolidated supervision in exceptional and clearly defined cases. Article 52(3) of Directive 2000/12/EC should be taken as a guideline.

The Basel Committee also states that majority interests in securities and other financial subsidiaries that are not consolidated for capital adequacy purposes are generally to be deducted from the capital of the group. If the subsidiary fails to meet its minimum stand-alone capital requirement, the capital shortfall will be deducted from the capital of the group.

In this connection, the exemption from mandatory deduction of capital allowed under Article 34 (2), no. 12 of Directive 2000/12/EC (temporary acquisition of shares in another credit or financial institution for the purposes of financial assistance designed to reorganise/save such an institution) should be adopted. An exemption from mandatory deduction should also be granted for capital investments of parent institutions whose holding company already includes the investment in group consolidation.

Level of consolidation

To ensure adequate capitalisation and distribution of capital within a "*banking group*", the Basel Committee feels it is necessary that internationally active banks at every tier below the top banking group level consolidate, in turn, their investments in financial institutions (**sub-consolidation**). Sub-consolidation can be waived if the Capital Accord is applied to the stand-alone bank (internationally active bank) and the book value of the investments is deducted from the bank's capital.

The obligation to provide for sub-consolidation must be rejected. Sub-consolidation would impose a considerable burden, without bringing any additional supervisory insight or benefit. For the same reason, mandatory sub-consolidation was dropped from efforts to harmonise European banking law (Article 52(7) of Directive 2000/12/EC, Article 7(7) CAD).

The **deduction of investments at the level of the subsidiary parent institution** provided for as an alternative to sub-consolidation would be a tougher provision than that currently applying under Section 10(6), sentence 2 of the German Banking Act, according to which a bank is

exempt from deduction of capital if its parent institution mandatorily or voluntarily consolidates an investment. Under the current supervisory regime, groups of institutions or financial holdings are regarded as a *single* entity, i.e. only the group is subject to consolidated supervision. The consolidation of *all* group institutions that is to be effected via the group parent ensures that the risks incurred within the group are captured fully and matched against the capital effectively available within the group. Exemption of a subsidiary parent institution is thus appropriate.

We also assume that proof of application of the Capital Accord to the stand-alone bank is deemed to have been furnished in Germany when the institution makes a Principle I compliance report.

Third-party minority interests

Under the Basel Committee's proposals, supervisors are to be free to decide whether and to what extent third-party minority interests may be included in the regulatory capital of the group. Third-party minority interests should continue to be counted in full towards group capital. The risks of subsidiaries should be fully included in the group by way of full consolidation. To assess the capital adequacy of the group, it is vital, for systematic reasons, that these risks be matched in full against the entire capital of the group. It would be wrong to unilaterally reduce the capital available to cover these risks.

Through the controlling relationship between parent and subsidiary third-party minority interests can also be used in full for the purposes and the benefit of the entire group (e.g. for investments in other group entities). The capital of the subsidiary is available in full to cover any losses that may arise.

The deduction of third-party minority interests would also be inconsistent with the aim of treating the group as a single entity for consolidation purposes.

Allowing national supervisors discretion in connection with the recognition of third-party minority interests should be avoided in any event as it would lead to significant distortions of competition if such discretion were exercised differently. A level playing field would be jeopardised particularly if tougher treatment of third-party minority interests than that possible under the discretionary powers granted by the Basel Committee were to be stipulated at EU level. Any discretionary powers granted to national supervisors by Basel would have to be incorporated into the corresponding EU rules.

C. Insurance subsidiaries (paragraphs 9-13)

The Basel Committee believes that "*at this stage it is, in principle, appropriate*" to deduct majority interests in insurance subsidiaries from the capital of the bank holding the interest.

A unilateral requirement for banks to deduct their interests in insurance subsidiaries must be rejected, firstly, for competitive reasons. Insurance entities are not required, conversely, to deduct majority interests in banks.

Secondly, the Basel Committee's proposal is also inappropriate from a risk angle. Insurance risks are completely different from the credit and market risks to which banks are typically exposed. They consequently lie outwith the scope of prudential rules. The deduction from capital of interests in insurance subsidiaries envisaged by the Basel Committee would be the equivalent of a risk weight of 1,250%. The risk resulting from an interest in an insurance subsidiary would thus be grossly over-exaggerated. Full deduction of an investment in an insurance subsidiary would imply under prudential risk management rules that the subsidiary uses the capital made available by the investment to conduct 12 ½ times as much business carrying banking risks. This assumption is completely unrealistic. The volume of business carrying credit and market risk that is conducted by insurance entities is still low compared with the volume of actual insurance risks. Insurance entities should, at most, be required to meet the prudential requirements applying to their "*banking activities*".

The risk of loss of an investment is covered under current regulatory capital rules – like credit risk – by the 8 % capital charge. The Basle Committee's intention to set higher capital charges for "*higher-risk*" investments would be taken into account by the expected ratings-based approach to treatment of equity.

So that risks resulting from an investment in an insurance subsidiary cannot be underestimated by means of deduction of the book value of the investment from group capital, the Basel Committee intends to ensure that **insurance subsidiaries** are adequately capitalised **on a stand-alone basis**.

In this connection, it remains unclear, however, how the capital adequacy of insurance subsidiaries is to be assessed for the purposes of prudential capital measurement. Equally unclear is how insurance enterprises and their supervisors are to be covered by the New Capital Accord for banks.

By proposing that possible "*risk aggregation*" be limited to corresponding supervisory requirements for insurance enterprises, the Basel Committee recognises the importance, in a competitive context, of measures that unilaterally burden banks. This is to be welcomed. An inconsistency is, however, that the Basel Committee only fears distortions of competition in connection with the proposed "*risk aggregation*".

The Basel Committee proposes that any **surplus regulatory capital** available to an insurance subsidiary may be included in the group "*under limited circumstances*". Under the deduction approach, the amount deducted would be reduced by the amount of surplus capital. The "*limited circumstances*" for assessing the amount and the availability of surplus capital that may be recognised in bank capital are to be determined at the discretion of national supervisors.

The Basel Committee leaves all the crucial points on this question to the discretion of national supervisors. This appears to be due mainly to a lack of acceptable concepts for prudential recognition for capital adequacy purposes of equity investments in insurance subsidiaries. Important questions concerning measurement of the consolidated capital of banking groups have considerable competitive implications and call for in-depth discussion. They should not be addressed under an apparently unbalanced approach providing for broad national discretionary powers.

German supervisors repeatedly stressed prior to publication of the Basel Committee's Second Consultative Document that – unlike under the proposals contained in the First Consultative Document – the deduction of investments in insurance subsidiaries was no longer discussed in the Basel II consultations. In contrast, the Basel Committee still advocates the deduction approach "*at this stage*." Given the repeated utterances by German supervisors and the consultative document's intention of not ruling out "*alternative approaches that can be applied*", we expect – at least until adoption of other rules for global supervision of financial conglomerates – German banks to be able to treat majority interests in insurance subsidiaries as "normal" risk assets in the future too[4]. This is also sufficient to prevent the double gearing feared by the Basel Committee.

[4] The planned EU Directive to implement the Joint Forum proposals on the supervision of financial conglomerates is of particular importance in this connection. If binding capital standards for financial conglomerates were to be introduced in the EU, banks domiciled in the EU would be put at a competitive disadvantage compared with banks domiciled in a country in which majority interests in insurance entities are not subject to any preferential prudential treatment. We therefore refer to our comments on the European Commission's consultation document "*Towards an EU Directive on the prudential supervision of financial conglomerates*" of 9 February 2001.

Overall, the Committee should postpone any activities in connection with the prudential treatment of investments in insurance subsidiaries until appropriate rules for global supervision of financial conglomerates have been adopted.

D. Significant minority-owned equity investments in non-insurance financial entities (paragraphs 14-15)

For the treatment of "*significant minority-owned equity investments*" in non-insurance financial entities the Basel Committee proposes pro-rata consolidation or, alternatively, deduction of the book value of the investment. The threshold for a significant minority-owned equity investment is to be left to the discretion of national supervisors.

To create a level playing field, the adoption of the relevant EU rules is required here too.

<u>Cross-holdings</u>

The Basel Committee underlines its view that reciprocal cross-holdings "*artificially designed to inflate the capital position of banks*" should be deducted from group capital for capital adequacy purposes.

We assume in this connection that in Europe bank cross-holdings are already covered adequately for prudential purposes by the relevant EU rules (deduction in each case of the investment on a stand-alone basis/non-inclusion at group level of positions resulting from legal relationships between group institutions). Any rules issued in Basel should be based on the European model.

Because of the vague wording used by the Basel Committee, it is, moreover, unclear whether specific rules on the treatment of cross-holdings are planned. Also unclear is how cross-holdings "*artificially designed to inflate the capital position of banks*" should be identified.

E. Significant investments in commercial entities (paragraphs 16-17)

The Basel Committee proposes that investments in non-financial institutions which exceed "*certain materiality levels*" of liable capital of the investing bank should be deducted from the bank's capital. Such materiality levels are to be determined at the discretion of national supervisors. As a "guideline", the Basle Committee refers to the currently applied European thresholds of 15 % for a single investment and 60 % for the aggregate of all significant investments in non-financial institutions.

It should, firstly, be made clear that what is intended where a threshold is exceeded is not deduction of the whole investment but – like the relevant provisions of the German Banking Act – only coverage of that part of the investment that exceeds the threshold (see in this connection Section 12(2), fifth sentence, German Banking Act).

Secondly, it should also be made clear that determination of how thresholds are used should be based in each case on the book value of the investment. To avoid any distortions of competition, the Basel Committee should, finally, set mandatory thresholds on the lines of those applying at European level.

According to the Basel Committee's proposals, non-significant investments in non-financial institutions are to be risk-weighted under the standardised approach at no less than 100 %; an "*equivalent treatment*" is envisaged for banks using an IRB approach.

Any special weighting of investments in non-financial institutions must be rejected. The risk of loss of an investment is covered under the existing regulatory capital regime by the 8 % capital charge. The Basel Committee's intention of setting higher capital charges for "*higher-risk*" investments would be taken into account via the expected ratings-based approach to treatment of equity.

PART 2: THE FIRST PILLAR – MINIMUM CAPITAL REQUIREMENTS

I. Calculation of minimum capital requirements (paragraphs 19-20)

When setting the risk weights for claims under the standardised approach, care should be taken to ensure treatment which is consistent with that applied to the risk weights under an IRB approach. To give banks an incentive to switch from the standardised approach to an IRB approach, the risk weights under the standardised approach should, in addition, be calibrated in such a way that the total capital requirements under the IRB approach are lower than under the standardised approach. For this purpose, the risk weights should be mapped into certain expected default probability intervals. However, final calibration should ensure that – taking the standardised approach as a basis – the average overall capital requirement, including the capital needed to cover operational risk, does not exceed 8 %, based on the capital charge currently in force, and that certain business structures are not systematically discriminated against.

II. Credit risk – the standardised approach (paragraphs 21-149)

A. The standardised approach – General rules (paragraphs 22-60)

Under the Basel Committee's proposals, the standardised approach for determining the capital requirements for credit risk will be adjusted by refining the risk weight categories. Prudential risk weights will be assigned on the basis of external agency ratings. To ensure a level playing field, the risk weights for each category of claim (sovereigns, banks, corporates) should be mapped on to an internationally uniform master scale containing default probability intervals. The rating categories of rating agencies recognised by supervisors should be slotted into this master scale using the default probabilities determined by the agencies. To create the required transparency in this connection, the Basel Committee should publish an international list of all recognised credit assessment institutions.

1. Individual claims (paragraphs 23-44)

(i) Claims on sovereigns (paragraphs 23-26)

We welcome it in principle that, to risk-weight exposures to sovereigns, the Basel Committee intends to recognise, alongside the ratings issued by recognised agencies, the country risk scores assigned to sovereigns by export credit agencies, provided that these subscribe to the

OECD 1999 methodology. However, recognition of export credit agencies should be based on the same criteria as those applied to other external rating agencies. Compliance with the aforementioned OECD methodology should therefore not automatically mean prudential recognition. To prevent any distortions of competition, it must be ensured that the credit ratings assigned to government or government-mandated export credit insurance agencies are not politically motivated but geared to the actual credit risk.

In connection with the national discretion for supervisors to allow lower risk weights for banks' exposures to their sovereign (or central bank), provided that these are denominated in domestic currency and funded in that currency, it must be ensured that such national decisions are published and made transparent and – to avoid any distortions of competition – that such risk weights may be freely adopted by institutions domiciled in another country without the need for a further decision by the foreign national supervisory authority (automatic mutual recognition of national discretionary decisions in this area). It must be made clear in this connection that the currency in which the exposure is funded is the domestic currency of the debtor country ("*... its currency ...*").

(ii) Claims on non-central government public sector entities (PSEs) (paragraph 27)

Under the Basel Committee's proposals, national supervisors are to be allowed to deviate from the basic rules and treat claims on PSEs like claims on sovereigns. To create the required transparency, the countries which grant such a privilege should be required to list those PSEs that are treated like a sovereign, and – to avoid any distortions of competition – it should be stipulated that such risk weights may be freely adopted by institutions domiciled in another country without the need for a further decision by the foreign national supervisory authority.

(iv) Claims on banks (paragraphs 29-33)

The plan to allow national supervisors to opt for one of two options for weighting claims on banks would lead to considerable distortions of competition at international level. Problems would arise particularly where a bank and a sovereign have a different credit rating.

While banks domiciled in Option 1 countries lending to well-rated banks domiciled in a country whose sovereign has a comparatively poor credit rating would have a higher regulatory capital requirement than banks in Option 2 countries, the reverse would be true in the case of banks in Option 2 countries lending to poorly-rated banks in countries whose sovereign has a good credit rating.

We therefore firmly support the internationally uniform use of one option[5]. If one option were to be used uniformly, banks would, moreover, be unable to practice regulatory arbitrage by shifting their lending operations to subsidiaries in countries with a “more favourable” option.

Under Option 2, interbank claims with an original maturity of three months or less will be weighted one category better. Preferential treatment of short-term loans should apply irrespective of the option chosen. However, it would be better, from an economic angle, to link a more favourable weighting to the *residual* maturity of the claim instead of the *original* maturity. In line with the current rules for claims on banks in zone B, the maturity should be raised to one year but at least six months. Furthermore, the planned non-preferential treatment of short-term claims rated AAA to AA- or below B- does not seem logical to us. The right thing to do here would be to assign prime claims a preferential risk weight of even lower than 20 % and to risk-weight claims rated below B- at 100 %.

A provision requiring supervisors to ensure that claims with an original maturity under three months which are usually rolled over do not qualify for preferential treatment for capital adequacy purposes is inappropriate in our opinion. The mere fact that claims are usually rolled over should not result in their being treated less favourably at regulatory level. Footnote 12 on paragraph 31 should therefore be deleted.

In this connection, we also suggest that, when using Option 2, a risk weight of 100 % should be set for claims on non-rated banks. There is no reason in our opinion why the two options provided for in the Consultative Document should weight these claims differently. A 50 % weight for non-rated banks would, moreover, provide no incentive for such banks to obtain a rating.

(v) Claims on securities firms (paragraph 34)

Claims on securities firms <u>must</u> be treated like claims on banks provided that they meet the condition stipulated, i.e. that they are subject to supervisory and regulatory arrangements comparable to those under the New Capital Accord.

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[5] The Association of German Savings Banks (DSGV), the Association of German Public-Sector Banks (VÖB), the Association of German Cooperative Banks (BVR) and the Association of German Mortgage Banks (VdH) are in favour of uniform application of Option 1 to interbank claims, whilst the Association of German Banks (BdB) advocates uniform application of Option 2 to such claims.

(vii) Claims secured by residential property (paragraph 37)

The 50 % weight for claims secured by mortgages on residential property should, for systematic reasons, be incorporated as a special case into the section on prudential recognition of collateral. This would make clear in particular that, besides the collateral specified in the consultative document, mortgages also qualify as "*eligible collateral*".

Furthermore, the definition of residential property should (a) be corrected so that, as set out in the Basel Capital Accord currently in force, such property is to be occupied <u>by the owner</u> and (b) expanded to include the possibility of its being rented in the future ("*... that is <u>or will be</u> rented ...*").

(viii) Claims secured on commercial real estate (paragraph 38)

We expressly welcome the Basel Committee's proposal for weighting mortgages on certain commercial properties in well-developed and long-established markets at 50 %. However, for systematic reasons, the 50 % weight for such claims should be incorporated as a special case into the section on prudential recognition of collateral to make clear that these mortgages are "*eligible collateral*" within the meaning of the Consultative Document.

We also assume that the 50 % weight for such claims is merely the ceiling and that for lendings to customers rated externally AAA to A- a risk weight of 20 % may therefore also be set.

(ix) Higher-risk categories (paragraphs 39-40)

The unsecured portion of any assets past due for more than 90 days is to be risk-weighted at 150 %. In our view, the basis for identification of those customers whose loans have to be weighted at 150 % should not be only that such loans are more than 90 days past due. To ensure that the rules are applied in manner consistent with that under the IRB approach, the basis should instead be the reference definition of default by a borrower under the IRB approach. At the same time, our remarks on the reference definition should be taken into account in this connection (see remarks on paragraph 272 on page 61).

In addition, it should be made clear that claims secured by mortgages for which a 50 % weight is justified are deemed to be secured for the purposes of the second bullet point in paragraph 39. See in this connection our remarks under (vii) and (viii) above.

Any extension of the 150 % category beyond the envisaged cases must be rejected, as classification in this category solely according to the type of investment is inappropriate. The sole criterion for classification should be the individual quality of the claim. Moreover, giving national supervisors discretionary powers to decide on the application of higher risks weights to certain assets would imply distortions of competition and jeopardise a level playing field.

(x) Other assets (paragraph 41)

Under the 1988 Basel Capital Accord, premises, plant and equipment as well as other fixed assets constitute risk assets and accordingly carry a capital charge of 8 %. However, under the definition proposed by the Basel Committee ("*The danger of direct or indirect loss resulting from failed internal processes, people or systems or from external events*") the risk of a depreciation in the value of fixed assets is clearly operational risk. Given that separate prudential treatment of operational risk is planned, a capital charge for these assets is therefore no longer appropriate. The capital requirement for premises, plant and equipment and other fixed assets should therefore be deleted.

(xi) Off-balance sheet items (paragraphs 42-44)

The Basel Committee could be understood to mean that credit commitments that are unconditionally cancellable at any time by the bank or that provide for automatic cancellation without prior notice by the bank may only be assigned a 0 % conversion factor if their original maturity is up to one year. A credit conversion factor of 20 % is to be applied to other commitments with an original maturity of less than one year. Commitments with an original maturity of more than one year are to be generally assigned a 50 % credit conversion factor.

The arrangement whereby uncancellable commitments are to be assigned a higher credit conversion factor than cancellable commitments appears appropriate. However, it should be made clearer that the maturity of the commitment does not matter in this connection. This is backed by the wording of paragraph 436, which states that under the IRB approach for retail off-balance sheet items undrawn amounts for products that are unconditionally cancellable are also not subject to differentiation according to maturity. Even if it is true that the longer the maturity of a commitment is, the more likelihood there is that it will be drawn on, the prudential credit risk need only be covered in each case for the following year. For this reason, business commitments that are cancellable at any time without prior notice by the bank should, regardless of their maturity, be assigned a credit conversion factor of 0 %. For other commitments, a credit conversion factor of 20 % should be applied.

We gather from paragraph 44 that securities lending/borrowing transactions and repurchase/ reverse purchase transactions qualify as off-balance-sheet transactions for the purposes of the Consultative Document. Clarification to the effect that the rules for off-balance-sheet transactions – in particular the unchanged prudential requirements with regard to off-balance-sheet netting – are applicable to these transactions as a whole, irrespective of national accounting rules, would be desirable. This would mean a consistent adaptation of the existing Capital Accord, which has already been opened to the whole spectrum of futures, swaps, options and similar derivatives contracts by way of the Basel Committee's announcement on the international convergence of capital measurement and capital standards[6]. Should this suggestion not be adopted, clarification to the effect that the new rules on on-balance-sheet netting are applicable to securities lending/borrowing transactions and repurchase/reverse purchase transactions would be helpful.

2. External credit assessments (paragraphs 45-46)

(i) The recognition process (paragraph 45)

Under the Basel Committee's proposals, the decision on whether an external credit assessment institution (ECAI) satisfies the eligibility criteria is to be left to national supervisors. So that national discretion does not lead to distortions of competition, we believe that (a) ECAIs which are recognised in one country should also be recognised in every other country (mutual recognition) and that (b) to improve transparency the Basel Committee should publish a list of recognised ECAIs.

(ii) Eligibility criteria (paragraph 46)

To qualify for recognition by supervisors, an ECAI must satisfy certain criteria. It should be ensured in this connection that ECAIs meet at least the same requirements as internal rating systems. We note that the standards concerning the disclosure of information on ECAI assessment methodologies and time horizons are less detailed and thus lower than the disclosure standards for the use of IRB systems. It must be ensured in this connection that disclosure requirements are not used to make external rating more attractive than internal rating.

[6] Last amended by the Announcement of 7 April 1998; see in particular the remarks on currency and interest-rate-related contingent liabilities therein.

Generally speaking, the criteria listed in the consultative document require further specification. Compliance with the criteria is to be monitored by supervisors.

3. Implementation considerations (paragraphs 47-60)

(i) The mapping process (paragraphs 47-50)

According to the Basel Committee, national supervisors are to be responsible for deciding which ECAI assessment categories correspond to which risk weights. To avoid any distortions of competition, we believe that for each type of claim (sovereigns, banks, corporates) the Basel Committee should provide an internationally uniform master scale with default probability intervals instead of assessment category intervals. The assessment categories of recognised ECAIs should be slotted into this master scale by means of the (average) default probabilities determined by the institutions. The default probabilities determined by the ECAIs should be reviewed annually (by supervisors) and the mapping process corrected where necessary.

The requirement that ECAIs' ratings must be applied consistently, i.e. the ratings of the same ECAI must be used for risk weighting and internal risk management purposes, appears reasonable to prevent "double counting". However, the requirement of consistent application of ratings should not mean that the same pre-determined ECAI(s) must always be used for certain claims. The exclusion of other rating agencies from assessing certain types of claim would seriously restrict the applicability of external ratings under the standardised approach and be a barrier to market access for new rating agencies. Such an arrangement would not be necessary to prevent "cherry picking", as, firstly, all rating agencies have to be recognised by supervisors and, secondly, there are clear rules for cases where a borrower is rated by several agencies.

(iii) Issuer versus issues assessment (paragraphs 54-55)

The Basel Committee proposes that for investments in (securities) issues that have an issue-specific assessment banks may use this assessment. The use of issue-specific assessments should, however, be confined to this particular case. The arrangement proposed by the Basel Committee concerning the use of issue-specific assessments for other claims that have no issuer assessment would impose an unreasonable monitoring burden on banks and should therefore be dropped. Any wider application of assessments of other issues of the same borrower is also inappropriate because transaction details (e.g. collateralisation, special legal

features, ranking, country risk) which are of no significance in other business with the borrower may come into play and thus lead to considerable over- or under-coverage of the risk.

(iv) Short term/long term assessments (paragraphs 56-58)

The Basel Committee stresses the preferability of long-term assessments over short-term assessments but does not intend to take a closer look at the feasibility of the use of short-term assessments. We should like the Consultative Document to make quite clear here that long-term assessments are generally preferred to determine asset quality, as short-term assessments usually take account of special circumstances that are not crucial to the borrower's creditworthiness in the long run but only reflect a relatively small part of it.

(vi) Unsolicited ratings (paragraph 60)

According to the Basel Committee, national supervisors are to be allowed under certain conditions to recognise unsolicited ratings for prudential purposes. Unsolicited ratings should not be recognised in our opinion, since, because they are based on much less information, their quality is poor. There is also the danger that pressure may be put on companies given unsolicited ratings to obtain a rating for a fee. Moreover, the recognition of unsolicited ratings would also be sharply at odds with the "*Resources*" criterion for the recognition of ECAIs set out in paragraph 46, according to which there should be substantial ongoing contact between ECAI staff and senior and operational levels within the entity assessed. Unsolicited ratings should therefore not be recognised for prudential purposes.

B. Credit risk mitigation in the standardised approach (paragraphs 61 – 149)

1. Scope (paragraphs 61 – 63)

We assume that the rules applicable to the banking book in accordance with paragraph 62 also apply to the counterparty risk positions of the trading book (section 27 Principle I). We would be grateful for clarification of this point in section VI (Trading book issues).

2. Collateral (paragraphs 64 – 111)

(i) Minimum conditions (paragraphs 67 – 74)

The Basel Committee envisages that banks will have to meet certain minimum standards before capital relief can be granted to collateral.

(a) Legal certainty (paragraphs 68 – 71)

The premise set out in paragraph 68 – namely that collateral is only effective if it has been ensured that the lender can liquidate or retain the collateral in the case of a credit event – is too narrow. First, this fails adequately to reflect market practice. Along with collateral instruments used in classical lending operations, such as assignment and pledges regulated by the general business conditions of German banks, there are now also other forms of collateralisation, such as full title transfer and pledges which may be re-used. When these modern collateral instruments are employed, the collateral provider transfers collateral in the form of cash or securities to the collateral taker, who has unqualified authority to make use of the assets and, in particular, to liquidate them. Correspondingly, the realisation of the collateral does not take place by way of sale. Instead, the market value of the collateral is calculated and set off against the collateral provider's liabilities vis-à-vis the collateral taker.

Second, this wording might be at odds with national insolvency provisions, such as section 166 of the German Insolvency Statute, under which the insolvency administrator is free to realise certain assets serving as collateral and deliver the amount realised to the collateral taker.

The references to "pledge" and "liquidation" in paragraphs 68, 71, 102 (e), 106, 108 (d) and 109 (6) should therefore be replaced by "provide" and "realisation". In addition, suitable wording should be added to take account of national insolvency rules ("*a claim to payment of the amount realised in accordance with the relevant statutory provisions*"). The reference to the bank's right to "seize" the collateral (paragraph 102 (i)) should be adjusted accordingly. Finally, the term "segregation" in paragraph 69 should be replaced with "separation"[7] in order to avoid misunderstandings.

The necessity to fulfil "local contractual requirements" in paragraph 69 is unclear and could place at risk the effectiveness of a choice of jurisdiction for contractual purposes. We would suggest using the wording "*the applicable law in respect of the collateral*". Irrespective of this point, it should be examined whether "collateral" should replace the term "security interest", which has a separate meaning under US law pursuant to U.C.C. Article 1 – General provisions § 201-1 (37).

[7] Under German insolvency law, "separation" indicates the right of certain creditors to preferential satisfaction from a certain item in the bankruptcy estate.

The requirement in paragraph 70 that banks must obtain legal opinions on the enforceability of the collateral arrangements in all relevant jurisdictions is clearly excessive, in our view, and also not necessary to minimise the legal risks associated with the provision of collateral. It is only necessary to obtain an external legal opinion if banks are unable reliably to evaluate the enforceability of a collateral arrangement, particularly in the light of section 25a (1) of the German Banking Act. We would like to point out the diverse circumstances which have to be assessed in this connection. First, a distinction must be made between the provision of collateral in a domestic context – the most common case in practice – , where both parties, as well as the collateral, are located in the same country, and the provision of collateral where a cross-border element is involved. Second, we must differentiate between standard business documented by means of standardised contracts which are normally regularly controlled by case law, and individual arrangements.

Banks have the necessary expertise to reliably assess purely domestic cases and document this assessment. At most, different criteria could be applied to the provision of collateral with a cross-border element, although it should be borne in mind that many banks also have the necessary expertise to evaluate these cases too – via the legal departments of their foreign branches, for example. Banks should only be obliged to obtain external legal advice in cases in which it is not possible to carry out an internal assessment of a collateral arrangement's enforceability. In this connection, it should be ensured that the opinion may be drawn up for a number of similar cases and that use may be made of opinions which are already available on the market, such as those of the International Swaps and Derivatives Association. An update should not be triggered by annual deadlines, but by a change in the legal situation or the circumstances of a case.

Otherwise, we would see a continuation of the disadvantages of an external opinion which the implementation of this requirement for off-balance sheet netting has brought to light. The external law offices charge extremely high fees for preparing the opinions and there are often delays with the updates. In practice, it has not proved possible to insist on contractual penalty clauses which would avoid such delays. On top of this, the banks then have to evaluate the opinions and verify their accuracy, which is an extremely onerous task.

The second sentence of paragraph 71 essentially repeats the requirements set out in paragraph 73 and should therefore be deleted.

(b) Low correlation with exposure (paragraph 72)

The rule that collateral is only eligible for supervisory recognition if there is no material positive correlation between the credit quality of the obligor and the value of the collateral is problematic. First, securities issued by the obligor may also be suitable for use as collateral. Examples are mortgage bonds, whose value is assured by separated assets or privileged rights to satisfaction in the event of insolvency. Second, the term "material positive correlation" is too vague. However, it would be extremely difficult to be more precise about the degree of positive correlation in view of the fact that the Basel Committee does not wish to recognise the double default effect and, in addition, since this would entail comprehensive risk modelling, which is also not envisaged by the Committee. This requirement should therefore be deleted in full.

(ii) Methodologies (paragraphs 75 – 111)

The principle set out in paragraphs 102 (h) and 108 (c), namely that collateral is linked to specific transactions, does not take adequate account of banking practice. As a rule, collateral is provided for a portfolio. In the case of third-party collateral, this is also true to some extent at least. With regard to OTC derivatives, securities lending transactions and repurchase agreements, this applies to the practice of regarding all the individual transactions entered into under the relevant master agreements as aggregate business and concluding close-out netting agreements to cover termination. The net market value or default loss constitutes the counterparties' credit risk. This is also recognised under prudential rules. In addition, the portfolio approach allows the exchange of collateral to be reduced; the resulting cost savings are also in the interests of the customers. Paragraphs 102 (h) and 108 (c) should therefore refer to "*business*", and the German version should avoid using two different terms (*Geschäft* and *Transaktion*) in paragraphs 102 and 108.

Furthermore, we do not consider it either appropriate or useful to restrict the banks to only one of the outlined methodologies. The banks must be able to apply different methodologies to their treatment of collateral, depending on the portfolio or sector involved. Regulatory arbitrage would be excluded by the fact that the Basel Committee intends to reward the different methodologies with escalating capital relief according to their degree of complexity. Banks opting to operate the simple approach in certain sectors, for example, could therefore gain no advantages whatsoever in terms of capital relief. Moreover, allowing a bank to apply different methodologies would facilitate the transition to the next higher approach, thus providing further encouragement for the development of more sophisticated risk measurement

systems, as desired by the Basel Committee. In addition, the justification for applying different methodologies could be monitored at any time under the supervisory review process (Second Pillar) and would also be subject to the disclosure requirements of the Third Pillar (market discipline).

(a) Eligible collateral (paragraphs 76 – 79)

The envisaged increase in the number of collateral instruments eligible for credit risk mitigation recognition in accordance with paragraph 76 is to be welcomed, in principle. We assume that the collateral instruments defined as eligible for the banking book may also be applied to the counterparty risk positions of the trading book (section 27 Principle I). We would be grateful for clarification of this point in section VI (Trading book issues). Where paragraph 76 refers to securities, we assume that paper used for payment transactions and bills of exchange, which are recognised as collateral by the central banks, are also covered. The following items should be added to the list of eligible collateral instruments:

- **Precious metals and precious metal certificates (in addition to gold**)

  Along with gold, silver, platinum and palladium are also suitable as collateral, as their immediate availability is ensured by the existence of commodity markets. A distinction is not necessary for banking supervisory purposes – cf. section 1 (11), sentence 3 no. 5 of the German Banking Act, for example, and the table in article 11 (a) of the Capital Adequacy Directive (CAD II), which refers to "precious metals in general. Due to existing volatility, we suggest a haircut of 50% on the value of the metal for precious metals under the comprehensive approach. Appropriate haircuts to reflect existing price volatility should ensure a more sophisticated treatment of this collateral in the comprehensive approach compared to the simple approach.

- **Claims and loans against borrower's note vis-à-vis debtors of unquestionable financial standing**

  Claims on debtors of unquestionable standing (external rating of at least A- for banks and sovereigns, at least AA- for corporates, or corresponding internal rating in each case), should be covered. This applies at least to claims or loans against borrower's note where the assignment has been disclosed to the debtor and the debtor is required to pay directly to the beneficiary bank under the assignment.

In addition, further collateral instruments which are customary in banking operations should be included in the list of eligible collateral in paragraph 77, especially

- cash deposits with third banks,
- property or rights equivalent to real property,
- ships and aircraft,
- movables which have a market value.

The term “main index” in paragraph 77 is not defined. If the national supervisory authorities are to be given discretionary powers regarding a precise definition, care should be taken to ensure the necessary transparency. See also our comments on page 17.

The Basel Committee proposes that the recognition of the collateralisation effect of **bonds** and the level of the haircut to be applied to these instruments should be linked to their issue rating. Unrated issues, with the exception of unrated bank bonds, are not to be recognised, in principle.

In our view, unrated senior bonds issued by an institution assessed by an external credit-rating agency should also be recognised as collateral with the issuer’s rating, since the rating of the issuer of such bonds is never higher than the potential rating of the issue. Furthermore, bonds issued by banks should be recognised as collateral even if the issuer has no rating, since banks throughout the world are subject to special supervision and special rules and regulations. In contrast, other bonds, which are not issued by banks and where there is no external credit rating either for the issue or the issuer, should not be recognised.

The conditions which must be fulfilled for unrated bonds issued by a bank in order for them to be treated like bonds rated A/BBB are too narrow. All securities traded on a market or listed on a stock exchange, including promissory notes, should be covered.

Nor is it justified, in our estimation, to recognise **securities rated BB- and above issued by sovereigns**, while only recognising securities rated BBB- and above issued by banks and corporates. If a suitable haircut is applied, bank and corporate securities rated BB- and above should also be eligible for recognition as collateral.

The Basel Committee proposes that **unrated bonds issued by banks** should only be recognised as collateral if, among other things, no other issue by the issuing bank is rated below BBB and the supervisor is sufficiently confident about the instrument’s market liquidity.

The restriction that no other issue by the issuing bank may be rated below BBB should apply to issues of the same class, i.e. only to senior liabilities. Otherwise, this would place a considerable administrative burden on the lending bank. The requirement should be dropped because implementation would be impracticable.

The requirement in 78 (e) that the supervisor must be "sufficiently confident" about the market liquidity of the bonds is unclear and should be dropped.

(b) The comprehensive approach (paragraphs 80 – 105)

In the comprehensive approach to calculating the capital requirement for a collateralised loan, the Basel Committee suggests that the market value of the collateral should first be adjusted by applying certain "**haircuts**". H_E is a haircut designed to capture the volatility of the exposure, H_C is intended to capture the volatility of the value of the collateral and H_{FX} is to reflect any currency volatility resulting from a currency mismatch between the collateral and the exposure.

The application of a **haircut on the exposure** (H_E) is to be rejected. The "adjusted value of the collateral" (cf. paragraph 85 of the consultative document) should depend exclusively on factors which are actually determined by the type of collateral. It is therefore illogical, in our view, to create an "add-on" for the exposure, which is deemed necessary to reflect market fluctuations, by applying a deduction when calculating the adjusted value of the collateral. An "add-on" to certain risk assets which are particularly susceptible to market risk, on the other hand, would be fundamentally at odds with the measurement of positions in the banking book for regulatory purposes. Stipulating that an add-on is only to be applied to such risk assets if they have been collateralised would be clear discrimination against collateralised as opposed to uncollateralised exposures, thus providing a disincentive to prudent credit risk management.

We also reject the general application of a **haircut for currency volatility** (H_{FX}) in the event of a currency mismatch between collateral and exposure. If collateral has to be reported in the financial statements, it is included in the overall currency position pursuant to part III of Principle I. Applying a haircut would therefore result in the double counting of the foreign currency risk. For this reason, H_{FX} should only be applied to collateral which is not already reported in the overall currency position.

The addition of the haircuts implies that in the event of a crisis, all potential instability and market volatility will occur simultaneously. But all laws of probability make this a completely

implausible scenario. Initial test calculations have shown that this “multiple counting” of adjustment factors represents a totally excessive risk buffer. This must be corrected by taking into account, at least to some extent, the theoretical probability of these contingencies occurring and the possible correlation between the types of volatility. In any event, adding the risks together will not result in a risk-sensitive approach to market fluctuations. Furthermore, adding together the haircuts would run the risk of banks having to vastly overcollateralise exposures in order to reduce their capital requirements. From a legal point of view, however, there are narrow limits to such a course of action. “Full collateralisation” in the sense of the Basel Committee’s proposals, could thus, in certain circumstances, conflict with the obligor’s legal rights if collateral is deemed excessive.

Own estimates for haircuts (paragraphs 92 – 95)

The Basel Committee proposes that supervisors should be able to permit banks to calculate haircuts using their own estimates of market price volatility and foreign exchange volatility. Permission is to be conditional on the banks meeting certain qualitative standards and satisfying the quantitative standards set out in the 1996 Market Risk Agreement for the use of internal market risk models.

First of all, we are of the opinion that internal estimates on the basis of externally calculated or pooled data should also be permitted, as long as this means that the internal estimate is likely to have a greater degree of accuracy, and thus reliability.

The regulatory recognition of an internal market risk model should be dropped as a prerequisite for permission to carry out own estimates for haircuts. A comprehensive internal market risk model is by no means necessary for a sound estimate of market volatility. The requirement to reflect non-linear market risks, for example, goes far beyond the qualifications necessary to describe volatility. Furthermore, banks which do not introduce an internal market risk model on account of their low trading volume should still be able to use their own estimates to calculate haircuts. The Basel Committee should therefore set appropriate qualitative standards for calculating internal haircut estimates, which could then be monitored under Pillar II.

The Basel Committee suggests that when using internal estimates for haircuts, banks should adjust the holding period upwards to take account of “the illiquidity of lower-quality assets”. The wording of this requirement should be amended to make clear that an extension of the

holding period should be determined only by the "illiquidity". It would be inappropriate to classify "lower-quality" assets as "illiquid" per se.

Remaining risks (*w*) (paragraph 101)

The Basel Committee intends to introduce a *w* factor for the calculation of capital requirements for a collateralised or guaranteed loan (cf. paragraphs 80, 101). The *w* factor will depend on the borrower's credit quality and is intended to reflect the uncertainty concerning the effective value of the collateral (realisation risk). This is to provide a buffer against potential weaknesses in the contractual documentation, in particular.

The application of the *w* factor is to be rejected. The risks which are to be captured here are, in essence, residual risks. Residual risks, however, are defined in the Basel Committee's paper as a component of operational risk and are therefore already covered by the envisaged capital requirements for operational risk. Using the *w* factor to capture this risk again would constitute a double counting. Furthermore, realisation risks are already countered by the extremely far-reaching qualitative requirements which have to be met before collateral can be recognised. An additional adjustment is therefore not necessary.

Moreover, applying the *w* factor would mean that even if a loan were overcollateralised – assuming this is enforceable – it would be impossible to achieve a zero capital requirement.

Furthermore, certain clarifications – some relating to the use of language – are necessary. In paragraph 87, the meaning of "instrument types" should be specified. In paragraph 97, it should be clarified that the holding period of ten business days does not only apply to haircuts calculated using internal estimates. It would be desirable to define the holding period in paragraph 97.

Carve-out from the comprehensive approach (paragraphs 103 – 105)

The Basel Committee proposes in paras . 103 to 105 that supervisors may choose not to apply a haircut for government securities repo and securities lending transactions if the counterparty is a "core market participant".

In order to avoid national discretionary powers regarding the implementation of paragraph 103, we suggest replacing the second half of this paragraph with "a zero *H* is to be applied instead

of the standard haircut". If a supervisory authority makes use of its discretionary powers under paragraph 105, the specific carve-outs should be published in appropriate records. See also our comments on transparency on page 15.

Furthermore, we assume that the scope of application of paragraph 103 has only been limited to standard haircuts because banks using their own estimates of market price and exchange rate volatility are also permitted to apply a zero haircut if the relevant conditions are satisfied.

(c) The simple approach (paragraphs 106 – 111)

Minimum conditions (paragraph 106)

The Basel Committee proposes that for collateral to be recognised in the simple approach, it must be revalued at least every six months and must be furnished for the entire life of the exposure.

Generally speaking, recognition should also be given to collateral which is revalued not every six months, but only after one year, for example. By and large, collateral instruments which are not subject to major market fluctuations should only have to be revalued more frequently than once a year if there is a relevant reason, without this having an adverse effect on recognition.

The requirement that the collateral must be provided for the entire life of the exposure excludes collateral with a maturity mismatch from recognition in the simple approach. In our estimation, limiting the recognition of collateral involving a maturity mismatch to the comprehensive approach cannot be justified. The credit risk mitigation effect of a collateral instrument does not depend on how this is counted for regulatory purposes. Collateral instruments involving maturity mismatches should therefore also be recognised in the simple approach using the system described in paragraphs 146 ff. of the consultative document.

Risk weights (paragraph 107)

The Basel Committee proposes that the portions of a claim collateralised by the market value of recognised collateral be weighted by the risk weight applicable to the collateral instrument. In principle, a 20% minimum risk weight is to apply.

The introduction of a 20% floor is to be rejected. This rule would be an unjustifiable change for the worse compared to the status quo. Collateralisation by eligible collateral with a zero risk weighting should, in general, result in a risk weight of 0% for the collateralised portion of an exposure. The conditions for undercutting the 20% floor stipulated in paragraphs 108 – 111 of the proposed New Accord could then be deleted.

3. On-balance sheet netting (paragraphs 112 – 116)

We welcome the proposed broadening of the scope of application of bilateral on-balance sheet netting agreements for loans and deposits vis-à-vis any other counterparty.

However, the Basel Committee makes the recognition of such netting agreements subject to certain conditions. The bank must, for example, have a legal basis for concluding the netting or offsetting which is enforceable in each relevant jurisdiction, including in insolvency proceedings. The bank should also be able to determine at any time the assets and liabilities with one counterparty that are subject to the netting agreement.

As far as the enforceability of the netting agreement “in each relevant jurisdiction” is concerned, it should be clarified that it is sufficient for the bank to prove that the agreement is enforceable in the counterparty’s home country. Regarding the requirement for a legal examination, we refer to our comments on page 25. In addition, we take the condition that the bank should be able to identify the positions subject to a netting agreement “at any time” (cf. paragraph 112 (b)) to mean that the bank must always be in a position to identify the relevant transactions without undue delay.

The condition that banks which have a number of loans and deposits with the same counterparty should decompose this portfolio of loans and deposits and net them on an individual basis should be dropped.

The motivation and content of this requirement are unclear. Netting agreements typically comprise several offsetting positions. The relevant risk in regulatory terms is thereby reduced to the net position. It is not clear why it should be necessary to match and separately set off “position pairs”.

The Basel Committee wishes to limit on-balance sheet netting to the loans and deposits of a single counterparty for the time being. Such a blanket restriction is inappropriate, however, in our view. If the legal enforceability of a netting agreement has been proven, netting should be permitted of all eligible on-balance sheet and off-balance sheet transactions in the banking and in the trading book. Furthermore, we refer to our comments on the treatment of securities lending transactions and securities repurchase agreements as off-balance sheet activities. We suggest it should be clarified that the existing rules on off-balance sheet netting may be applied to these transactions.

If there is a currency mismatch, the Basel Committee proposes applying an H_{FX} haircut to the liability side. If there is no daily revaluation, the standard 8% haircut is to be raised using the “square root of time rule”.

Applying a haircut to take account of foreign exchange risks is to be rejected. The banks’ overall currency position already takes account of foreign exchange risks.

The Basel Committee also suggests treating potential maturity mismatches between transactions included in the netting agreement according to the system described in paragraphs 146 ff. of the consultative document.

This requirement is not practicable and should be dropped. When a netting agreement is concluded, a portfolio comprises a number of fluctuating positions. The portfolio is not broken down and individual positions matched. A meaningful definition of maturity mismatches is therefore not possible.

4. Guarantees and credit derivatives (paragraphs 117 – 145)

In the 1988 Accord, recognition as a guarantor was limited to OECD central governments or other public sector entities, OECD banks and securities firms, non-OECD banks (when the underlying transaction had a residual maturity of less than one year) and multilateral development banks. The proposed broadening of the circle of recognised guarantors in Basel II reflects the development of the market for guarantees and is warmly welcomed.

When the Basel Committee refers to “guarantees” in paragraph 117, we assume this term covers all the types of guarantee recognised by the 1988 Accord, including, in particular, warranties and guarantee-type letters of comfort (hard letters of comfort). We would suggest this point be clarified. The fact that the term “guarantee” is not meant to be understood in its narrowest sense is shown by the reference to letters of comfort in paragraph 412, which generally recognises letters of comfort subject to compliance with the stipulated conditions. All references to “guarantee” and “guarantor” below are based on this interpretation of the terminology.

Up to now, a substitution approach has been applied to guarantees for risk assets, under which the risk weight of the guarantor is substituted for the risk weight of the obligor. The Basel Committee proposes that this “pure substitution” method should no longer be applied to the protected portion of an exposure. Instead, the risk weight of the obligor will also be reflected in the risk weight of the guaranteed portion of the exposure by means of a “*w*” weighting. As with the treatment of collateral, the ***w* factor** is to provide a buffer against the guarantee proving ineffective due to weaknesses in the documentation of the contract.

The application of the *w* factor is to be rejected. The risks which are to be captured here are, in essence, residual risks. Residual risks, however, are defined in the Basel Committee’s paper as a component of operational risk and are therefore already covered by the envisaged capital requirements for operational risk (cf. our comments on page 98).

A bank accepting a guarantee only suffers a loss on a guaranteed asset if both the obligor and the guarantor default. Since the probability of the default of both parties is normally lower than the probability of the default of the guarantor, the actual risk is systematically overstated by using the risk weight of the guarantor as a basis. In its first consultative paper, the Basel Committee was prepared to take this “**double default effect**” into account. In its second consultative document, the Committee rejects recognition of the double default effect on the grounds that none of the potential weighting systems could offer a satisfactory compromise between the simplicity of application and an appropriate reflection of the risk mitigation.

An exact measurement of the risk reduction would involve evaluating the correlation between the probability of default of the obligor and that of the guarantor on an individual basis and thus fall into the category of credit risk modelling. It can be assumed, however, that the correlation is considerably lower than inferred by the Committee, particularly if a claim on a sovereign or a bank is involved. To take account of the double default effect by means of an

uncomplicated system, we suggest applying the risk weight of the guarantor, reduced by 50%, to the guaranteed claim.

(i) Minimum conditions (paragraphs 117 – 128)

(a) Requirements common to guarantees and credit derivatives (paragraphs 120 – 124)

The Basel Committee envisages that in order to recognised, guarantees and credit derivatives must, in addition, represent a *direct* claim on the guarantor, be *explicitly* linked to specific exposures and be *irrevocable* (paragraphs 121 ff.).

Under the portfolio approach[8], guarantees and credit derivatives are not necessarily undertaken for a single liability of an obligor. It is also quite usual to guarantee, up to a certain maximum amount, the fulfilment of all present and future liabilities of an obligor to a bank. Against this background, we understand the "*explicit*" requirement to mean that although the bank accepting the guarantee must be in a position to clearly define the extent of existing protection by a guarantee for every exposure with a particular borrower, a guarantee may be accepted for various fluctuating facilities of an obligor during the term of the guarantee without prejudice to regulatory recognition. The Basel Committee should clarify this point.

The *irrevocability* clause would disqualify all guarantees and credit derivatives with "cancellation clauses" for the protection provider. This rule is illogical, in our view. Up until the protection provider's first opportunity to terminate the contract, the quality of the protection is just as high as that of an instrument without such a clause. These instruments should therefore be recognised as protection – possibly involving a maturity mismatch – for the period up to the first possibility to terminate the contract. Furthermore, we assume that for credit derivatives concluded for a revolving asset pool, so-called early amortisation clauses, which give the protection provider the right not to admit any new assets to the pool if the quality of the pool deteriorates significantly, will not be considered a cancellation clause preventing recognition. This would not be appropriate, since the assets already in the pool are completely covered.

The wording of paragraph 124 is also problematic. In the context of the protection provider's obligation to pay out, this paragraph focuses on the timely fulfilment of this obligation and on the default of the original obligor alone. This requirement would exclude guarantees modelled

[8] See also our comments on the portfolio approach with regard to collateral on page 26.

on sections 765 ff. of the German Civil Code, which allows the guarantor the fundamental right to claim the benefit of execution (cf. section 771 of the German Civil Code), as well as accessory guarantees and indemnity bonds (see also paragraph 125 (a)). It should be borne in mind that due to the radical impact of an unconditional liability to pay, case-law has made the waiving of the benefit of execution conditional on the fulfilment of strict requirements. For this reason, directly enforceable guarantees play virtually no role in domestic business.

(b) Operational requirements for guarantees (paragraph 125)

The Basel Committee wishes to stipulate that in the event of *default or non-payment* of the obligor, the lender must be able, in a timely manner, to claim payment from the guarantor of the amounts outstanding under the loan instead of having to continue demanding payment from the obligor (paragraph 125 (a)).

The requirement that it must be possible to demand payment of outstanding amounts without delay is appropriate, in principle. However, it should not be generally linked to the "default/non-payment of the obligor". The content and scope of a guarantee may differ depending on the terms of the contract. A guarantee normally covers only the default of the obligor. Under the terms of such a guarantee, the non-payment of the obligor has no relevance. A condition for payment may also be the loss of a primary security (e.g. under the terms of indemnity bonds). In order to take account of the way guarantee contracts are usually formulated in practice, the Basel Committee should refer more generally to "the occurrence of contractual conditions for payments to be made". If the Basel Committee stipulated, as a requirement for the regulatory recognition of guarantees, conditions enabling the guarantor to be pursued for payment which did not conform to those normally envisaged in the contract, this would have a considerably adverse effect on guarantee transactions.

Moreover, the second sentence of paragraph 125 (a) should be deleted, since the guarantor's right to pursue the obligor for outstanding payments on a loan is a matter concerning the relationship between the guarantor and borrower only and has no relevance for banking regulators whatsoever.

Regarding paragraph 125 (b), it should be made clear that not only obligations (voluntarily) <u>assumed</u> by the guarantor are to be covered, but also those obligations which arise from statutory provisions, for example.

The Basel Committee also intends to require the guarantor to cover **all payments** which the obligor is expected to make under the loan.

Up to now, supervisory regulations on backing risk assets have only covered the loss of the book value. The requirement that a guarantee must cover not just the loss of the risk asset, but all claims associated with the loss would therefore be inconsistent and should be dropped. It should continue to be up to the parties to the contract alone to decide whether a guarantor should be obliged to guarantee not only the repayment of the loan, but also the bank's entitlement to interest. Furthermore, the envisaged requirement would render invalid existing guarantees which cover repayment only.

In addition, the Basel Committee proposes that guarantees be **legally enforceable** in all relevant jurisdictions (cf. paragraph 125 (d)). This wording is too broad, since it implies that every jurisdiction of a country in which the guarantor has a branch office would have to be examined. This is obviously not the intended meaning. What is actually required – and what would also be adequate – is to ensure that the guarantee is enforceable in the jurisdiction of the guarantor's head office or a jurisdiction stipulated in the guarantee. Please also see our comments on the legal examination of the enforceability of collateral instruments on page 25.

(c) Operational requirements for credit derivatives (paragraphs 126, 127)

The requirements set out in paragraphs 126 ff., which must be met for credit derivatives to obtain capital relief, are too narrow. It is doubtful that they will promote the market for credit derivatives, which, particularly in continental Europe, is just beginning to develop and expand. Instead, the requirements are more likely to prove a constraint on the market.

Paragraph 126 (a) sets out the credit events which must be specified in the contract. In 126 (d), the Basel Committee then stipulates that default events must be triggered by **any material event**.

The proposed minimum credit events do not adequately reflect current market practice (e.g. ISDA master agreements). The restructuring[9] credit event mentioned in paragraph 126 (a), for example, is highly controversial in practice, and is often excluded under the terms of individual contracts. The credit events listed in paragraph 125 (a) should therefore be limited to the failure to pay amounts due according to the reference asset specified in the contract.

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[9] By restructuring, the credit events listed in the last three sub-sections of para. 126 (a) are meant.

The difference between a credit event as specified in paragraph 125 (a) and a default event as outlined in paragraph 125 (d) is unclear. If a default event is to be understood as meaning a credit event, this additional requirement should be dropped. The conditions under which the protection provider has to provide the agreed service are sufficiently well specified by the stipulation of the minimum credit events to be included in the contract. The requirement that each event must be triggered by any material event would mean, in practical terms, introducing additional and more extensive minimum credit events. This would constitute an inappropriate restriction on the freedom to determine the contents of a contract and clearly be at odds with normal market practices. The Basel Committee should therefore replace the term “default events” with “credit events”.

The Basel Committee does not wish to recognise **any other types of credit derivatives** apart from credit default swaps and total return swaps for the time being (credit linked notes issued by the banks are to be treated as cash collateralised transactions).

In our estimation, recognition should be given to all products satisfying the conditions listed in paragraph 126. The Basel Committee should therefore delete sentences one and two of paragraph 127 and paragraph 128 in its entirety so that other types of credit derivatives can also be integrated into the regulatory framework, depending on the development of the market and the products themselves.

In addition, the Basel Committee stresses that only credit default swaps and total return swaps offering **credit protection equivalent to guarantees** are to be recognised (paragraph 127). We understand this to mean that credit derivatives will always be deemed to offer credit protection equivalent to guarantees if credit default swaps and total return swaps satisfy the requirements for credit derivatives listed in paragraph 126.

(ii) Range of eligible guarantors/protection providers (paragraph 129)

Under the Basel Committee’s proposals, the circle of eligible guarantors/protection providers will comprise, in principle, sovereigns, PSEs, banks and corporates (including insurance companies). The Committee will always consider credit protection eligible if it is given by sovereigns, PSEs and banks with a lower risk weight than the obligor. Credit protection given by corporates, however, will only be recognised as risk reducing if the protection-providing company is rated A or above.

This envisaged discrimination against corporate guarantees is unfair. Guarantees provided by corporates rated below A also reduce the risk for the protection purchaser and should thus be recognised. The fact that the Basel Committee considers the protection provided by such corporates potentially less valuable is adequately taken into account by assigning the protection provider's risk weight to the protected exposure. For this reason, it is superfluous to stipulate minimum credit ratings.

Furthermore, we assume that securities firms are also to receive the same treatment as banks in paragraph 129. See also paragraphs 39, 76, 104 and 154.

In its covering letter accompanying the second Basel consultative document, the Federal Banking Supervisory Office states that in Germany, collateralisation by way of assignment of claims from life insurance policies will be recognised as a guarantee of the insurer in the amount of the surrender value. It should be made clear that collateralisation by assigned deposits in home loan and savings contracts will also be recognised as a guarantee of the home loan and savings association in the amount of the balance saved. Applying different prudential treatment to these two instrument would not be justified from the point of view of their liquidity.

(iii) Risk weights (paragraphs 130 – 140)

The Basel Committee considers it necessary for **materiality thresholds**, below which no payments will be made in the event of loss, to be deducted in full from the capital of the bank. The Committee regards such thresholds as equivalent to retained first loss positions (paragraph 131).

It is inappropriate to deduct these thresholds from the bank's capital. We suggest treating the portion of the exposure below the materiality threshold as uncovered. Treating this portion of the exposure as a first loss position could lead to the absurd situation whereby – regardless of the level of the materiality threshold – more regulatory capital would have to be set aside for this kind of "incompletely" covered exposure than for a totally uncovered exposure because of the capital deduction for this position.

Irrespective of our request to dispense with the *w* factor altogether, we would like to point out that in paragraph 132, the *w* factor should, in line with the rule in paragraph 134, be applied to the residual risk factor, not to the underlying exposure. The applicable wording in paragraph 134 should therefore also be used in paragraph 132.

(b) Tranched cover (paragraphs 136 – 140)

The Basel Committee proposes special rules to calculate risk weights if banks use guarantees or credit derivatives to obtain credit protection only for the senior tranche or the junior tranche of a loan. If the bank obtains protection for the senior tanche only, the Committee states that the total capital requirement (i.e. of the protection provider and the protection taker) shall not exceed that on an otherwise identical loan for which there is no credit protection. This is self-evident and should, moreover, also apply in the event that the bank only protects the junior tranche. In our estimation, it is considerably more important that the protection should result in an appropriate reduction in the amount of regulatory capital required. This is not the case under the rules proposed by the Basel Committee. In addition, these rules are inconsistent, in our view.

If only the **credit risk on the junior tranche is transferred**, the Basel Committee envisages that for the protection taker, the junior tranche will be treated as covered. This is appropriate, since the protective effect of a guarantee or credit derivative does not depend on the seniority of the protected loan. We would nevertheless refer you to our fundamental comments on determining weighted risk assets for loans protected by means of a guarantee or credit derivative (page 35 f.). It is not seem reasonable, on the other hand, for the unprotected senior tranche to receive the risk weight of the original obligor. Since the senior tranche only carries the “second loss” and the exposure to loss is therefore considerably lower, the risk weight of the original obligor should receive an appropriate reduction for such tranches.

Nor is it appropriate, in our view, that the junior tranche must, in any event, be deducted from the capital of the protection provider. It is true that the level of risk certainly increases as a result of the subordination of the loan tranche. Deducting the amount from the bank’s capital, however, would assume that there would be a default on the protected loan in any event (i.e. probability of default = 100%!) and that the junior tranche, regarded over the term of the loan, would also suffer a 100% loss (i.e. LGD of the junior tranche also 100%). This is clearly too conservative an assessment. The subordination does not increase the probability of default of the original obligor. Since the standard approach does not contain a LGD component, the increase in the risk level should be reflected by an appropriate increase in the risk weight of the original obligor – not, however, by a deduction from the regulatory capital.

If only the **risk on the senior tranche is transferred**, the Basel Committee wishes the unprotected junior tranche to be deducted from the capital. This is also inappropriate, in our

estimation, in view of the arguments put forward in the previous paragraph. In this case too, account should be taken of the higher risk of loss by means of an appropriate increase in the risk weight of the original obligor.

The proposed rules for the treatment of the guarantee for the senior tranche are unclear and unnecessarily complicated, in our view. For reasons of simplicity and consistency, the capital requirements for the protection provider should be the same as the capital requirements for the unprotected senior tranche incurred by a bank which has only obtained credit protection on the junior tranche (see above). In this case too, the risk weight of the original obligor should be appropriately adjusted to take account of the subordination.

(iv) Currency mismatches (paragraph 141)

The Basel Committee suggests applying an H_{FX} haircut to the protected exposure when the currency of the credit protection is different from that of the exposure. The haircut is to be scaled up using the square root of time formula to take account of the frequency of revaluation (no. 141).

The Basel Committee should clarify what holding period should be used as a basis when using the square root of time formula.

(v) Sovereign guarantees (paragraph 142)

Regarding the treatment of sovereign guarantees with a lower risk weight at the discretion of the national supervisory authority, we refer to our comments on page 16 (Claims on sovereigns). Here, we ask that such national decisions should be published and made transparent and that – in order to prevent competitive distortions – such risk weights should be able to be adopted by banks based in other countries at their own discretion, without the necessity of a further decision by their national supervisory authority.

(vi) W: remaining risks (paragraphs 143 – 145)

We reject the application of a *w* factor in determining the risk weight of the guaranteed portion of an exposure for the reasons set out above (see our comments on page 35).

5. Maturity mismatches (paragraphs 146 – 148)

The Basel Committee makes clear that hedges with less than one year residual maturity which do not have matching maturities with the underlying exposures will not be recognised.

This arrangement would make the risk-reducing, mismatched hedging of short-term products (less than one year) impossible. This would be unfair discrimination against these products. The Basel Committee should also provide regulatory incentives for prudent risk management for short-term exposures. The system for calculating the risk weights for maturity-mismatched exposures with hedges of more than one year residual maturity should also be applied when there is a residual maturity of less than one year.

III: Credit Risk – the internal ratings-based (IRB) approach (paragraphs 150-515)

A. Mechanics of the IRB Approach (paragraphs 150-170)

1. Categorisation of exposures (paragraphs 150-158)

It should generally be made clear that the categorisation of assets into the classes of exposures proposed by the Basel Committee does not mean that only one rating method can be used for each class of exposures. Banks must be able to use different rating methods (e.g. special ratings for housing companies or insurance firms) for certain sub- portfolios within a class of assets as long as the other minimum rating requirements have been fulfilled.

(iv) Definition of retail exposures (paragraph 156)

Unlike with the other definitions of exposures, the definition of retail exposures also covers loans whose repayment is guaranteed by private individuals. However, this raises considerable problems in banking practice, as such exposures are not classified here according to collateral. Assignment of exposures to the different definitions should therefore not be made dependent on how or by whom the exposure is guaranteed. A corporate exposure that is guaranteed by a private individual or a small business should not be turned by such a guarantee into a retail exposure.

Segmentation according to product-specific criteria should be possible but not stipulated as a condition for categorising an exposure as a retail exposure. It is neither appropriate from a risk angle nor economically sensible. For one thing, the products listed are generally offered to all borrowers and thus not confined to the retail segment. For another, categorisation according to groups of products would mean that, despite having the same PD, one and the same borrower would have to be assigned different product-specific risk weights.

Moreover, the Basel Committee’s proposals would allow national supervisors to set a maximum loan amount for exposures to be treated as retail in nature under the IRB approach. When setting such ceilings, it should be borne in mind that in the retail exposure class there are also borrowers or types of credit with high individual loan amounts. We feel that it should be possible to duly include such borrowers in the retail category.

(v) Definition of project finance exposures (paragraph 157)

As is known, it is difficult for technical and data-related reasons to capture project finance in prudential rules. This is why transactions should, whenever it makes sense, be treated under the borrower-related IRB approaches.

We believe that the provisional definition of project finance contained in paragraph 157 is in principle appropriate, subject to the following condition:

It should be borne in mind that, if the definition proposed by the Basel Committee is used, the category “project finance exposures” would cover subportfolios with highly differing risk characteristics. When determining the capital requirements, a distinction should therefore be made at least between

- classical project finance (e.g. nuclear power stations, sewage plants, refuse incineration plants, telecommunications facilities, etc.)
- so-called “asset-based” finance (e.g. shipping or aviation finance), and
- non-privileged real estate lending that is not included in the IRB approach for corporate exposures.

Differentiated treatment of different types of “project finance” would prevent any unwarranted “compensatory pricing”, which would be at odds with the Basel Committee’s aim of gearing capital requirements more strongly to the true risk of a financing facility. This differentiation makes it clear that we expect cash-flow-based commercial and residential property loans in the IRB approach, particularly also in the advanced approach, not to generally fall within the scope of project finance. Finally, it must be ensured that project finance does not from the outset imply a higher capital charge than for other corporate exposures.

(vi) Definition of equity exposures (paragraph 158)

The definition is too broad. Inclusion in the equity exposures portfolio should be based instead on the definition of ownership interests under existing accounting standards (e.g. Section 271 of the German Commercial Code, IAS).

2. Adoption of the IRB approach across all exposures (paragraphs 159, 160)

The approval and supervision of internal systems for measuring credit risk, but also other risk, e.g. operational risk or interest rate risk, is to fall under Pillar 2 (Supervisory Review Process) of the future Basel Capital Accord. Considerable national discretion is allowed in this connection. This could therefore mean that a situation may arise in which internationally active banks and their subsidiaries face auditing in different countries with conflicting requirements. This would result not only in substantial extra costs; in extreme cases, the use of internal systems already approved by home-country supervisors would have to be dropped in other countries. For this reason, home-country supervisors should be put in charge of group-wide recognition of internal systems. This principle of home-country control has proved successful within the European Union.

The rules on partial use of the IRB approach are, overall, too strict and make it difficult for German banks to qualify early for the IRB approach.

Generally speaking, the requirement to present a binding plan to adopt the IRB approach across all exposure classes and all significant business units within a reasonably short period of time must be dropped. As the Basel Committee intends to calibrate the IRB approach more favourably than the standardised approach, appropriate calibration of the different approaches will give banks sufficient incentive to move to the next more sophisticated approach at the earliest possible stage. Just exactly when they do so should be left to the discretion of each bank without the need for further consultation with supervisors.

This goes particularly for the requirement to adopt the IRB approach across all exposure classes and all significant business units with a short period of time. Banks should be allowed to generally exclude definable business units such as subsidiaries or branches, but also separate retail segments, for which the establishment of a data history is impossible or unreasonable, from the IRB approach.

Furthermore, banks should also be free to apply the IRB approach only to certain types of portfolio and to generally exclude other – for example, smaller – business lines from the IRB approach for cost-benefit reasons. Against this background, the arrangement proposed by the European Commission in its Consultation Document of 5 February 2001 (see paragraph 56) should also be adopted by the Basel Committee. Under this arrangement, financial institutions which may have only one or more exposure classes for which they have developed rating methods and systems are allowed to use much less complicated methods and systems for the

other exposures. Accordingly, it should also be possible for banks to permanently apply the modified standardised approach to certain sub-portfolios, e.g. exposures to sovereigns or other banks, for which it makes no sense for them to develop an internal rating system of their own.

The Basel Committee intends to counter the danger under a partial-use approach of transactions being moved to the business unit with the lowest capital requirement by not allowing any capital relief for internal transactions in such cases. This arrangement is understandable, but should be limited so that it only applies to internal transactions for which there is no other good reason than to obtain capital relief. The justification for such a transaction can then be checked within the framework of the Supervisory Review Process.

3. Adoption of elements of the advanced approach for IRB (paragraphs 161-162)

When moving from the foundation approach to the advanced approach, banks should remain free to decide whether they wish to apply the foundation approach or the advanced approach to each individual portfolio (permanent co-existence of the foundation approach and the advanced approach).

4. Transition period for data requirements under the IRB approach for corporate, sovereign, bank and retail exposures (paragraphs 163-166)

The transitional arrangements and implementation periods set out in the Consultative Document are highly inconsistent in some cases. The period of three years (starting in 2004) stipulated for establishing a data history, within which a five-year data observation period must be progressively built up, is at odds with the requirement for a bank to demonstrate that it has been using a rating system that was broadly in line with the new rules (so-called “use test”) for at least the last three years, since the thrust of the former is mainly into the future, while that of the latter is solely into the past, back to the start of 2001. It is unacceptable that certain requirements are to apply already for the period from 2001 onwards, without there being any even remotely concrete rules or criteria at this time that could serve as a framework for elaborating the details of a rating system.

Progressively raising data requirements parallel to the entry into force of the New Basel Capital Accord (Basel II) means that rating systems can, de facto, only be recognised for prudential purposes either in 2004 or 2008. Where a bank fails to meet internal rating system requirements or has failed to capture and rate its total loan exposure at the end of 2001, it will no longer be able to establish the required historical observation period by 2004. Capturing

their exposure retroactively, i.e. extending the data period, and thus the data, backwards would impose an unreasonably heavy burden on banks and not in fact be possible in certain cases, as subjectively assessed elements of a rating cannot be determined or reproduced ex post. What is more important, however, is that the requirements in many areas will be unclear until at least the end of the year, i.e. until the scheduled adoption of the Basel rules. Supervisors are therefore setting an impossible requirement here too by stipulating that rules which will not be known until the end of 2001 at the earliest must be implemented by that date. We therefore suggest that, at least until the end of 2006, merely a two-year data history should be stipulated for internal ratings, without any increase in requirements during the transition period.

Furthermore, until the end of 2006 as well, banks should only be required to demonstrate that they have been using a rating system that is broadly in line with the new rules (see paragraph 301) for a period of twelve months within the two-year data history so as to facilitate access to more sophisticated methods of risk measurement and to provide sufficient incentive for improvement of internal risk management.

After expiry of the transition period, i.e. from 2007 onwards, the original requirements (a five-year data history, three-year “use test”) will then apply. It must, however, be ensured in this connection that, once recognition of an IRB system has been obtained, it is not invalidated by higher data quality and “use test” standards set after expiry of the transition period (“grandfathering”).

The transition periods for establishing a data history should be extended to cover LGD and EAD. There is no economic reason why a longer data history should be required for estimating LGD and EAD than for estimating the probability of default (PD). EAD, in particular, is a secondary credit risk parameter. We also suggest that, particularly where parameters in question are concerned, statistical sampling should be eligible for recognition.

5. Derivation of risk-weighted under IRB approach (paragraphs 167-170)

The capital rules under the IRB approach are wrongly calibrated in our opinion. We also feel that the overall structure of the capital rules is wrong. The numerous safety cushions, haircuts, floors and caps imply that all potential crisis scenarios will occur simultaneously and with full force. This is totally unlikely, however. The planned allowance for maturity, the size of the proposed risk weights and the – in our opinion – inappropriate rules for reflecting granularity further aggravate the problem so that a capital charge that is higher than the total loan exposure can only be avoided by providing for a cap. Generally speaking, medium and poor credit

quality have been systematically discriminated against so far under the IRB foundation approach in particular, mainly at the expense of small and medium-sized borrowers.

B. Rules for Corporate Exposures (paragraphs 171-421)

1. Risk-weighted assets for corporate exposures (paragraphs 171-234)

(i) Formula for derivation of risk weights (paragraphs 171-177)

Calibration of risk weights

The calibrated benchmark risk weights (BRW_C) in paragraphs 173-176 are much too high compared with our proposal for a master scale (see p. 18 of the comments of the Zentraler Kreditauschuss of 10 March 2000 on the Basel Committee's First Consultative Document). In our view, this is due, firstly, to the Basel Committee's intention of subjecting expected losses as well as unexpected losses to a regulatory capital charge. The much too high risk weights are also due, secondly, to the proposed add-on of 20% for errors in estimating PD.

The planned capital charge for expected losses must be rejected, as such losses are already covered by banks via risk premiums. As inadequate risk provisioning by banks would lead to losses or even failure on their part, banks have a keen interest in setting the right size of risk premiums. Furthermore, banks which use internal rating systems are also able to calculate the required risk premiums accurately enough.

The Basel Committee rightly calls on banks to take their own PD estimates into account also in their risk provisioning arrangements. It must, however, be pointed out in this connection that adequate risk provisioning can only be called for by supervisors at portfolio level and not at individual exposure level. It cannot be up to supervisors to stipulate individual pricing and risk provisioning arrangements for banks, since pricing may also have to take account of market entry considerations (see in this connection also the remarks below on minimum requirements on page 63).

In the Basel Committee's view, the main argument in favour of a capital charge for expected losses is the fact that the Committee's definition of capital, as Tier 2 capital, includes part of the so-called "general provisions"[10] and thus part of banks' risk provisioning for expected

[10] See December 1991 Amendment of the Basel Capital Accord in respect of the inclusion of general provisions/general loan-loss reserves in capital.

losses (paragraphs 164 and 185). Indeed, calibration of capital requirements solely on the basis of unexpected losses and simultaneous recognition of general provisions to cover expected losses would mean that the general provisions in question would be wiped out already by the expected losses and would no longer be available to cover unexpected losses.

This argument fails to convince as far as Germany is concerned. In Germany, the Basel rules have been implemented merely in the form of hidden contingency reserves for general banking risks (Section 340f of the German Commercial Code). The danger of "dual use" of the contingency reserves pursuant to Section 340f of the Commercial Code was countered within the framework of the Fourth Amendment to the German Banking Act by stipulating that on-balance-sheet risk provisioning measures which, on the one hand, reduce the book value and, on the other hand, constitute liable capital must be added again when assessing the exposure for Principle I (Section 6, paragraph 1, no. 1 of Principle I). In our view, the IRB approach should also be geared to the exposure. Taking into account the expected loss when calibrating the risk weight would then be unnecessary. This would also be the appropriate solution in the circumstances because it is the only way to ensure that "dual use" is reduced to the right extent and does not result in an additional capital charge, i.e. a penalty. It should also be noted that most banks subject to the Basel rules prepare their accounts in accordance with IAS or US GAAP. Under these, the contingency reserves pursuant to Section 340f of the German Commercial Code are not allowed in any case.

As banks hold economic capital for commercial reasons solely to cover unexpected losses[11], the planned capital charge for expected losses would also create a gap between economic capital and regulatory capital. The result would be mismanagement of risk at banks.

As the Basel Committee rightly points out, covering expected losses affects the capital requirements for companies with a low credit standing in particular (paragraph 187). This would be harmful particularly to small businesses and start-ups.

If the Basel Committee were to stick to imposing a capital charge for expected losses, it would logically have to recognise banks' total risk provisions for expected losses as regulatory capital. The practical problems this would involve – particularly as regards quantification – would be virtually insurmountable in our opinion. Apart from this, differing national tax law would also lead to unsolvable distortions of competition.

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[11] This is also the finding of the Basel Committee in paragraph 164 of the Technical Supporting Document on the IRB approach (see page 34 thereof).

As a paper produced by the Basel Committee's Working Group on Overall Capital on 21 February 2001 shows, the proposed risk weights are also so high because, when calibrating them, an add-on of 20% for errors in estimating PD was set. This add-on must be rejected, since banks – as expressly called for by the Basel Committee – are required to estimate PD conservatively. This makes the scale of errors in estimating PD negligible. Such errors could be dealt with under the Supervisory Review Process. We refer in this connection to our remarks on Pillar 2 on page 131.

Setting the individual parameters in the formulae for derivation of benchmark risk weights (BRW_C) remains problematic. A standard normal random variable is assumed, although in our view it does not realistically reflect the distribution of risk in a typical reference portfolio. The same goes for setting the parameter for average granularity and a standard value for assumed correlations. Yet, submitting alternative proposals for fixing these parameters poses considerable problems, as the credit risk model taken as the basis for calibration and the manner in which the formula is derived from this model or from a number of models cannot be fully understood until the Basel Committee discloses all the individual steps of the calculation and all methods and models used.

It should also be pointed out here that all efforts to introduce a further add-on for risk weights because components of Tier 2 capital may be unable to absorb losses adequately must be firmly rejected (see paper produced by the Working Group on Overall Capital). This problem is already addressed today by the existing caps on Tier 2 capital.

(ii) Inputs to the risk-weight function (paragraphs 178-234)

(a) Probability of Default (PD) (paragraphs 179-193)

The proposed floor of 0.03% for the PD is unfounded and must therefore be rejected.

We also do not think it makes sense (for prudential purposes) to uniformly fix the PDs of borrowers belonging to a particular rating grade. Paragraph 67 of the Supporting Document explains why an average PD per grade is preferable for prudential purposes. We assume that, to allow adequate internal use of PD measurements, it is also possible to use different PDs for borrowers in a particular rating grade, as a uniform PD for each rating grade could be too rough a classification for internal management purposes.

Paragraph 193 explains how residual maturity mismatches are to be treated. The Basel Committee is considering in this connection whether additional capital beyond that implied by the difference in risk weights should be held. This supposedly necessary additional capital requirement is unfounded and inappropriate, and should therefore be dropped.

(b) Loss Given Default (LGD) (paragraphs 194-224)

LDG in the foundation IRB

CRE (commercial real estate) and RRE (residential real estate) – see footnotes 14 and 30 in Main Document)in the IRB approach (paragraphs 207-221)

The effective LGD is determined on the basis of different intervals of the quotients C (collateral) and E (exposure). See table in paragraph 212 of the Main Document:

Case	**Condition**	**Effective LGD**	**Treatment**
Case 1	C/E ≤ 30%	50%	As uncollateralised
Case 2	C/E>140% ⇔ E/C < 100/140=71%	40%	Floor LGD for this type of collateral where the loan to value ratio does not exceed 71% (100/140)
Case 3	30%<C/E ≤ 140%	{1-[0.2 x (C/E)/140%]} x 50%	Weighted average of collateralised and uncollateralised LGD

The recognition of “normal” commercial real estate as collateral means that the special rules for commercial real estate lending in Germany are seriously devalued in the IRB approach for real estate lending portfolios with borrowers of good credit standing. This is because under the “normal” treatment of commercial real estate as collateral the reduced LGD applies to the overall exposure, while under the “exceptional” treatment an LGD of 40% only applies to that part of the exposure which does not exceed 60% of the lending value or 50% of the market value of the real estate. The part of the exposure exceeding these thresholds must be assigned an LGD of 50%. These LGD values for the exceptional treatment are clearly too high and

inconsistent with the special treatment of commercial real estate under the standardised approach. We therefore suggest that the exceptional treatment should be based on the LGDs which are produced when the definition of default used in the empirical survey of losses in the field of commercial mortgage lending in Germany and thus the relevant PDs are converted into the definition of default adopted by the Basel Committee. The empirical survey only assumes that default has occurred if the exposure is written off in the event of insolvency (foreclosure due to insolvency). On this basis, it determines empirically an LGD ratio of approx. 20%. If the definition of default used by the Basel Committee (90 days past due) is taken as a basis, the earlier time of default produces a higher PD ratio but, at the same time, a lower LGD ratio than 20%. Because of the different reference basis (definition of default or time of default), the Basel Committee arrives at a highly overstated risk profile that does not reflect the actual situation. However, if the definition of default used by the Basel Committee is applied to the results of the survey, the LGD ratio also has to be reduced accordingly.

The arrangement proposed by the Basel Committee makes it necessary instead to provide for a cap for the "privileged" area, i.e. exposures eligible for exceptional treatment. Without taking into account the "below-4% cap" (limiting the capital charge for privileged real estate lending to less than 4%), the capital charges for privileged commercial real estate lending (column 2) – regardless of the creditworthiness of borrowers – would be less favourable than under "normal" treatment (column 1) upwards of a C/E ratio of 30%. This is illustrated for an exposure of 100 MU with a risk weight of 100% by means of the following table:

C	E	C/E	LGD non-privileged	Capital in % (1)	E up to 50 % of C	Capital in %	E over 50% of C	Capital in %	Overall capital in % (2)
0	100	0%	50.0%	8.0%	0	6.4%	100	8.0%	8.0%
10	100	10%	50.0%	8.0%	5	6.4%	95	8.0%	7.9%
20	100	20%	50.0%	8.0%	10	6.4%	90	8.0%	7.8%
30	100	30%	47.9%	7.7%	15	6.4%	85	8.0%	7.8%
40	100	40%	47.1%	7.5%	20	6.4%	80	8.0%	7.7%
50	100	50%	46.4%	7.4%	25	6.4%	75	8.0%	7.6%
60	100	60%	45.7%	7.3%	30	6.4%	70	8.0%	7.5%
70	100	70%	45.0%	7.2%	35	6.4%	65	8.0%	7.4%
80	100	80%	44.3%	7.1%	40	6.4%	60	8.0%	7.4%
90	100	90%	43.6%	7.0%	45	6.4%	55	8.0%	7.3%
100	100	100%	42.9%	6.9%	50	6.4%	50	8.0%	7.2%
110	100	110%	42.1%	6.7%	55	6.4%	45	8.0%	7.1%
120	100	120%	41.4%	6.6%	60	6.4%	40	8.0%	7.0%
130	100	130%	40.7%	6.5%	65	6.4%	35	8.0%	7.0%
140	100	140%	40.0%	6.4%	70	6.4%	30	8.0%	6.9%
150	100	150%	40.0%	6.4%	75	6.4%	25	8.0%	6.8%

If, however, the “below-4% cap” is taken into account, it becomes evident that the relative advantages of both methods depend on the creditworthiness of the borrowers in the real estate lending portfolio. If the real estate lending portfolio consists merely of the above-mentioned exposure (100 MU, 100% risk weight), it becomes clear that application of the “below-4% cap” has made the exceptional treatment really more favourable. However, in the example given, this only applies upwards of a risk weight of 62.5%, i.e. upwards of a PD of approx. O.4%.

C	E	C/E	LGD non-privileged	Capital in %	E up to 50 % of C	Capital in %	E over 50% of C	Capital in %	Overall capital in %
0	100	0%	50.0%	8.0%	0	4.0%	100	8.0%	8.0%
10	100	10%	50.0%	8.0%	5	4.0%	95	8.0%	7.8%
20	100	20%	50.0%	8.0%	10	4.0%	90	8.0%	7.6%
30	100	30%	47.9%	7.7%	15	4.0%	85	8.0%	7.4%
40	100	40%	47.1%	7.5%	20	4.0%	80	8.0%	7.2%
50	100	50%	46.4%	7.4%	25	4.0%	75	8.0%	7.0%
60	100	60%	45.7%	7.3%	30	4.0%	70	8.0%	6.8%
70	100	70%	45.0%	7.2%	35	4.0%	65	8.0%	6.6%
80	100	80%	44.3%	7.1%	40	4.0%	60	8.0%	6.4%
90	100	90%	43.6%	7.0%	45	4.0%	55	8.0%	6.2%
100	100	100%	42.9%	6.9%	50	4.0%	50	8.0%	6.0%
110	100	110%	42.1%	6.7%	55	4.0%	45	8.0%	5.8%
120	100	120%	41.4%	6.6%	60	4.0%	40	8.0%	5.6%
130	100	130%	40.7%	6.5%	65	4.0%	35	8.0%	5.4%
140	100	140%	40.0%	6.4%	70	4.0%	30	8.0%	5.2%
150	100	150%	40.0%	6.4%	75	4.0%	25	8.0%	5.0%

To achieve consistency of capital requirements between the standardised approach and the IRB approach, a further cap is required also for the non-privileged part of commercial real estate lending below a ceiling of 8%, unless the LGD values criticised as being too high are lowered significantly.

LGD in the advanced IRB (paragraphs 222-224)

Subject to additional requirements, banks may be permitted under the advanced approach to estimate the LGD themselves ("*conservative view of long-run average LGD values for exposures in each internal LGD grade*"; paragraph 100 of the Supporting Document).
This means that individual bank-specific factors influencing LGD are taken into account. Unlike the foundation approach, the advanced approach does *not* limit the list of eligible collateral to "*high-quality, high-marketable financial collateral or specified forms of commercial and residential real estate*" (paragraph 102 of the Supporting Document). Valuation of collateral is not prescribed either.

Many banks still lack data periods for LGDs according to type of transaction or type of borrower. Establishing such data periods is likely to impose a considerable workload in terms of time and money. Requiring approval of an internal market risk model for estimating price volatility of marketable collateral puts up an absurdly high hurdle. Banks with non-market risk models should also be able to estimate such price volatility. We also assume that the regulatory standard haircuts provided for in the standardised approach and the IRB foundation approach can also be used for the purposes of the advanced approach alongside pooled or other data that have been reliably compiled externally.

(c) Maturity (M) (pargaraphs 225-228)

In the case of maturities other than three years, the formula for deriving the risk weights (paragraph 173) will be multiplied, under the advanced approach, by a scaling factor (where PD and LGD are constant) taking maturity into account.

For maturities of more than three years, there will be an add-on, and for maturities of less than three years a deduction. Overall, a positive correlation between maturity and risk (or economic capital) is modelled across all maturities.

Inclusion of maturity must be rejected for the following reasons:

- Because of the requirement to review and, if necessary, adjust ratings at least annually, it is sufficient if the prudential horizon is limited to one year. In this way, latent deteriorations in creditworthiness will be detected and lead to higher capital requirements (recapitalisation). This ensures that the time component of credit risk is captured adequately for prudential purposes.

- Economic capital is influenced only slightly by maturity. Other credit risk drivers (e.g. granularity, diversification, PD and LGD) have a much greater impact on economic capital. In order to reduce the complexity of the IRB approach, inclusion of the maturity component can therefore be dispensed with.

- The Basel Committee points out itself that its survey failed to produce any consistent results indicating a correlation between maturity and capital allocated internally by banks.

- The inclusion of M as a factor influencing capital charges creates unwanted incentives to split up a long-term exposure into a revolving series of short exposures.

- The serious danger of model errors when estimating the influence of maturity offsets the desired enhanced risk sensitivity of the IRB approach.

- In a macroeconomic context as well, a trend towards shorter maturities (eliminating the long-term culture) may have a destabilising effect (lack of predictability of the size of payments, higher interest rate risk for borrowers).

- The inclusion of maturities of more than one year also fails to take account of the fact that banks usually take measures to protect themselves against a deterioration in credit quality (e.g. request for additional security, reduction of credit lines, or right to cancel in the event of non-compliance with covenants)

(d) Measurement of exposure amounts for corporate exposures (paragraphs 229-234)

According to the Basel Committee's proposals, exposures in both on and off-balance-sheet transactions will be measured *net of* specific provisions (paragraph 108 of the Supporting Document). The well-known tripartition for measurement of exposures in Section 2 of Principle I (on-balance-sheet transactions, traditional off-balance-sheet transactions, OTC derivatives) is to remain in place.

The admission of on-balance-sheet netting for measuring exposures in on-balance-sheet transactions is to be welcomed and accommodates a demand that has been made by banks and their associations for many years (see in this connection also our remarks on on-balance-sheet netting in the standardised approach).

For measurement of exposures in traditional off-balance-sheet transactions, the credit conversion factor (CCF) for credit lines that are not unconditionally cancellable is to be set at 75%, regardless of maturity[12]. We do not understand why. The same credit conversion factors as in the standardised approach should be used here.

We welcome the fact that banks will be allowed in the advanced approach to use their own internal model estimates to measure their potential future exposure (PFE). In this way, they

[12] A maturity-based approach should be adopted here; see in this connection our remarks on the treatment of off-balance-sheet transactions in the standardised approach on page 20 f.

may be able to considerably reduce their capital requirements for derivatives business under the advanced approach. In this connection, we request that portfolio-based PFEs also be allowed.

2. Minimum requirements for corporate exposures (paragraphs 235-323)

(i) Composition of minimum requirements (paragraphs 235-236)

The Basel Committee's ideas in this area are evidently influenced by those in the trading book area (Minimum Requirements for the Trading Activities of Credit Institutions in Germany, qualitative requirements for internal market risk models). These ideas are also to be applied to the requirements in regard to organisational structures in the area of credit risk, where they are in some cases *not* standard practice. Implementation of these requirements would therefore involve considerable organisational changes. When setting minimum requirements, thought should therefore be given to whether it is actually necessary or sensible to call existing, established structures into question as a whole and replace them with more complicated structures.

(ii) Criteria to ensuring meaningful differentiation of risk (paragraphs 237-243)

(a) Overall rating system structure (paragraphs 237-239)

The requirement for banks to possess a special transaction-specific rating component can, in our opinion, only apply to the advanced IRB approach. As, in the IRB foundation approach, the LGD ratio is set by supervisors, including an additional transaction-specific rating component in this approach makes no sense.

(b) Rating grade structure (paragraphs 240-243)

Generally speaking, it makes sense to spread borrowers across rating grades so as to ensure a meaningful differentiation. However, stipulating that no more than 30% of the gross exposures should fall into any single borrower grade could lead to considerable interference in banks' business policy and must therefore be rejected. Moreover, there is no reason from a risk angle why a bank should not have more than 30% of its gross exposures in its top rating grade. Setting a rigid ceiling could also mean that small and medium-sized banks in particular, whose business is concentrated on certain types of borrowers, will be unable to adhere to such a ceiling, especially if these banks – at association level, for example – pool their data to obtain

statistically reliable PD estimates. In the field of small and medium-sized enterprise finance in particular, this could mean a bank being excluded from the IRB approach solely because of such a ceiling. In addition, any forced categorisation into grades could lead to just an artificial accuracy of PD quantification that may be inadequate once the underlying risk data are taken into account (see in this connection also the argument in the EU Consultation Document, paragraph 68 f.).

(iii) Completeness and integrity of rating assignments (paragraphs 244-247)

The requirement that every rating assignment must be reviewed by an independent unit whose remuneration does not depend on the rating assignment and which otherwise does not stand to benefit from the rating assignment is impracticable. Up to a certain ceiling amount, ratings should not have to be reviewed at all (de minimis regulation). Where exposures exceed this ceiling amount, random sampling by independent units should be regarded as adequate.

In the area of mechanised rating assignments, i.e. rating systems where the rating unit has no discretionary leeway whatsoever, rating reviews can be completely dispensed with. Under such rating systems, ratings should only be reviewed in individual cases where mechanised ratings are overridden.

It should also be made clear that the requirement for ratings to be reviewed independently merely means a functional separation of responsibilities.

Under the Basel Committee's proposals, banks must provide for suitable processes to enable them to obtain all the information they need to assess their customers' creditworthiness. New information should be used promptly to update ratings. This latter requirement is appropriate in our opinion and in banks' own interests. Random compliance checks on this are already made today by internal audit. The deadlines for rating updates proposed by the Basel Committee must, however, be rejected, as they are impracticable.

(iv) Oversight over the rating system and processes (paragraphs 248-257)

(a) Oversight by the board of directors and senior management (paragraphs 248-252)

As regards the required oversight by the board of directors and senior management[13], the following should be made clear:

- The approval of material aspects of the rating and PD estimation process by the board of directors and senior management should be limited to overrides, new measures or changes that are the equivalent of a new measure.

- The requirement for the board of directors and senior management to demonstrate a general understanding of the methods described in the documentation of the rating system and process goes too far and should be limited to the requirements set similarly in this connection in the Minimum Requirements for the Trading Activities of Credit Institutions.

Moreover, we feel that the monthly reporting requirements are too detailed and leave little room for accommodating banks' own individual requirements. It should be borne in mind, particularly when determining the frequency of reporting on the risk profile by rating grade, migration across grades, quantification of loss estimates per grade and comparison of realised default rates against expectations, that changes in banks' loan portfolios take place more slowly than in their trading portfolios.

(a) Internal and external audit (paragraphs 253-254)

To avoid any duplication of auditing as far as possible, the requirements for reviewing rating systems and quantification of ratings should be specified more precisely by internal audit. It should, firstly, be made clear that internal audit is only required to make random checks on whether the credit risk control unit has duly performed its duties. It should, secondly, be made clear that individual ratings also only need to be reviewed on a random basis.

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[13] It should be made clear that the "board of directors and senior management" referred to in the document means the management as defined in the German Banking Act.

(b) Credit review function (paragraphs 255-256)

The requirement that the credit risk control unit should be independent from "*the personnel and management functions responsible for originating exposures*" is appropriate in our opinion, provided that this merely means a functional separation.

The responsibility for assigning and/or reviewing and monitoring internal ratings called for by the Basel Committee should cover the rating process methodology, but not individual ratings, as these are already reviewed by an independent unit and, on a random basis, by internal audit.

(v) Criteria and orientation of the rating system (paragraphs 258-269)

(c) Assessment horizon (paragraphs 262-263)

As regards the requirement that, when assigning a borrower to a grade, banks should assess risk factors for the future horizon, it should be noted that this is not possible in regard to all rating criteria.

(d) Criteria on risk assessment of a borrower (paragraphs 264-265)

The decision on the use of certain rating criteria should, in principle, be left to banks. The sole basis for choosing rating criteria should be a risk factor's ability to differentiate risk and its predictive power. This must be demonstrated by banks within the framework of validation. The requirement that a bank's criteria cover "*all factors that are relevant to the analysis of borrower risk*" calls to mind the corresponding passage for internal market risk models (Section 35, paragraph 1 of Principle I). For rating systems too, the rule is that more risk factors do not automatically improve the statistical predictive power. Models that include only three or four variables may be adequate as such. Variables which are, for example, (functionally) dependent on modelled variables are implicitly taken into account. The requirement that all rating criteria must be taken into account should therefore be dropped. For this reason, the criteria set out in paragraph 265 should merely be seen as examples, which is also in the interests of the continuous enhancement of internal rating systems. It should, in addition, be noted that it is not the stipulated intuitiveness and plausibility of factors or adequate specification thereof to enable a third party to measure an exposure that are important but their predictive power.

(e) Specific criteria for the use of models within the rating process (paragraphs 266-267)

It must be clarified in this connection what the Basel Committee means, e.g. in paragraph 266, by “*models*” or “*model-based rating assignments*”.

(f) Exceptions to rating criteria (paragraphs 268-269)

The requirement that banks must track separately the performance of overridden grades is unclear. Validation processes generally cover the entire rating system. Separate validation processes should only be called for where this is absolutely necessary.

(vi) Minimum requirements for estimation of PD (paragraphs 270-283)

The minimum requirements for estimation of PD should not be made too rigid. This goes particularly for the detailed ideas set out in paragraph 217 of the Supporting Document as well. As the adequacy of processes for estimating PD must be demonstrated by validation, selection of these processes should, in principle, be left to the discretion of banks. Any over-restrictive approach in this area would, moreover, impede the continuous enhancement of rating systems.

The requirement in paragraph 271, calling for a “*long-run average PD*”, is open to misunderstanding and should therefore be deleted. Which time basis PD is determined on is a question of an adequate data history (see in this connection paragraph 163 f, where this is dealt with conclusively)

(a) Estimation using reference definition of default (paragraphs 271-273)

According to paragraph 272, a default is considered to have occurred if *one or more* of the events set out in this paragraph has taken place.

The main problem in our view is that the default events specified in the reference definition are scarcely objectifiable. For one thing, they are influenced by different accounting rules (e.g. in regard to when specific provisions are made). For another, supposedly objectifiable points in time (e.g. 90 days past due) depend to a great extent on the products considered or repayment frequency. We also believe that monitoring all the default events specified in the definition would impose an unreasonable burden on banks. It should also be noted that, if the definition proposed by the Basel Committee were to be retained in Germany, existing historical data stocks would be rendered useless. The Basel Committee, as is known, leaves open the question

of whether it is possible, using a mapping technique, to map different definitions of default into a single reference definition.

To enable banks to use their internal definitions of default and thus possibly of already existing historical data periods as well, we suggest the following procedure as an alternative to the use of the reference definition of default:

The benchmark definition of default should be the final (partial) write-off of an exposure. The advantage of this criterion, which sets default at a very late point in time, is that it can be standardised most easily at international level by means of general procedural rules. At the same time, by determining the percentage of defaulting customers where no (partial) write-off had to be made after default (so-called "cure rate"), banks can adjust their internal definition of default to the benchmark definition of default. Moreover, this mapping does not pose any additional technical problem.

Where internal data for measuring PD are available, banks can also determine the cure rate or write-off rate for defaulting exposures. This also allows a comparison of all PDs and avoids any enormous data collection workload.

(e) Specific minimum requirements for mapping to external data sets (e.g. agency grades) (paragraphs 278-279)

When mapping to external data sets, it is difficult to demonstrate the comparability of external and internal rating criteria, as rating agencies are usually not prepared to provide more detailed information on their rating method. For this reason, the requirements in the second sentence of paragraph 279 should be made practicable.

(f) Specific minimum requirements for use of statistical default models (paragraphs 280-282)

The requirement for a bank to demonstrate that the data used in statistical models are representative of the population of the bank's actual borrowers may prove difficult to fulfil where pooled data are involved. Consequently, this requirement should not be interpreted so narrowly that the use of pooled data is no longer possible.

(g) Length of underlying data period (paragraph 283)

See in this connection our remarks on page 47 (on paragraph 163 f: *Transition period for data requirements under the IRB approach*).

(vii) Data collection and IT systems (paragraphs 284-288)

Mandatory periods for retention of a "*complete rating history*" should be set (e.g. the retention periods under commercial law)

(viii) Use of internal ratings (paragraphs 289-301)

The Basel Committee's requirement that internal rating systems should also be used internally basically makes sense. However, the details of this requirement must on no account go as far as to allow supervisors to interfere in banks' business policy, e.g. in connection with transaction pricing. Banks must retain their independent decision-making powers in this area, which should not be subjected to banking supervision.

(a) Credit risk measurement and management (paragraphs 289-293)

It is unclear what the "*daily credit risk measurement*" requirement means. Paragraph 249 calls for a monthly reporting frequency. Risk measurement should therefore also take place on a monthly basis. Because of the special features of loan portfolios, measuring risk more often would not make sense. The Basel Committee should therefore confine itself in this paragraph to stating that the quantitative information derived from internal ratings must be an integral part of *current* credit risk measurement. The word "*daily*" in the original document should thus be replaced by "*current*" (see paragraph 228 of the Supporting Document: "*... integral part of its current business and risk management culture*").

The requirement that rating information should be reflected in the cost of credit must be rejected in this form, as it ignores the individual market situation, particularly the enforceability of certain loan terms. It cannot be up to supervisors to stipulate pricing and risk-provisioning arrangements for banks on a transaction basis, since pricing may have to take account of market entry considerations.

(d) Length of time a rating system has been in place (paragraph 301)

As regards the so-called “use test” requirement, see our remarks (on paragraph 166) on page 48.

(ix) Internal validation (paragraphs 302-308)

To ensure the adequacy of an internal rating system over the course of time, the assignment of PDs to rating grades needs to be regularly reviewed. The adequacy of an internal rating system can be validated on the basis of different, generally recognised methods.

The results of validation methods must be assessed against the background of the rated segment, the available population and the chosen definition of default. To allow an assessment of the ability of ratings to differentiate risk, validation methods must therefore accurately reflect circumstances specific to individual banks and customer groups. Any supervisory straitjacket should be avoided. Especially counter-productive would be rigid cut-offs that may not be under- or overshot in validation (e.g. for the size of the Gini coefficient).

The individual validation requirements set out – particularly mandatory monitoring of model performance by means of statistical testing – are a significant obstacle to the implementation of the IRB foundation approach.

The requirement for “*statistical testing of the dynamic stability of the model and its key coefficients*” should be dropped. Instead, validation should be possible, as mentioned above, on the basis of different methods.

The general requirement for the use of “*other quantitative validation tools*” should be dropped. Since it is in their own interests, banks will try in any case to use the validation method suited to both their own needs and the nature and complexity of their rating system.

(x) Disclosure requirements (paragraph 309)

To be eligible for the IRB approach, banks must meet the disclosure requirements set out in Pillar 3. If they fail to meet these requirements, they will be ineligible for the IRB approach. This eligibility requirement must be firmly rejected. It should suffice if banks explicitly demonstrate the adequacy and suitability of a rating system to supervisors. For further details, please see our remarks on Pillar 3 – Market discipline – on pages 137, 144.

(xi) Minimum requirements for supervisory estimates of LGD and EAD (paragraphs 310-323)

(a) Overall minimum requirements (paragraph 310)

According to the Basel Committee, banks must meet the minimum requirements for the recognition of collateral before they can use prudential estimates of LGD and EAD. We therefore refer to our remarks in this connection (page 23 f.)

(b) Definition of subordination (paragraph 311)

In order to ensure a level playing field, the definition of subordination of an exposure should not be left to the discretion of national supervisors. For this reason, the second and third sentences in paragraph 311 should be deleted.

(c) Definition of eligible commercial real estate (CRE) and residential real estate (RRE) (paragraphs 312-315)

It is not clear why only property pledged by small and medium-sized corporate entities is to be recognised as collateral. The quality of such collateral does not depend to any recognisable extent on the size of the corporate providing the collateral. This goes for both commercial and residential real estate. For this reason, all property pledged by corporates should be recognised as collateral.

We also refer to our remarks on the separation of "*project finance*" from other commercial real estate lending (see page 45 f. above) and on the exceptional treatment of "privileged" commercial real estate lending (see page 19 f.). Generally speaking, it must be ensured that the treatment of privileged commercial real estate lending and residential real estate lending in the IRB approach is consistent with that in the standardised approach. This goes especially for the question of application of the rules for determining the lending value in the IRB approach.

(d) Operational requirements (paragraphs 316-321)

For the recognition of a claim on collateral, the criterion applied by the Basel Committee is that the bank should have a *first lien on, or charge over*, the collateral. No recognition for second or subsequent charges will be provided. This is inconsistent with the Committee's

approach of taking the actual economic risk more strongly into account for prudential purposes. Under German law, the ranking of a lien influences certain procedural rights or their ranking in judicial proceedings for compulsory enforcement of the lien, without directly influencing the value of the lien. The sole criterion should therefore continue to be the value of the collateral in relation to the collateralised exposure (see in this connection also paragraph 318, which refers to the objective market value of collateral).

Part 3. Minimum requirements for the advanced IRB approach (paragraphs 324-402)

(i) Own estimates of loss given default (paragraphs 326-365)

The thrust of paragraphs 326-365 is essentially in line with the requirements already set for rating and PD estimation. We therefore refer to our remarks in this connection (see page 62 f.)

(e) Minimum requirements for the estimation of LGD (paragraphs 336-345)

Estimation using reference definition of default and loss (paragraphs 338-340)

The requirement to use the "*economic*" loss and not the loss recording in accounting records may impose a considerable extra burden on banks that would not be justified by any gain in knowledge. The definition of default and loss used should therefore be consistent with existing accounting standards. For the same reason, the requirement that banks should be able to compare the economic loss and the loss recorded in accounting records must also be rejected.

Data sources and process for estimation (paragraphs 341-345)

According to the Basel Committee, internal estimates of LGD should be based on a minimum data observation period of *seven* years. This means that higher data history requirements would be set for LGD estimates than for PD. There is no economic justification for this. It is therefore essential that the length of the required minimum data history for estimation of LGD be brought into line with that stipulated for estimation of PD.

As, generally speaking, hardly any banks will already have the data periods of the required length, the requirement of a minimum data history of seven years would also greatly reduce the number of institutions able to use the advanced approach.

For the same reason, the transition period allowed for estimation of PD in all approaches should be applied to estimation of LGD in the advanced IRB approach as well. As regards the arrangement of this transition period, we refer to our remarks on page 47.

It also does not always make sense to use average values over a credit cycle when estimating LGD, as other risk drivers such as changes in bankruptcy law or improvement of internal loan workout, for example, are likely to have a much stronger impact on the size of LGD. It is also the case with estimation of LGD that rigid prudential requirements would hinder the continuous improvement of internal rating systems. Furthermore, banks have to demonstrate the adequacy of their LGD estimates within the framework of validation. The additional requirement that banks should take the current state of the economic cycle into account should be deleted.

(h) Internal validation (paragraphs 356-362)

Paragraphs 357 and 360 suggest that a total of at least three quantitative validation techniques have to be used: two internal techniques (paragraph 357) and a plausibility test through a comparison with external data sources (paragraph 360). It is unclear in this context what the "*other validation tools*" referred to in paragraph 357 means. We refer in this connection to our remarks on validation of PD estimates (page 64.)

A plausibility test using external data would pose considerable problems, as such data are difficult to obtain and a comparison with these is not easy, meaning that the value of such a test would be greatly reduced. This requirement should therefore be dropped.

Stress tests are called for at input level for PD, LGD and EAD. In our view, isolated model input-related stress tests make little sense.

(ii) Minimum requirements for use of own EAD estimates (paragraphs 366-402)

(c) Oversight by board and senior management (paragraph 371)

It must be made clear that the approval requirement cannot apply to individual estimates but that instead – like the requirements for PD and LGD estimates – only "*all factors that are relevant*" to estimation of EAD need to be approved. We refer in this connection also to our remarks on the "*Oversight over the rating systems and processes*" in estimation of PD (paragraph 248, see page 59 f. of our comments).

(e) Minimum requirements for estimation of EAD (paragraphs 375-383)

Data sources and process of estimation (paragraphs 378-383)

The minimum data observation period for estimating EAD is *seven* years. This means that higher data history requirements would be set for EAD estimates than for PD. There is no economic justification for this. It is therefore essential that the length of the required data history for estimation of EGD be brought into line with the period of five years stipulated for estimation of PD.
Moreover, hardly any banks will already have the data periods of the required length.
For this reason, the transition period allowed for estimation of PD in all approaches should be applied to estimation of EAD in the advanced IRB approach as well. As regards the arrangement of this transition period, we refer to our remarks on page 47 f.

As EAD is a secondary risk parameter, random statistical sampling should also be allowed for it.

As regards the requirement that EAD estimates must be based on a minimum observation period that should ideally cover a complete economic cycle, we refer to our remarks on estimation of PD (page 63) and on estimation of LGD (page 67).

(h) Internal validation (paragraphs 395-401)

Because of the problems anticipated in connection with the plausibility test using external data, we refer to our remarks on internal validation of LGD estimates (see page 68 above) and suggest dropping the requirement for such a test in this context too.

4. Minimum requirements for assessment of guarantors and sellers of credit derivatives (paragraphs 403-421)

(i) Guarantees (paragraphs 404-418)

According to the Basel Committee, the criteria for recognition of guarantees for regulatory capital purposes should be as detailed as borrower rating criteria and must, in addition, follow all minimum requirements for assigning borrower ratings. We therefore refer to our remarks in this context (page 58).

As regards the requirement in paragraph 406 that each individual rating assignment must be performed or reviewed by personnel independent of lending or business line functions, we refer to our above remarks on assignment of customer ratings (page 58).

Also as regards the requirement that the guarantee must be legally enforceable against the guarantor, we refer to our above remarks on recognition of guarantees in the standardised approach.

C. Rules for Retail Exposures (paragraphs 422-478)

1. Risk-weighted assets for retail exposures (paragraphs 422-437)

Formula for derivation of risk weights (paragraphs 424-430)

As in the rules for corporate exposures, the benchmark risk weights (BRW_R) for retail exposures are basically too high. Although the Basel Committee stresses that, unlike under the IRB approach for corporate exposures, the risk weights specified are only intended as illustrative examples, the risk weights BRW_R are much higher than those which we calculated in our proposed master scale for portfolios with a high granularity (see p. 20 of the ZKA comments of 10 March 2000 on the first Basel consultative document):

PD (in %)	BRW_R	ZKA[14]
0.03	6	3.5
0.05	9	3.5
0.1	14	5.0
0.2	21	9.0
0.4	34	9.0
0.5	40	15.0
0.7	50	15.0
1	64	15.0
2	104	32.0
3	137	32.0
5	195	32.0
10	310	46.0
15	401	46.0
20	479	52.5
30	605	n.a.

This difference is due particularly to the fact that the Basel Committee – as when setting the risk weights for corporate exposures – wants to have the expected loss (EL) covered with capital alongside the unexpected loss. We therefore refer to our remarks in this connection concerning corporate exposures (see page 49 f. above).

[14] It should be noted that the ZKA did not calculate any risk weights for an LGD of 50%. Calculation of risk weights in the master scale was based on an LGD of 100%. The risk weights would thus have to be reduced accordingly.

Here, too, fixing the other parameters in the formula for deriving the BRW_R is problematic for the same reasons as with corporate exposures (see page 51 above). For example, our master scale proposal for a portfolio with a high granularity produces much lower risk weights, although we assumed a remaining return/recovery rate of 0% (LGD = 100%). Moreover, the average correlation of 10% assumed (see paragraph 302 of the supporting document) appears too high. In our experience, it tends to be nearer 0%. Paragraph 313 of the Supporting Document on the IRB approach also stresses the danger that risk may be overstated particularly in the case of borrowers with a higher probability of default. This is backed up by calculations with internal credit risk models of ZKA banks. Here, too, disclosure of the credit risk model on which calibration is based and how the formula is derived from the model or from a number of models is required before we can comment on and understand this approach more fully.

We do not think it would be right to possibly allow different risk weight formulae for different product types (paragraph 430). Apart from the fact that we reject mandatory segmentation by product group (see in this connection our remarks on page 72), the relatively subordinate importance of unexpected losses in retail portfolios makes any further differentiation superfluous. There is, moreover, nothing to indicate that several risk weight formulae make sense, as pointed out in the Supporting Document. This means that further differentiation would then have to take effect all the more in the C&I area as well.

(ii) Risk inputs (paragraphs 431-437)

No foundation approach for retail IRB is planned. We believe this is wrong and unfounded. To promote the transition to the IRB approach in general, an exclusively PD-based approach should be allowed in this area as well. For this foundation approach, we propose that, like in the foundation approach for corporate IRB, an appropriate LGD should be used. It is pointed out in the Supporting Document that there are good reasons for doing so. The relatively minor importance of unexpected retail losses by no means justifies tougher rules in this portfolio segment than in the corporate customer segment.

We also support the aim of not stipulating any minimum number of rating/scoring grades for the retail segment. To ensure sufficiently homogeneous and stable portfolios, also over time, it should suffice if the capital charge is determined on the basis of an overall PD/EL ratio.

The Basel Committee states that risk weights in retail business can be determined either via a PD/LGD approach or via the expected loss (EL). For this purpose, the Committee proposes two methods in the Supporting Document on the IRB Approach (see p. 65, paragraph 314 f.):

either (1) determining the historical PDs and deriving from these the relevant LGD value per risk segment via the formula LGD = EL/PD or (2) determining all reasonable PD/LGD combinations that yield a given value of EL via the formula EL = PD x LGD, then incorporating the PD and LGD values determined into the formula for computing BRW_R and, finally, using the highest risk weight obtained.

While the first option imposes more of a data collection workload, the second option merely means an increased computational workload, although it normally leads to higher risk weights. Since the Basel Committee finds in any case that retail sector data are highly bank-specific and cannot automatically be compared, every bank should be left to decide at its own discretion which of the two methods it wishes to use.

It is not completely clear from the Consultative Document whether banks are allowed to use the credit conversion factors (CCFs) set by supervisors under the foundation approach for corporate customers alongside their own EAD estimates. To give as many banks as possible an incentive to use the IRB approach for retail business, these should be allowed as an alternative to the use of banks' own estimates of EAD.

2. Minimum requirements for retail exposures (paragraphs 438-478)

(ii) Criteria to ensure a meaningful differentiation of risk (paragraphs 439-453)

(a) Minimum requirements for segmentation (paragraphs 443-447)

The proposed minimum requirements for segmentation of retail portfolios must be rejected. We believe that segmentation should generally be left to the discretion of banks. The appropriateness of a chosen segmentation must be demonstrated by banks within the framework of validation. As segmentation of retail portfolios generally leads to a more differentiated allocation of economic capital and possibly also to a reduction of the regulatory capital charge, this also gives banks sufficient incentive to segment portfolios appropriately.

Segmentation in line with the Basel Committee's proposals would, as we understand it, also imply that the segments set by supervisors would have to be retained for all time. This would hinder the continuous improvement of rating systems and thus be at odds with the declared aim of the Basel Committee. Banks should therefore generally be free to subsequently change any segmentation they have opted for, subject to compliance with the other requirements for prudential recognition.

There is no disputing that the segmentation criteria set by the Basel Committee *may* be suitable differentiating features. This should not, however, mean that they *must* be used. They should instead merely serve as examples.

Rating systems used in the retail segment should be able to differentiate properly between different borrower risk. However, not only scoring methods should be recognised by supervisors for this purpose (see in this connection also paragraph 454). The choice of method should, in principle, be left to the discretion of banks here, too.

Implementation of the Basel Committee's proposals would also mean taking all conceivable combinations into account and – depending on the minimum number of segments into which borrower risk has to be subdivided – differentiating and managing risk on the basis of a large number of segments. This is at odds with banking practice in the retail sector and contradicts the Committee's aim of providing relief in this sector not only because of its special risk profile but also because of the possibility of standardised processing of loans to retail customers. A requirement to differentiate more strongly according to numerous criteria would mean economically unjustified management complexity for typical universal banks in particular, which focus more on the relationship with the customer and less on individual products. Where universal banks are concerned, focusing on the relationship with the customer is also appropriate for measuring risk, as borrowers do not default product-specifically.

(c) Number of exposures within a segment (paragraphs 450-451)

According to the Basel Committee, banks must ensure that the number of loans in a given segment is sufficient so as to allow for reasonable power in the statistical tests used to quantify segment-based loss concepts (paragraph 450). There should also be no "*undue concentration*" of the bank's total retail exposure in any single risk segment (paragraph 451). We refer in this connection to our remarks on the equivalent passages concerning the treatment of corporate exposures in the IRB approach (page 58 f.).

(d) Criteria in allocating exposures to segments (paragraphs 452-453)

Banks must take into account all "*factors that are relevant to the analysis of risk*" when allocating exposures to individual segments. As already explained in connection with the treatment of corporate exposures in the IRB approach, the choice of rating criteria should be

based solely on their ability to differentiate risk. See in this connection also our remarks on page 61.

(iii) Completeness and integrity of rating assignments (paragraphs 454-457)

(a) Coverage of ratings (paragraph 454)

We reiterate our demand that banks be allowed to perform the assignment of exposures to individual segments called for by the Basel Committee by means of methods other than scoring methods.

(b) Independent review (paragraphs 455-457)

The frequency of the regular review to determine whether the assignment of certain customers to a segment has changed should also be made dependent on the segmentation criteria chosen. The annual (and, in the case of poor-quality borrowers, more often than annual) review of ratings called for by the Basel Committee is inappropriate for the retail customer segment in our opinion. An annual review, not of individual ratings, but – within the framework of validation – of the adequacy of the segmentation criteria, should be called for instead.

(iv) Oversight over rating system and processes (paragraph 458)

The requirements in this area should be the same as those in the corporate customer sector. We therefore refer to our remarks in connection with the latter.

(v) Criteria on orientation of rating system (paragraphs 459-461)

(b) Time horizon (paragraph 461)

The Basel Committee stipulates that rating grades must be reviewed at least once a year. We feel that this is unreasonable for the retail customer segment. We refer in this connection to our above remarks on the independent review of rating assignment. How often rating grades are reviewed on an ongoing basis is something that should, in principle, be left to banks. It can be checked within the framework of the Supervisory Review Process (Pillar 2).

(vi) Requirements for estimation of EAD, and either (a) PD/LGD or (b) EL (paragraphs 462-472)

Banks must provide an explicit estimate of both PD and LGD, separately identified, or EL, for each segment. In addition, banks must provide an explicit estimate of the exposure amount for each transaction. This means that much higher requirements are set for the IRB approach for the retail customer segment than for the IRB foundation approach for corporate exposures and that requirements are brought more into line with the advanced IRB approach.

As already explained elsewhere (page 69), it is not possible for all banks at present to estimate EAD on their own. To give as many banks as possible an incentive to use the IRB approach for the retail customer segment, they should be allowed to use the credit conversion factors (CCFs) set by supervisors for the foundation rating approach for corporate customers instead of their own EAD estimates in the retail customer sector. Moreover, as already mentioned (page 71), use of an appropriate standard LGD should also be allowed for uncollateralised loans. In line with the standardised approach, this must apply all the more to exposures secured by residential property.

In the estimation of LGD and EL, losses should be understood to be "economic losses". This means that, discount effects, funding costs, as well as direct and indirect costs associated with collecting on the instrument, should be included in the determination of loss. Banks should therefore not simply use the loss recorded in accounting records, although they should be able to compare the two (paragraph 462). We refer in this connection to our remarks on the use of "economic losses" in the estimation of LGD and EAD for corporate exposures.

As with estimates of corporate exposures, estimates of risk input parameters must be based on a long-run average, but should also contain a forward-looking element (paragraph 464). We also refer in this connection to our corresponding remarks on corporate exposures (page 62).

As regards the requirements in respect of the data history for PD estimates for retail exposures, we refer to our above remarks (A. Mechanics of the IRB Approach – 4. Transition period for data requirements) The requirement that all relevant data sources must be used as comparative sources is, in particular, neither reasonable nor technically necessary.

As regards the definition of default, we also refer to our above remarks (A. Mechanics of the IRB Approach).

(ix) Internal validation (paragraph 477)

As regards validation of PD, LGD and EAD estimates, the same minimum requirements as for corporate exposures will apply. We therefore refer to our remarks in connection with the latter.

(x) Disclosure requirements (paragraph 478)

As regards compliance with specific disclosure requirements as a condition for eligibility for the IRB approach for retail customers, we refer to our remarks on Pillar 3 (see pages 134, 147 below).

D. Rules for Sovereign Exposures (paragraphs 479-494)

For inclusion of sovereign exposures in the IRB approach, the same requirements as for the treatment of corporate exposures should, in principle, apply. We therefore refer to our above remarks on the latter (page 57), particularly to the freedom regarding the choice of rating criteria called for by us. This latter should apply to rating of sovereigns as well.

We reject in particular the requirement for banks to use information on spreads from traded securities when rating sovereigns. In addition to the credit standing of the issuer, this information is influenced by numerous other market factors. The transfer risk in the case of exposures to sovereigns in their own currency should also not be taken into account.

Most German banks will not have any better information than external credit assessment institutions (ECAIs) on the creditworthiness of sovereigns. In addition, sovereign rating coverage ought to be more or less complete.
For this reason, banks should be allowed to use the PDs of recognised ECAIs instead of their own PD estimates for internal assessment of sovereign risk. There should also be a such an option for exposures to multilateral development banks, which are treated like sovereigns under the Standardised Approach.

If ratings of several recognised ECAIs are available, the rules provided for such cases under the Standardised Approach should apply. Since validation of PDs must meet strict standards already at ECAI level, the prudential requirements for internal validation by banks should be reduced accordingly where externally determined PDs are used.

E. Rules for bank exposures (paragraphs 495-502)

Most German banks will not have any better information than ECAIs on the creditworthiness of other banks. However, rating coverage for this area – particularly for small banks – will be lower than for sovereigns. We therefore suggest that banks should be allowed to use the PDs determined by EACIs for exposures to banks which have an external rating. As pointed out in our remarks on the treatment of sovereign exposures,
the prudential requirements for internal validation should also be reduced accordingly in this case.

Approach to equity exposures for IRB banks

In the Supporting Document on the Internal Ratings-Based Approach, the Basel Committee outlines its ideas on the treatment of equity exposures for IRB banks. One option it is considering is including these – like the approach to corporate exposures – in the IRB approach. This approach would, in the Committee's view, be appropriate for equity investments that are not primarily held with an intent to resell for capital gain purposes.

Inclusion of equity exposures in the IRB approach is, we believe, a practicable way to achieve a capital regime geared more strongly to the true risk profile of equity exposures as well. In our opinion, banks should be allowed to include any form of equity exposure in the IRB approach. This possibility should be independent of (a) banks' motives for holding such equity exposures and (b) of the question of whether or not the exposures in question are exchange-listed.

We believe that the inclusion of equity exposures in the IRB approach would not pose any great problems. The minimum requirements should generally be the same as for corporate exposures. However, in order to accommodate the special features of this type of exposure, two modifications should be made:

The Basel Committee rightly stresses that, if equity exposures are included in the simplified IRB approach, this raises the question of an appropriate regulatory LGD. Given the subordination of equity exposures, a higher LGD for this type of exposure than for uncollateralised senior exposures could be justified. Compared with the LGD of 50% for loan exposures, the LGD of 100% proposed by the Basel Committee is, however, much too high and counter-productive in terms of economic policy. We therefore suggest that, because equity

exposures carry a similar risk, the same LGD should be set for them as for subordinated debt (i.e. 75%) for the purposes of the foundation IRB approach.

We welcome the Basel Committee's proposal that the definition of default should generally be based on default by the borrower on other claims (cross-default).

According to the Basel Committee, an argument against inclusion of equity exposures in the IRB approach is that such an approach would not be suitable for capturing the intensity of loss associated with equity positions, as the market value of such a position may fall significantly before default. This overlooks the fact that changes in the value of assets have not been captured so far when setting the capital requirement for the banking book. It would not be fair to depart from this approach merely in the case of equity positions. The Basel Committee rightly points out that such an argument would also apply to other tradable corporate debt instruments. In addition, if the lower of cost or market rule is applied, the existing limits for counting Tier 2 capital in general and hidden reserves in particular mean that, where a drop in market value above the book value occurs, the regulatory capital decreases to a much lesser extent than the change in market value. For this reason, banks' risk-carrying capacity scarcely declines where such a change in market value occurs.

The demand raised on occasions that, when determining the exposure for equity positions, such positions should be stated at their market value instead of their book value must be categorically rejected. Here, too, this would mean departing from the established banking book approach in just one area.

Finally, because of the growth of banks' equity exposures in Germany, the market value approach would mean a significant increase in their capital requirements and thus a deterioration of their competitiveness. For existing equity exposures in particular, the current capital charge should therefore be retained unchanged ("grandfathering").

F. Calculation of IRB Granularity Adjustment to Capital (paragraphs 503-515)

1. Definition and Scope of Granularity Adjustment (paragraphs 503-506)

The ZKA associations unanimously agree that risk concentration or risk diversification needs to be taken into account in determination of banks' capital requirements. For this purpose, we call for the inclusion of portfolio effects, which can only be captured absolutely properly by the – ideally – simultaneous recognition of credit risk models.

As, however, the Basel Committee has repeatedly stated that it does not intend to recognise credit risk models at the present time, it proposes to limit the inclusion of risk concentration/diversification, in an intermediate step, solely to consideration of granularity.

The majority of the banking associations in the ZKA welcome consideration of granularity as a first step towards full recognition of portfolio effects[15]. However, the Basel Committee's proposal for granularity adjustment urgently requires improvement in several respects.

To start with, it is absolutely essential that baseline calibration is actually adequate for risk purposes (see remarks above) and that the granularity adjustment to the baseline level of risk-weighted assets is appropriate in relation to the baseline calibration portfolio.

Moreover, the effect of diversification measures is inadequate in the context of the parameters provided for in the Consultative Document. As in the Consultative Document in general, risk is overstated – crassly, in some cases – particularly in the case of medium and poor creditworthiness. Small and medium-sized businesses are also put at a disadvantage by granularity. For banks, this means that unjustifiably high, critical capital charges can also occur if large loan exposures migrate to poorer rating grades. A comparison with credit risk models also reveals sharp distortions. Overall, critical leverage effects are to be expected. Yet, given the complexity of the proposed granularity adjustment, any in-depth analysis of these effects is virtually impossible. The Consultative Document fails to set out the economic rationale needed to allow more detailed comments.

It is also gives food for thought that, because of the critical effects of the interaction of baseline calibration and granularity adjustment, measures that objectively reduce risk do not have the required or desired effect, although precisely this is a key objective of Basel II.

(i) Exposure aggregation (paragraph 504)

The whole section on granularity adjustment fails to make clear on which level data must be aggregated and (weighted) averages calculated. Different procedures may produce different

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[15] The Association of German Banks (BdB) and the Association of German Mortgage Banks (VdH) reject consideration solely of granularity as an intermediate step, as they fear serious competitive effects to the detriment of internationally diversified banks. The BdB and the VdH call instead for full consideration of portfolio effects by way of simultaneous recognition of credit risk models. They point out that they therefore do not subscribe to the following remarks on granularity adjustment to capital.

results. However, we assume that averages will be calculated on an aggregated basis across all non-retail portfolio activities and not individually for each exposure class.

It is also unclear whether the rating grades are sub-classes of the exposure classes or whether sovereigns, banks and corporates with the same rating, i.e. with the same PD, will be treated together. Here, too, we take it that an aggregated approach will be applied.

It is also unclear whether corporate groups are to carry out granularity adjustment solely at group level or whether granularity adjustment is first to be carried out individually and the results aggregated later. The same goes for consolidated banks.

Before calculation of granularity adjustment, borrowers with high default correlations are to be combined into a single borrower. Related borrowers are to be identified on the basis of national rules for limiting credit risk concentrations to single borrowers – under German law, this would be Section 19 (2) of the Banking Act. A problem in this connection is that the definition of "single borrower" under Section 19 (2) of the German Banking Act is not (completely) adequate for risk purposes. Compliance with this provision for the purposes of granularity adjustment may, for legal reasons, result in the emergence of very large single borrowers without any real or sufficiently high default correlation. Instead, the default correlation should be determined by the level of real economic dependence among different borrowers and thus more strongly by the actual risk. As an alternative, an approach providing for net treatment of exposure amounts (i.e. after deduction of collateral) on the basis of Section 19 (2) German Banking Act and the definition of "single borrower" set out therein, could be discussed.

(ii) Treatment of guarantees and credit derivatives (paragraph 505)

The rule that, where banks have received regulatory capital relief on exposures through recognition of guarantees or credit derivatives, such exposures will be regarded as exposures to the guarantor or seller of the credit derivative, raises the danger that a portfolio secured by guarantees will, overall, be subjected to a higher capital charge than an identical portfolio that is not secured by guarantees. This will lead to supposed cluster risks and thus to granularity add-ons particularly where a large number of transactions are secured by a guarantee but the number of guarantors is very small (e.g. in the case of federal or Land guarantees). Where the number of guarantors is correspondingly low, these add-ons may cancel out the capital relief obtained beforehand by taking into account the risk-mitigating effect of the guarantees or credit derivatives and require banks to provide more funds exceeding the capital savings made under individual risk weighting.

Particularly in the case of banking-group institutions which conduct risk-mitigating transactions with their central bank, there is the danger that the capital charge may soar because of the cluster risk with the central bank. The implications are completely unacceptable; they are at odds with the aim of Basel II and utterances made by high-ranking supervisors.

2. Methodology for Calculations (paragraphs 507-515)

Simulations on the basis of the Basel Committee's proposals for granularity adjustment have shown that, in the case of poorly diversified portfolios, the value of granularity adjustment may significantly exceed the level of risk assets before adjustment. In contrast, what the Basel Committee regards as optimal granularity only allows a deduction of 4% on the baseline level of risk-weighted assets. Moreover, on migration of customers of a steady portfolio to poorer risk grades, the higher capital charge applying in any case due to the deterioration in credit quality is compounded by an unjustified granularity add-on.

All this leads, on the one hand, to an uneven, overproportionate burden for banks with higher cluster risks and may mean that the IRB approach will be put at a disadvantage compared with the standardised approach, in which such an adjustment is not made, while, on the other hand, optimally diversified portfolios do not receive adequate capital relief.

This imbalance must be removed. Precisely because of the distortions that occur during granularity adjustment, the question of recognition of internal credit risk models should be looked at once again. These can solve the problem of adequate risk weighting of individual exposures and measurement of portfolio granularity much more appropriately and simply.

(i) Calculation of aggregate characteristics (paragraphs 510-513)

It must be determined how LGD_b is to be measured, e.g. as exposure-weighted LGDs in rating grade b. However, hedging measures should definitely be taken into account in this connection.

It must also be clarified how EAD is to be determined in the case of fund units. It is proposed that, by way of approximation, the current book value be used.

IV. Asset securitisation[16] (paragraphs 516-546)

Preliminary remarks

The Basel Committee's intention to establish uniform, global prudential rules for securitisations helps to create a level playing field in this field and is explicitly welcomed, especially since at present national rules are determined to a large extent by the particularities of national legal regimes (e.g. of accounting rules). To achieve a level playing field at international level, it is therefore necessary to establish prudential rules which set mandatory minimum regulatory requirements for all countries and are independent of individual national legal regimes. We therefore believe that any national discretion allowed should be dropped from the rules.

With regard to capital requirements, it must also be ensured, regardless of the approach chosen (standardised approach or IRB approach), that the overall capital requirements of all banks involved in a securitisation transaction are at least no higher than the capital requirements that would result if the assets were not securitised, as in banking business the credit risk of the underlying asset pool is not affected by the securitisation transaction.

Asset-backed transactions and synthetic securitisations, if used sensibly and structured professionally, can be an important risk-based portfolio management tool and also allow smaller companies to shift or hedge their risks. Not least, they also enable banks to manage risk efficiently. The restrictive treatment of such transactions now being considered by the Basel Committee will seriously impair a functioning market.

A point of criticism is that some of the proposed rules are still incomplete or only outlined in brief. This goes particularly for the treatment of synthetic securitisations and the inclusion of securitisations in the IRB approach. It is therefore essential that work in these areas in particular is continued in close contact with the banking industry even after expiry of the consultation period.

[16] The Association of German Banks wishes to point out that the comments on IV. "Asset Securitisation" are subject to approval by its committees.

1. The treatment of explicit risks associated with securitisations under the standardised approach (paragraphs 518-536)

(i) Treatment for originating banks (paragraphs 518-523)

(a) Minimum operational requirements for achieving a clean break (paragraphs 518-519)

Accounting rules differ from country to country and also pursue a different aim than prudential standards. For this reason, answering the question of whether securitised assets should no longer be recognised for regulatory capital purposes must not depend on whether or not these assets have to be shown in the balance sheet under national rules.
In the case of true sale structures, what should matter for prudential purposes is that the securitising bank no longer has any power of disposal over the securitised assets. To this end, minimum regulatory standards that must be applied internationally without regard to national legal regimes should be established.

It should be made clear in this connection that retaining residual risks does not rule out compliance with the criteria for a clean break, as long as suitable treatment of these risks is ensured.

(b) Minimum capital requirements for credit enhancements (paragraphs 520-522)

According to the Basel Committee (paragraph 520), originators and loan servicers that provide credit enhancement must deduct the full amount of the credit enhancement from capital, taking into account the risk-based capital charge that would have been assessed if the assets were held on the balance sheet.

This requirement is not clear. It is made even unclearer by the reference to the capital weights that have to be applied by a bank investing in asset-backed securities (ABS) (paragraph 526). This could mean that banks should (a) deduct the credit enhancement from capital, (b) cover it with capital as if the asset were still held on the balance sheet, or (c) cover it with capital as if they had invested in such an ABS.

In our view, when setting the capital requirements for credit enhancements that have been provided, it should first be borne in mind that only unexpected losses need to be covered with capital for prudential purposes. Expected losses, on the other hand, are normally already

covered by banks via risk premiums. If loans and income earned on these (e.g. interest payments) are transferred under securitisation structures to a special-purpose vehicle (SPV), the originating bank no longer receives any risk premium. In these cases, where credit enhancements by means of first-loss retention or credit guarantees to the SPV up to the amount of the expected loss are involved, a deduction from capital is therefore appropriate. Any losses on the securitised portfolio lead to a reduction in the period profit and thus indirectly to a reduction in the balance sheet capital of the credit-enhancing bank. The amount deducted should therefore be reduced accordingly by the amount of the loss incurred. Full deduction from capital of the credit enhancement is also not justified if income (e.g. via an interest rate swap) is available to the asset seller from the assets sold.

Forms of credit enhancement described above that go beyond first-loss should, on the other hand, be treated like “normal” risk assets in accordance with the arrangements under the modified standardised approach.

Credit enhancements which create reserves at SPV level to cover the expected losses, such as over-collateralisation (the volume of assets transferred to the SPV exceeds the nominal value of the securities issued by the SPV) or purchase price discounts (the purchase price paid by the SPV for the assets is lower than the book value), are included as costs in the profit and loss account, reduce earnings and thus indirectly also the balance sheet capital. There should therefore be no requirement to provide additional capital in these cases.

The Basel Committee also suggests that, subject to national discretion, second-loss credit enhancement may be treated as a direct credit substitute. The condition for this is a significant first-loss protection that must be provided by a third party and may elevate the credit quality of the second-loss enhancement to an investment grade level (BBB- or better). Alternatively, a second-loss enhancement may also be deducted from capital.

This arrangement appears to imply that a second-loss credit enhancement may also generally be deducted from capital. This is inappropriate. As already explained, a deduction from capital is only justified for retained first-loss positions equivalent to the amount of the expected losses. Second-loss credit enhancements that are not designed to cover expected losses should, on the other hand, be treated as normal risk assets in an internationally uniform manner. In this connection, it should not matter who provided the first-loss credit enhancement. The rating of the second-loss position should not matter either, as higher unexpected losses automatically lead to a lower rating and thus to a higher capital charge. However, it is unclear how these tranches are to be covered with capital if the rating cannot be taken as a basis.

The Basel Committee also proposes that the notional amount of the second-loss should be covered with capital. This is not justified either. As with other risk assets in the banking book, the assessment basis for second-loss tranches should be the book value.

The Basel Committee believes that, apart from contractual provisions for providing short-term liquidity, originators or loan servicers should not be allowed to provide cash advances or liquidity facilities to the SPV to cover short-term deficiencies in cash flow. Subject to national discretion, supervisors are to be allowed to permit the servicer (but not the originator) – where contractually provided for – to advance cash to ensure an uninterrupted flow of payments. This is, however, only to be possible if certain conditions are fulfilled.

Liquidity facilities provided by originators to loan servicers are an important refinancing tool for SPVs if disturbances make refinancing in the marketplace impossible. It is essential that the provision of such facilities is also allowed at supervisory level. It should only be prohibited in cases where the provision of liquidity facilities is for the purpose of funding losses on portfolios. Drawing on a credit line after the failure of the SPV should also be prohibited.

It should also be noted that the rules on the provision of liquidity facilities should, from a risk angle, be independent of whether such liquidity facilities are provided by the originator or the servicer or by third parties.

Unused liquidity facilities should be assigned a credit conversion factor of 20% and generally risk-weighted at 100%. We feel that, subject to fulfilment of the above-mentioned conditions, special treatment of liquidity facilities provided to SPVs is unwarranted. It should generally be possible for an SPV to receive a rating that reflects its risk. For this reason, the rules on liquidity facilities in the modified standardised approach should be applied.

(c) Minimum requirements for revolving securitisations with early amortisation features (paragraph 523)

Revolving credit securitisations[17] which provide for an early wind-down of the securitisation programme if the credit quality of the underlying asset pool deteriorates significantly are to be

[17] "Revolving credit" is understood by the Basel Committee to be credit where the customer can himself determine the amount of the credit within certain limits (e.g. credit card facilities, overdrafts, loan commitments, etc.). The securitisations are mainly collateralised loan obligations (CLOs). These should not be confused with the revolving sale of assets.

assigned a minimum conversion factor of 10% on the notional amount of the securitised asset pool, even if the “clean break” criteria are fulfilled.

This proposal must be rejected, as there is no evidence of any special risk. Early amortisation merely means that that no new facilities are included in the securitisation programme. Banks are not, however, required to repurchase existing, already securitised assets. Facilities used after commencement of the wind-down are covered with capital by banks in accordance with the arrangements under the modified standardised approach.

(ii) Treatment for investing banks (paragraphs 524-530)

Capital requirements for banks’ investments in ABS are to be based on the ratings provided by eligible external credit assessment institutions (ECAIs). According to the Basel Committee, securitisation tranches will be risk-weighted as follows :

External Credit Assessment	**AAA to AA-**	**A+ to A-**	**BBB+ to BBB-**	**BB+ to BB-**	**B+ and below or unrated**
Tranches	20 %	50 %	100 %	150 %	Deduction from capital

Special risk weights for ABS must be rejected. The Basel Committee bases calculation of risk weights on issue ratings in the standardised approach too. In our opinion, investments in ABS should be risk-weighted at the same rate as non-securitised assets. This view is backed by rating agency studies (e.g. Fitch Ibca of 8 January 2001), which show that ABS do not generally carry a higher risk of default than normal risk assets. As the rating reflects the risk regardless of the type of asset, there is no justification for higher risk weights. The planned deduction from capital for ABS with a rating of B+ and below must, in particular, be rejected. Risk weights should, moreover, be set regardless of whether the investment is in own or third-party ABS.

The rules for senior ABS which are part of a securitisation structure that is not rated do not take adequate account of diversification effects and credit enhancements. The general deduction from capital of unrated ABS does not appear justified. A weighting of not more than 150% would be appropriate here. Furthermore, implicit ratings should also be recognised. If, alongside an unrated tranche, there exists a second tranche that is subordinate to the unrated

tranche, and if this second tranche has an external rating, it should be possible to apply the risk weight of the rated tranche to the unrated tranche.

According to paragraph 529, the unrated senior tranche of an underlying pool of an ABS that qualifies for the look-through approach and that is composed of assets that are assigned to different risk weight categories may be assigned a risk weighting according to the highest risk-weighted asset that is included in the underlying asset pool. We believe that there is no justification for this and suggest a weighted average approach.

(iii) Treatment for sponsoring banks (paragraphs 531-536)

If, in conduit programmes, banks sponsor SPVs that purchase assets from non-banks and place these on the market and if they provide credit enhancements and liquidity facilities for such securitisation, we feel they should be treated in the same way as other providers of credit enhancements and liquidity facilities. There is no justification from a risk angle for different treatment.

2. Securitisation under IRB: A hybrid approach (paragraphs 537-542)

A point of criticism is that the proposals for a securitisation treatment for IRB are still incomplete. It should therefore be ensured that the proposals can be further elaborated in close contact with the banking industry even after expiry of the consultation period.

(i) Issuing banks (paragraphs 539-540)

According to the Basel Committee, banks issuing securitisation tranches would be allowed to deduct from capital the full amount of retained first-loss positions, regardless of the IRB capital requirement that would otherwise be assessed against the underlying pool of securitised assets. As already explained, we do not feel that this is appropriate in every case. We therefore refer to our remarks on the treatment of first-loss positions under the standardised approach (page 84 f.).

The Committee is also considering whether issuing banks that retain tranches with an explicit rating from a recognised ECAI could apply an IRB capital requirement tied to that rating which follows the approach for externally rated tranches held by investor banks.

It should be noted that, when calculating the capital requirements for issuing banks, preference should generally be given to the IRB approach. Issuing banks have enough information at their disposal to be able to determine PDs on the basis of their internal rating systems. Accordingly, use of a ratings system recognised by supervisors should be allowed also for determining the capital requirement for retained tranches.

Excursus I:

A paper circulated by the Basel Committee's Joint Securitisation IRB Group on 15 February 2001 contains proposals for a completely different approach for calculating the capital requirements for originating banks. This Working Group goes much further than the Basel Committee in its negative assessment of securitisation. It suggests that the only reason for securitisation is regulatory arbitrage and challenges the view that securitisation is normally motivated by economic considerations, i.e. that it is used for risk transference and portfolio management purposes.

Under the so-called "foundation approach", supervisors are to determine by what percentage the capital requirements for all securitisation tranches are to be allowed to exceed the capital requirements that would result for banks if they applied the IRB approach to the exposures included in securitisation, the "reference capital level" (so-called "add-on") The most subordinated tranches (possibly also parts of tranches) are to be deducted from capital up to the reference capital level. For calculation of the capital requirements for the more senior tranches (or parts of tranches), the Working Group proposes "spreading" the add-on across the other tranches by means of a formula set by supervisors.

The conclusion that can be drawn from these ideas, i.e. prohibitive treatment, is in our opinion likely to make the securitisation of banks' own assets and their placement on the banking market unattractive in general.

We therefore categorically reject these ideas. As already explained in our preliminary remarks, it must be ensured that the overall capital requirements of all banks involved in the securitisation transaction are at least no higher than the capital requirements that would result if the assets were not securitised.

(ii) Investing banks (paragraphs 541-542)

For banks investing in ABS, the Basel Committee proposes to rely primarily on ratings provided by ECAIs. This is inappropriate in our opinion. Should investing banks have enough information at their disposal to determine PDs on the basis of their internal rating systems, they should be able to use rating systems recognised by supervisors to determine their capital requirements as well.

The Basel Committee also proposes to generally apply a 100% LGD to investments in ABS. There is no justification for this, as in the event of bankruptcy ABS creditors are treated on a par with original asset creditors and, moreover, there is no difference in regard to collateralisation. Like with uncollateralised exposures, a standard 50% LGD should be set under the IRB foundation approach for ABS as well. Under the advanced approach, the LGD could be determined accordingly by banks themselves.

Unrated tranches are viewed as evidence of low credit quality and should be deducted from capital. While we believe this is generally appropriate, implicit ratings should also be recognised under the IRB approach. See in this connection our remarks on page 86 f.

3. Treatment of implicit risks and residual risks arising from securitisations (paragraphs 543-545)

Implicit recourse, i.e. provision of support to a securitisation transaction by a bank that exceeds its contractual obligations, is to be heavily penalised. Due account should be taken in this connection of the principle of proportionality.

Excursus II:

The treatment of explicit risks arising from synthetic securitisations (paragraph 68 ff. of the Supporting Document on Asset Securitisation)

Synthetic securitisations are an important portfolio management tool for banks, particularly in the area of medium to long-term securitisations (so-called “term ABS”). According to Moody’s, 14 of the 15 term ABS in Germany last year were synthetic. At the same time, the volume of such transactions jumped by over 70%. According to Merrill Lynch & Co., the total volume of synthetic securitisations in Europe more than doubled in 2000 to almost $ 40 billion. These transactions are expected to play an even more important role in the future. For this

reason, the Basel Committee’s intention to harmonise the prudential treatment of such transactions at global level is expressly welcomed.

Such harmonisation is required particularly also because of the rules in force in the United States. These result in what are in some cases serious competitive disadvantages for German banks, especially where banks act as guarantors in synthetic securitisation transactions. Whereas, for example, US guarantor banks that have an adequate internal risk management system only have to risk-weight a credit default swap linked to a super senior tranche at 20%, regardless of the risk weight assigned to each borrower, German banks are required to risk-weight such instruments at 100%.

What must be criticised, however, is that the proposals for the treatment of synthetic securitisations are still incomplete. It should therefore be ensured that these proposals can be further elaborated in close contact with the banking industry even after expiry of the consultation period.

A. Degree of risk transference

Retention of first-loss

According to the Basel Committee, retained first-loss positions in synthetic transactions are also to be deducted from capital. This is inappropriate. In measurement of the capital charge for first-loss on synthetic securitisations, it should be borne in mind that under the current prudential rules only unexpected losses need to be covered with capital. Expected losses, on the other hand, are covered by the risk premiums accruing. Unlike true sale ABS, assets in synthetic securitisations remain on the balance sheet of the originating institution. For this reason, the exposure risk premiums covering the amount of the expected losses accrue to the bank during the term of the exposures. Provided it is ensured that the originating bank will receive interest income equivalent to the size of the expected losses, it is not necessary to cover the part of the first-loss position containing the expected losses with capital.

Retained portions of the first-loss position that exceed expected loss should, like true sale ABS, be treated for regulatory capital purposes as “normal” risk assets in accordance with the arrangements under the modified standardised approach.

Also under discussion is whether the first-loss position should be limited to expected losses. This must be rejected. First-loss positions that exceed expected losses should be treated as

"normal" risk assets in accordance with the arrangements under the modified standardised approach. In this way, the risk incurred by the originating bank would be adequately addressed; restriction of the first-loss position to the amount of expected losses is unacceptable. Such a restriction is, moreover, at odds with market practice. Rating agencies normally expect a first-loss position that at least slightly exceeds expected losses. Banks should be given enough scope in this connection for gearing transactions to capital market and investor requirements.

Retained/repurchased senior/mezzanine risk

The Basel Committee is discussing the principles and the operational requirements which would make it acceptable for the originating bank to retain the senior risk position. We believe that retention of a senior risk position should definitely be possible. The risk of the position is reflected either in the internal rating provided by a rating system recognised by supervisors or, where the standardised approach is concerned, in the rating provided by a recognised rating agency and is covered with capital by banks in accordance with the arrangements under the modified standardised approach. No special requirements are therefore needed.

Retention of both first-loss and senior risk

If the originating bank holds both the first-loss and the senior risk positions, the Basel Committee believes that in an extreme case it could transfer only DM 1 worth of risk to the market and thus reduce its capital requirements significantly while still effectively maintaining the same risk. To avert such a situation, the Basel Committee is considering the following options:

1. Require that the retained first-loss be restricted to expected loss in order for the retained senior risk to qualify for the lower capital requirement ;
2. Require a minimum percentage of the nominal amount of the portfolio to be transferred to the market;
3. Require a minimum transfer of risk to the market, i.e. notes issued to the market must be AAA;
4. Impose a minimum time period for which notes must be in issue prior to repurchase;
5. Do not recognise any implicit rating on retained or repurchased senior positions but apply the capital charges as set out for unrated structures in traditional asset-backed security structures.

It is correct that asset securitisation may enable banks to obtain lower capital requirements than those under the modified standardised approach. However, the capital savings result in this case from the fact the use of external ratings allows a capital charge more strongly geared to the actual risk of the securitised portfolio for non-externally rated assets as well. This is one of the targets explicitly pursued by the Basel Committee in its revision of the Capital Accord and should therefore not be penalised at supervisory level. Branding such an approach from the start as “capital arbitrage” is totally unreasonable. For this reason, all restrictions on the retention of first-loss and senior risk should be dropped.
The requirements proposed above meet with the following reservations:

1. Restriction of the first-loss position to expected loss is unacceptable (see above).
2. The requirement that a minimum percentage of the nominal amount be transferred to the market is unnecessary. Also, due to the diversity of possible transactions (e.g. depending on the structure of the securitised portfolio or investors’ preferences), it could not reasonably be determined.
3. The requirement of a minimum transfer of risk to the market is unnecessary and should therefore be dropped. Moreover, the risk transferred to the market is likely to be small particularly in the case of AAA-rated securities.
4. Imposition of a minimum time period for which notes must be in issue prior to repurchase must be rejected. In order to support the market, banks must at least be able to repurchase part of the notes issued to the market.
5. The proposal that unrated senior tranches be treated for regulatory capital purposes like unrated structures in traditional asset-backed security structures must be rejected. Here, too, “implicit ratings” should be recognised (see our remarks on page 86 f.).

B. Consistency with CRM

The treatment of synthetic securitisations should fit into the overall framework of the New Basel Capital Accord. The rules on capital relief for credit derivatives should therefore – with due regard to our remarks in this connection – also apply to synthetic ABS structures. We wish to draw attention once again in this connection to our rejection of the “w” factor (see page 30). It should also be noted that the proposed “w”-based discrimination of credit derivatives as compared to guarantees is unfair.

C. Operational requirements

The Basel Committee proposes a number of criteria that would have to be met in order to obtain a preferential capital charge for synthetic securitisations. These criteria should, in our opinion, be appropriate for a standardised approach.

Structural criteria

According to the Basel Committee, early amortisation of transactions due to a deterioration in the credit quality of the underlying asset pool should not be possible.
This is unreasonable. As already explained in our remarks on the treatment of traditional securitisations with early amortisation clauses (page 85 f.), early amortisation simply means that no new facilities are included in the securitisation programme. Banks are not, however, required to repurchase existing, already securitised assets. Facilities used after commencement of the wind-down are covered with capital by banks in accordance with the arrangements under the modified standardised approach. This requirement should therefore be dropped.

It is also questionable how issuing a substantive amount of AAA-rated securities to the market strengthens market discipline. This requirement must therefore be rejected.

Securities are also to be rated by at least two rating agencies. If the capital charge is to be based on external ratings, the rating provided by an agency that is recognised by supervisors should suffice. The quality of the rating is, after all, ensured by supervisory recognition. The value of an additional rating is not clear. Non-externally rated transactions (e.g. private placements) should, of course, be possible under the IRB approach.

A further proposal by the Basel Committee is that an SPV, even though highly rated, should not be considered to be an eligible guarantor. This rule is an unwarranted exception to the proposed rules for recognition of guarantees/credit derivatives for regulatory capital purposes under the standardised approach and should therefore be dropped.

According to the Basel Committee, the contract should show which sources of public information would be used to determine the occurrence of a credit event. This must be rejected. For one thing, there are cases where banks are prohibited by banking secrecy rules from making a credit event public. For another, adequate sources of information for determining the occurrence of a credit event are not available for all securitised assets.

In addition, a legal opinion is to be required to ascertain that the synthetic securitisation structure actually works as specified to supervisors. This requirement must also be rejected. A legal opinion is usually issued for each transaction; it should, however, be up to supervisors to ascertain the adequacy of the construction.

Risk management criteria

According to the Basel Committee, banks are to have enough capital to cover unhedged exposures. It is not clear in this connection what the Basel Committee means by “unhedged exposures”. If it means those risk assets that are not included in securitisation transactions, this requirement is definitely fulfilled. As a synthetic ABS transaction does not affect the risk arising from unsecuritised assets, the regulatory capital charge covers the risk arising from unsecuritised assets even after outplacement of other assets. Under no circumstances should the execution of a securitisation transaction mean that positions which are not included in securitisation attract higher capital charges.

V. Operational Risk

Preliminary remarks

1. Calibration

The Basel Committee has repeatedly stressed that, while the average capital requirement should not rise as a result of the new rules, it should not fall either. The Committee is thus pursuing a “compensatory approach”. Expected savings in the area of credit risk are to be offset by a mandatory capital requirement for operational risk. Against this background, calibration of the operational risk capital charge (mainly by fixing the alpha, beta and gamma parameters) will only make sense after the effects on capital in the area of credit risk have been reliably assessed. On the other hand, the Basel Committee’s intention of gearing the size of the capital charge for operational risk to a pre-determined “ideal result” of an average of 20% of the regulatory capital required so far appears arbitrary and makes it more difficult to achieve the aim of establishing a risk-sensitive capital regime. Rough calculations also suggest that capital relief of 20% in the area of credit risk is a highly exaggerated figure.

Except for the Basic Indicator Approach, the requirements resulting from the proposed methods of determining the capital charge for operational risk are still completely open. Consequently, it is also unclear in particular how the envisaged mechanisms for providing incentives to banks to move on to a more advanced measurement method are to be ensured. Given the Basel Committee’s compensatory approach, we assume that use of the Standardised Approach in the area of credit risk and of the Basic Indicator Approach in the area of operational risk will result in a capital requirement in line with the status quo. To give every bank a sound incentive to enhance its operational risk management system, it must then be ensured at individual bank level that the capital relief afforded by moving on to a more complex approach is always reasonable in proportion to the project costs that have to be outlayed. Banks must be able to assess this before opting for an approach.

The capital relief effect that is to be obtained should not, however, be designed methodically as a true part of each quantification system. The required capital relief should, instead, be granted on the basis of the progress made by banks in improving the quality of their operational risk management, such progress being required under the “qualifying criteria” set out in part C of the Basel proposals for them to qualify for the next approach. Setting fixed deductions from the capital requirement where banks move on to the next approach would be conceivable, for example.

2. Event-based loss categories

Successful management of operational risk is not possible on the basis of effect-based loss categories. The effect-based categorisation of losses proposed in the Basel Committee's Consultative Document should therefore be replaced throughout by an event-based categorisation of loss. The calculation method would in this way remain essentially unchanged.

3. Flexibility

The introduction of a capital charge for operational risk was designed – in line with the Basel Committee's original intention – to ensure risk-focused treatment of such risk. Risk-sensitive measurement methods have not been possible to date mainly because of the lack of available data. It is therefore crucial that the Basel rules on operational risk are worded openly and flexibly enough so that new knowledge obtained on the basis of an improved data situation can be incorporated into the rules even after adoption of the New Basel Capital Accord (Basel II).

4. Avoidance of double gearing

Following the introduction of an explicit capital charge for operational risk, double gearing of identical risks must be ruled out. The danger of double gearing of operational risk exists in the following areas:

- Introduction of the so-called "w factor" in the area of credit risk to cover the uncertainty regarding the effectiveness of a loan collateralisation technique (realisation risk). We refer to our remarks in the section "Credit Risk Mitigation in the Standardised Approach" on pages 35, 43.

- Capital backing of other risk assets, e.g. premises, plant and equipment, and other fixed assets (see our remarks on the section "Credit risk – The Standardised Approach – General Rules" on page 20)

- Use of banks' internal risk models for determining the capital charges for market risk positions. The multiplication factors to be applied in this connection (Section 33, paragraph 2 of Principle I) are, according to the explanatory notes on this provision, also designed to offset the shortcomings in the technical/organisational environment of models.

5. Quality factor

The Basel Committee intends to formulate qualitative entrance requirements for the options provided for under its continuum concept. Within the scope of these options, it will not be possible for banks to reduce the capital charge for operational risk by improving their risk

management. This is at odds with the Basel Committee's declared aim of creating positive regulatory incentives for enhancement of operational risk management systems.

To create a permanent incentive for improvements in operational risk management, any progress made in this direction should bring capital relief within the individual Pillar I options as well. For this purpose, we suggest introducing (for all options) a quality factor QF_i reflecting the degree of sophistication of the operational risk management of institution i. To measure the capital requirement, the charge determined within the option selected would have to be multiplied by QF_i. If institution i only meets the minimum qualitative requirements set for this level, $QF_i = 1$. If certain qualitative criteria belonging to a more advanced option under the continuum concept are fulfilled in advance, this is rewarded with $QF_i < 1$. We refer in this connection to the experience made by supervisors with evaluation of management quality, e.g. pursuant to Section 25a (1) and Section 29 of the German Banking Act, Section 5(1), nos. 12 and 13 of the Audit Report Regulations, the Securities Trading Act and the Law on Transparency in the Corporate Sector (Section 91 (2) of the Stock Corporation Act).

6. Transparency

The Basel Committee should disclose how the parameters required for determining the capital charge for operational risk (alpha, beta and gamma parameters) are derived, regularly review their adequacy and adjust them where necessary.

A. Definition of Operational Risk (paragraph 547)

A meaningful discussion of the prudential treatment of operational risk can only be conducted on the basis of clear terminology. A generally accepted definition of this category of risk is therefore needed first. In the Basel Committee's Second Consultative Document, operational risk is defined as "*the danger of direct or indirect loss resulting from inadequate or failed internal processes, people and systems, or from external events*".

In the interest of a clear-cut definition, we suggest deleting "*processes*" as a cause of loss from the definition. Processes are established by the interaction of people and systems. The operational risk resulting from processes is thus already covered by the definition via these risk drivers.

The Basel Committee makes clear that legal risk would be implicitly covered by this definition of operational risk. This approach is appropriate, as legal risks can be attributed to one of the causes described in the definition. General business risk/strategic risk and reputational risk

would not, on the other hand, be covered by the definition. This regulatory loophole identified by the Basel Committee is to be addressed in a further dialogue with the industry.

The banking industry welcomes this clarification, although it does not see any regulatory loophole for the following reasons:

- General business risk/strategic risk is the typical entrepreneurial risk that is explicitly assumed by the owner of a bank. Strategic decisions of individual banks cannot be a matter of concern for banking supervisors. Where, however, one bank's strategy is shown to put the system as a whole at risk, this should be addressed by supervisors in individual cases.

- Reputational risk is not an independent risk. It results from other risks that are already addressed adequately by means of quantitative and qualitative prudential rules. Moreover, a deterioration in reputation also manifests itself mainly in lost profit opportunities. Prudential rules should, however, only address banking risks that erode capital.

Credit Losses vs. Operational Losses

Footnote 14 in the Basel Committee's Supporting Document on Operational Risk makes clear that credit losses due to operational risk are also to be included in the scope of the operational risk rules.

An analytical separation and cause-based allocation of losses due to credit and operational risk is, in principle, a sensible concept in our opinion. However, a consistent categorisation of losses, particularly where loss events due to more than one risk factor are involved, does not appear to be possible for the time being. There is a lack of precise knowledge concerning the correlation between operational risk and the probability and scale of the losses resulting from such risk. The loss databases required to track this correlation are still in the process of being set up. Retroactive separation of credit losses that are due solely and unequivocally to operational risk would only be feasible at an unreasonably high burden. The possible consequence of inconsistent allocation of losses would be double counting and thus double gearing of the same risks.

Segregating credit losses due to operational risk from the credit risk regime would also have a significant impact on the use of the internal ratings-based (IRB) approach. Already existing data series would be rendered useless as a basis for the IRB or – where possible – would have

to be subsequently adjusted. This would also make a mockery of supervisors' current efforts to adjust overall capital in that the implications of the new rules in the area of credit risk would have to be assessed on a different basis.

A further argument against the separation of credit losses due to operational risk is that, while international accounting rules provide for fiscally effective provisions for imminent credit losses, such provisions for operational losses are only possible within very narrow limits or do not actually exist at all.

An analytical separation of credit losses resulting from operational risk and credit risk poses a great challenge that must be addressed within the framework of a separate project and not by way of a footnote in Basel II. The banking industry is working to develop processes that allow consistent allocation of both types of losses. For practical reasons, credit losses resulting from operational risk should be included solely in the area of credit risk until appropriate processes have been developed.

Direct vs. Indirect losses

The Basel Committee's definition of operational risk covers direct and indirect losses. The banking industry appreciates that both types of loss are, in principle, to be subjected to a regulatory capital charge. Yet, a limitation of indirect losses, which are used as a data base, to a precisely defined partial amount is necessary.

Whilst no further examples of direct losses are given, as it is assumed that these can be derived accordingly from the definition of operational risk, the Basel Committee introduces two types of indirect losses into the discussion: costs to fix an operational risk problem and write-downs and payments to third parties due to operational risk. Consideration is also being given to capturing near misses, latent losses and contingent losses.

While capturing and accordingly categorising direct losses proves to be extremely difficult in practice because of the problems defining these, it must be firmly stressed that this applies even more so to indirect losses. Their size can only be roughly estimated in most cases. Events that did not lead to an actual loss (near misses) should generally be excluded from calculation of a capital charge, even though an analysis of such cases may make sense from a risk management angle.

The indirect losses to be taken into account when determining the capital charge should ultimately be limited to certain components that can be derived directly from external accounting and identified and assessed in a non-arbitrary manner. These could cover

- external costs to fix a problem (consulting fees, legal costs, temporary workforce)
- compensation payments to third parties.

Equal treatment of these components in different accounting systems is a minimum requirement for this purpose and must be checked before prior to adoption.

Indirect losses which do not fulfil these requirements and whose size in particular can only be estimated in a highly arbitrary manner, as well as such events which did not have any actual financial effect (near misses) or are reflected merely in opportunity costs, should therefore not be subjected to a capital charge because of their serious lack of determinability.

This applies in particular to

- Near misses
- Contingent losses
- Opportunity costs/foregone income
- Internal costs to fix a problem (i.e. overtime, additional staff)
- Costs to improve inadequate systems/processes
- Goodwill payments.

Ultimately, only direct and indirect losses that are objectifiable, i.e. whose size can be determined precisely by an accounting system, should be captured and used for quantification. A statistical analysis of loss data should only be based in any case on precise figures. On the not unrealistic assumption that direct and indirect losses display the same statistical behaviour, an analysis of direct losses is, moreover, sufficient as a basis for further study.

Expected vs. Unexpected losses

The Basel Committee intends to calibrate the capital charge for operational risk on the basis of unexpected and expected losses. Although the Committee admits that – in line with the prudential treatment of other banking risks – limiting the capital charge for operational risk to

unexpected losses would be conceptually correct, it nonetheless explicitly calls for a capital charge for expected losses as well.

In the banking industry's view, this requirement is at odds with general principles for the calculation of economic capital. The Basel Committee should accept the position repeatedly outlined by the banking industry that expected losses are covered by the cash flow from earnings. If a bank did not cover the yield expectations of its shareholders and expected losses via the prices of its products, the result would be its failure in the long run.

Establishing a capital cushion for extreme operational risk events would lead to unreasonably high capital requirements for banks. When estimating the expected loss as a determinant of the capital charge for operational risk, the Basel Committee should therefore take an appropriate confidence level as a basis.

B. The Measurement Methodologies (paragraphs 548-565)

Preliminary remarks

Analytical methods of quantifying or modelling operational risk are still at an early stage of development. Any method which claims to be risk-sensitive presupposes an exact knowledge of the losses due to operational risk. Banks have been stepping up their efforts recently to establish comprehensive loss databases to track the correlation between operational risk and the probability and scale of the losses due to such risk.

Because of the quantification problems, a risk-focused regulatory capital regime for operational risk is not available for the time being. Until risk-focused methods of measuring a regulatory capital requirement for operational risk have been developed, **interim solutions** are therefore required. As these solutions are not geared to true risk, there is the danger of counter-productive risk management incentives and distortions of competition. To keep the adverse effects of such interim solutions to a minimum, the following principles, part of which have also been laid down by the Basel Committee, should be observed:

- The approach involved should be as risk-sensitive as possible.
- Banks should be able to influence the size of the capital charge.
- Incentives for prudent operational risk management should be created.

- Assumption of operational risks by third parties should lead to a reduction of the capital charge.
- There should be a level playing field between internationally operating banks, local banks and non-regulated financial service providers.
- The approach should be open to enhancement as part of an "evolutionary process".

Aware of the problem of how to quantify operational risk, the Committee outlines in its Second Consultative Document four progressively complex methods for determining the regulatory capital requirement for operational risk (**continuum concept**): a *Basic Indicator Approach*, based on a single risk indicator for the whole bank, a *Standardised Approach*, differentiating between individual business lines, an *Internal Measurement Approach*, using banks' internal loss data, and a *Loss Distribution Approach*, based on the value-at-risk method. The increasing complexity of the approaches is designed to achieve higher risk sensitivity and a lower capital requirement. Banks are to be given regulatory incentives to continuously improve their operational risk management as part of an evolutionary process.

The continuum concept proposed by the Basel Committee is expressly welcomed. This approach reflects the varying levels of progress made by banks in the management of operational risk and is at the same time open to enhancement. When framing the individual options provided for under the continuum concept, it must, however, be ensured that the other operational risk capital regime requirements mentioned are also taken into account as far as possible.

The Basel Committee expects the internationally active banks to use **at least the Standardised Approach** (paragraph 550). Banks are basically open to use of the Standardised Approach on level 2 of the Basel Committee's continuum concept. If it can be made risk-sensitive and competitively neutral by the time Basel II is implemented, the internationally active banks will seek to qualify for this approach. However, until acceptable concepts have been submitted, no banking group should be committed to using a particular option.

The Basel Committee intends to allow banks to use the Standardised Approach for some lines of business and the Internal Measurement Approach for others. The possibility of **partial use** is to be welcomed. Progress made in operational risk management in certain segments can in this way be "rewarded" in the form of a reduced regulatory capital requirement. To create cross-segment incentives for improvement of operational risk management systems, the scope of partial use should, however, be extended to cover the Loss Distribution Approach, i.e. depending on their level of sophistication, banks should be able to use the Standardised

Approach, the Internal Measurement Approach or the Loss Distribution Approach in a given business line. So that partial use of a system represents a practice-oriented option, it should not be made a condition that *every* group undertaking must use the approach in the given business line. Exceptions for small subsidiaries and appropriate transitional rules for newly acquired subsidiaries are required.

The Consultative Document makes clear that banks should capture the relevant operational risks for each business line on a **consolidated basis**. The business lines proposed by the Basel Committee also cover activities which are not supervised at the level of an individual institution or are not subject to banking supervision. At EU level, this goes, for example, for "custody" (not regulated) or "asset management" and "investment banking" (regulated differently)18. Where these activities are carried out by bank subsidiaries or via a holding set-up, the Basel Committee's proposals would mean an operational risk capital charge on a consolidated basis. Institutions which carry out these activities on a stand-alone basis would, on the other hand, not be required to hold regulatory capital for operational risk. In its Second Consultation Document, the European Commission rightly draws attention in this connection to the danger of distortions of competition and "*regulatory arbitrage*" (paragraph 173). One possible solution would be to remove all units which are not subject to a capital charge for operational risk on a stand-alone basis from the consolidated treatment of operational risk at group level.

1. The Basic Indicator Approach (paragraph 552)

The Basel Committee suggests that the capital charge for operational risk should be set under the Basic Indicator Approach as a fixed percentage α of a bank's **Gross Income**.

Gross Income must be rejected as an operational risk exposure indicator for the following reasons:

- Regulatory "punishment" of additional earnings is diametrically opposed to a bank's business strategy aims.
- The approach is not risk-sensitive in our view, as there is no evidence of a significant correlation between a bank's earnings level and operational risk exposure.

[18] See in this connection, for example, the already existing requirements for an explicit capital charge for investment firms' operational risk under Annex IV of the EU Capital Adequacy Directive.

- The approach tends to display a negative correlation with operational risk, as operational losses reduce the capital charge[19].
- As the capital charge is not geared to the true level of operational risk, counter-productive risk control and management incentives are created.
- Banks have no way of influencing capital requirements by reducing or prudently managing operational risk. This approach therefore does not create any incentives for sound risk management.

The Basel Committee's current provisional estimate is that α be set at around **30%** of Gross Income. It derives this figure from the adjustment of the capital charge for operational risk to 20% of the current minimum regulatory capital requirement. The Committee backs its assumption that 20% of the minimum *regulatory* capital is an appropriate proportion of capital to cover operational risk by arguing that a sample of banks put their volume of operational risk at an average of 20% of their *economic* capital.

Given the "compensatory approach" pursued by the Basel Committee, the capital charge for operational risk must not be calibrated to achieve a pre-determined "ideal result". α can only be set once the impact of the new credit risk rules can be reliably assessed (see section 1 of our preliminary remarks). As regards the value of α determined by the Basel Committee, it should be noted that statements to the effect that banks estimate the size of their operational risk at 20% of their economic capital can by no means be regarded as representative. The Basel Committee should also have borne in mind that a bank's economic and regulatory capital are not comparable as variables.

As an alternative to "Gross Income", the majority of the ZKA associations suggest that banks' **General Administrative Expenses** (GAE) be used as a basic indicator[20]. GAE is, in our opinion, more sensitive than Gross Income as an operational risk indicator. Linking the capital charge for operational risk to a cost variable is, moreover, compatible with the aims of global bank management.

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[19] The Basel Committee's intention is for the Gross Income Indicator to reflect income before deduction of operational losses, i.e. operational losses would first have to be identified, quantified and then included in the "gross income" resulting from the profit and loss account. An objective separation of all operational losses does not, however, appear feasible yet at present. This requirement is therefore sharply at odds with the Basel Committee's idea that the use of the Basic Indicator Approach should not be linked to any criteria and thus also not to any requirement to compile data.

[20] The Association of German Cooperative Banks does not support this proposal made by the other ZKA associations. Instead, like the IIF Working Group, it regards the Gross Income as a more suitable risk indicator under the Basic Indicator Approach.

The capital regime outlined in the following is intended as a counter-proposal for the Basel Committee's Basic Indicator Approach (Option 1 under the continuum concept). Our approach dilutes the weaknesses of the Committee's proposal. It is more strongly risk-sensitive, without, however, claiming to track operational risk exactly. As an alternative to Option 1 under the Committee's proposals, it is a simple method that can be used by all banks. Modifications to increase risk sensitivity would only have been possible in each case at the expense of practicability and were thus rejected. Nevertheless, we feel that our approach offers potential for further development. Furthermore, it also qualifies for internal risk management. It is already used by some banks for internal purposes.

A survey of the reasons for, and the significance of, operational risk losses showed that, although the existing data situation means that this survey cannot claim to be complete, such losses are in the great majority of cases to human error on the part of bank staff or to inadequate technology. To achieve the aim of higher risk sensitivity, the proposal for a quantitative capital regime for operational risk must take account of this situation.

General Administrative Expenses[21] as an indicator

We propose that a bank's "General Administrative Expenses" (GAE) be taken as an indicator of the volume of operational risk. Our reasons for choosing this indicator are as follows:

- GAE reflects via the components personnel costs (→personnel deployment and qualification), operating expenditure (process and technology risk) and write-downs (investment activity) all the main abstract and complex business processes at the highest level.
- Regulatory "rewarding" of lower GAE is consistent with banks' business strategy aims.
- Linkage to GAE means a benchmark that is independent of business lines.
- GAE is transparent, and can be influenced, at all levels (cost centres, organisational units, business divisions, business lines, earnings segments, bank as a whole).
- GAE tends to rise in step with an expansion of business (increase in operational risk).
- Due to its low volatility, GAE is more suitable than earnings as a planned figure (the size of a bank's operational risks is by no means as volatile as its earnings).

[21] General administrative expenses is to be understand as the sum of **personnel costs** (wages, salaries, remuneration, social security costs, pensions and assistance) and **operating costs** (non-personnel costs, building and room occupancy costs, plant and equipment – excluding computer systems, IT costs, advertising and marketing, office running costs/other costs, other costs for consultancy/auditing/insurance/ contributions, write-downs on property and buildings, normal write-downs on intangible economic assets.

- GAE is an objective indicator published in the annual accounts and the interim accounts (external analysts).
- Definition/determination of GAE is largely comparable nationally and internationally (both in the comparative approach under the German Commercial Code and IAS and under IAS in general).

The merits of the GAE Indicator contrast with the acceptable weakness that all GAE-reducing measures also reduce the regulatory capital requirement for operational risk at the same time. This means that, for example, a reduction in appropriate control mechanisms increasing operational risk would reduce the capital charge. On the other hand, measures to reduce operational risk (risk-mitigation activity), such as training personnel, introducing/enhancing safeguards or improving risk management by recruiting extra (qualified) staff generally lead to an increase in GAE and thus to a higher capital charge.

Under the approach proposed by us, both scenarios are addressed by introducing an adjustment factor which reflects the quality of risk management. The increase/reduction in the capital charge made via this quality factor may, however, not be sufficient to compensate unique operational-risk-related circumstances that reduce/increase GAE. To smooth out the effects of one-off investment measures or to reduce incentives for a risk-increasing reduction of GAE, the average GAE of a bank over the past three years is taken as an indicator. Deficits in operational risk management are also ruled out by the requirement that all banks comply with the Operational Risk Sound Practices which are currently being elaborated by the Basel Committee. Compliance with these minimum standards will be checked under the Supervisory Review Process.

Any indicator proposed as a basis for regulatory measures must be examined to determine whether or not it has a distortive effect on competition, i.e. whether it systematically creates different requirements for differently structured banks or groups of banks. A major advantage of the GAE Indicator is that it covers banks regardless of their main lines of business. On the other hand, it could produce a distortion in the case of differently organised banks (e.g. absence of a branch network). A comparison of GAE in relation to earnings (cost-income ratio) in the different banking groups in recent years has, however, shown that distortions of competition are not to be expected.

Summing up, it may be said that, as a basis for a regulatory capital requirement for operational risk, GAE has many strengths but also some weaknesses. Nevertheless, despite legitimate objections, GAE is strongly preferable to the Exposure Indicator currently proposed by the

Basel Committee (also for Option 2 under the continuum concept). As an indicator, GAE is more risk-sensitive and, unlike the Basel Committee's proposals, incentive-compatible.[22]

The GAE Approach

The regulatory capital for an institution's operational risk (RC_{ORi}) should be calculated as follows:

$$RC_{ORi} = \alpha \text{ x } GAE_{i3years} \text{ x } QF_i$$

with

α	=	"Adjustment factor" to calibrate the absolute level of the operational risk capital requirement
$GAE_{i3years}$	=	3-year average of GAE of institution i at group level
QF_i	=	Quality factor reflecting the level of operational risk management sophistication of institution i. In the event of over-fulfilment of the minimum qualitative requirements set for the approach, $QF_i < 1$ applies.

Adjustment factor "α":

The introduction of a capital charge for operational risk is intended by the Basel Committee to offset the capital relief that the new rules in the area of credit risk are expected to bring. The Basel Committee has at the same time stressed that the overall capital should not increase. Calibration of the capital requirement for operational risk thus only makes sense once it can be estimated on the basis of meaningful model calculations to what extent banks will actually benefit from capital relief in the area of credit risk.

The above equation for determining the operational risk capital requirement can be calibrated by fixing an α value. In the following, an α value is determined by way of example. For

[22] IIF Working Group A assessed the suitability of different indicators under a Basic Indicator Approach and identified "Gross Income" as the best. A critical appraisal and refutation of this finding are contained in **Annex** ... to these comments.

demonstration purposes, the capital charge sought by regulators of an average of 20% of the capital that must be held to cover credit risk (RC_{CR}) is taken as a basis. The quality factor QF is assumed to be 1. $GAE_{\text{as a whole}}$ and $RC_{\text{CRas a whole}}$ are generated by data from 10 (including smaller) German banks.

Regulators seek an average operational risk capital charge of 20% of $RC_{\text{CR as a whole}}$:

$$\alpha \times GAE_{\text{as a whole}} = 0.2 \times \mathrm{RC}_{\text{CRas a whole}} \Leftrightarrow \alpha = 0.2 \frac{\mathrm{RC}_{\text{CRas a whole}}}{\mathrm{GAE}_{\text{as a whole}}} \approx 0.5$$

with

$RC_{\text{CRas a whole}}$ $= \sum_{i=1}^{10} \mathrm{RC}_{\text{CRi}}$

RC_{CRi} = 8% of the risk weighted assets of institution i for 1999 (excluding counterparty risk positions in the trading book),

$GAE_{\text{as a whole}}$ $= \sum_{i=1}^{10} \mathrm{GAE}_{\text{i 3years}}$

GAE_{i3Jahre} = average GAE of institution i at group level between 1997 and 1999.

The α value determined above is an example. α can only be fixed finally – subject to the "no increase in overall capital" proviso – once the average capital relief in the area of credit risk has been quantified.

Quality factor (QF_i):

The Basel Committee intends to formulate qualitative entrance requirements for the other options under the continuum approach as well. Within the scope of these options, it will not be possible for banks to reduce the capital charge for operational risk by improving their risk management. This is at odds with the Basel Committee's declared aim of creating positive regulatory incentives for enhancement of operational risk management systems.

To create a permanent incentive for improvements in operational risk management, any progress made in this direction should bring capital relief within the individual options as well. For this purpose, we suggest introducing (for all options) a quality factor QF_i reflecting the degree of sophistication of the operational risk management of institution i. To measure the capital requirement, the charge determined within the option selected would have to be multiplied by QF_i. If institution i only meets the minimum qualitative requirements set for this level, $QF_i = 1$. If certain qualitative criteria belonging to a more advanced option under the continuum concept are fulfilled in advance, this is rewarded with $QF_i < 1$.

Under the GAE Approach, we suggest the following sliding scale for QF_i:

- Fulfilment of the minimum requirements: $QF_i = 1$
- Fulfilment of one qualitative criterion: $QF_i = 0.95$
- Fulfilment of two qualitative criteria $QF_i = 0.90$
- Fulfilment of all three qualitative criteria $QF_i = 0.80$

The higher relative capital relief for fulfilment of all qualitative criteria is justified by the higher overall operational risk management demands involved.

The qualitative criteria we suggest are:

Criterion 1:

- Loss data compiled from operational risk events are collected and reported at regular intervals specified by the institution.
  Documentation can be ensured by way of a report on the losses which occurred during the reporting period.

Criterion 2:

- Self- or risk assessments are conducted at least at business division level at regular intervals fixed by the institution and their results reported at regular intervals fixed by the institution.

  Documentation can be ensured by way of a report containing the results of self- or risk assessments conducted during the reporting period.

Criterion 3:

- The operational risk is monitored on the basis of defined risk indicators and reported at regular intervals specified by the institution.

  Documentation can be ensured by way of a report outlining the performance of the risk indicators defined by the institution during the reporting period.

Each qualitative criterion should be verified by the institution's auditors.

2. The Standardised Approach (paragraphs 553-555)

Under the Standardised Approach, banks' activities are to be divided into standardised business units and **business lines**. The Basel Committee's Consultative Document provisionally proposes seven business lines.

We believe that differentiating between different business lines basically has the potential to increase the risk sensitivity of the regulatory system for determining the capital charge for operational risk. We also believe that the proposed standardisation of business lines is appropriate under a Standardised Approach.

Standardised business lines set by supervisors pose problems, however, in that the heterogeneous business and organisational structures of banks cannot generally be reflected adequately in these. The activities of a bank consequently have to be mapped into the pre-set business lines. This mapping of activities involves a conflict of interests in our view in that, on the one hand, sufficient leeway and also scope for a pragmatic approach are required, whereas, on the other hand, supervisors should ensure uniform implementation in order to rule out regulatory arbitrage.

The Basel Committee intends to specify a **broad indicator** for each business line that reflects the size or volume of banks' activities in that area. The indicators are to serve as a rough proxy for the amount of operational risk within each of these business lines.

Gearing the Standardised Approach to actual risk depends to a crucial extent on whether a risk-sensitive indicator can be identified for each of the business lines. The proposed indicators do not meet this criterion.

The Basel Committee rightly says that the proposed indicators reflect the size or the volume of the activities of a bank in each business line. Its conclusion that these indicators serve as a rough proxy for these business lines' inherent operational risk is wrong. There is no evidence of any significant correlation between such indicators and the level of operational risk in a business line. Our criticism of the proposed basic indicator "Gross Income" applies accordingly in this connection. The capital charge for operational risk determined by means of the proposed indicators would be inadequate for risk management purposes. This would be at odds with the Basel Committee's aim of achieving improvements in the management of operational risk. What is important is therefore that the Standardised Approach is kept open for modifications on the basis of an improved data situation even after the adoption of Basel II. Banks are willing to work closely together with supervisors to set more risk-sensitive parameters.

The Basel Committee suggests that the capital charge for each business line should be calculated by multiplying the indicator by a **beta parameter** assigned by supervisors to that business line. Beta will serve as a rough proxy for the industry-wide relationship between the operational risk experience for a given business line and the indicator for that business line. To determine beta, business lines will be assigned **risk weights** set by supervisors.

The proposed risk weights are in very much at odds with the opinion of experts. In our view, it is vital that the risk weights be readjusted transparently using a broad data base. Until suitable data are available, the Basel Committee should leave the parameters open. Against this background, readjustments solely within the risk weight interval limits proposed in the Consultative Document must also be ruled out. A further requirement is that supervisors regularly review the adequacy of the risk weights and adjust these where necessary.

From a technical point of view, it should also be made clear that, under the Standardised Approach, the capital charge for operational risk is set by means of the relevant indicator on the balance sheet date for the following year.

3. The Internal Measurement Approach (paragraphs 556-558)

In the Internal Measurement Approach, the activities of a bank are categorised into the same business lines as in the Standardised Approach. Our remarks on page 111 above therefore

apply accordingly. Also, in the Internal Measurement Approach, six operational "loss types" are defined and applied to all business lines (7x6 – business line/loss type matrix)[23].

We believe that the Internal Measurement Approach is, in principle, a suitable concept for bringing the regulatory capital charge for operational risk more into line with the actual risk. However, the criticisms set out in the following make modifications of the approach necessary. The banking industry is willing to make a constructive contribution to work on elaborating the required modifications.

<u>Calculation of the expected loss</u>

The expected operational risk loss (EL) of a business line/loss type combination will be calculated as the product of the exposure indicator (EI), the probability of event (PE) and the loss given that event (LGE):

$$EL = EI \times PE \times LGE$$

- The exposure indicators proposed so far are purely size indicators. There is no evidence as yet that there is any significant correlation between these indicators and operational risk. We refer in this connection to our criticism of these indicators in the Basic Indicator Approach and the Standardised Approach. The capital charge generated in the Internal Measurement Approach would thus also be inadequate for risk management purposes. The Basel Committee should formulate the Internal Measurement Approach flexibly enough so that modifications of the indicators on the basis of an improved data situation are possible even after adoption of Basel II.

- Determining the expected loss on the basis of EI, PE and LGE means adopting the system used to measure credit risk. While the factors in question have been adequately defined in the area of credit risk, there is no clear-cut separation of PE and LGD for operational risk in the Internal Measurement Approach. Moreover, the factors are interpreted and fixed differently within the approach, depending on which indicator is chosen for each business line/loss type combination. Estimates of the expected loss are therefore inconsistent. The Basel Committee should consequently first provide a clear-cut and consistent definition of the determinants of EL. For this purpose, it would, among other things, have to be clarified for each business line/loss type combination when a loss event is deemed to have occurred

[23] We refer in this connection to section 2 of our preliminary remarks.

(determination of PE) and which components (direct/indirect losses) are to be counted up in which amount as operational loss (determination of LGE).

Calculation of the unexpected loss

The expected loss of a business line/risk type combination will be translated into a capital charge by means of the gamma factor set by supervisors. The expected loss will be scaled by the gamma factor so that the capital charge is sufficient to cover a given "overall loss" (= expected and unexpected loss that must not be exceeded during a certain "holding period" within a certain confidence interval (e.g. 99%)).

The gamma factor concept assumes a linear correlation between expected and unexpected loss. This assumption is unfounded. There is no functional correlation between the loss potential (specified distribution quantile) and the expected value. The breadth/spread of a distribution cannot thus be determined from its mean.[24]

Standardisation of the gamma factor also means that a uniform correlation between expected and unexpected loss is assumed across all banks. Differences between a bank's own loss distribution and the industry-wide loss distribution would be ignored.

Should the Basel Committee stick to the gamma factor concept, it should be required to ensure that supervisors regularly review the adequacy of gamma and adjust it where necessary.

Modelling difficulties

Modelling of the factors constituting the capital charge for operational risk raises the following problems:

Both internal loss data and pooled industry data stem, as a rule, from truncated distributions (losses can only be compiled in practice upwards of a certain amount). The ratios determined on the basis of such data (expected or unexpected loss) are not valid estimators of the true sizes of the complete distribution. It is also to be expected that the ratios will be biased statistically.

Use by banks of loss data compiled by other banks or belonging to an industry pool equires that they adapt such data to their own situation. This cannot be done using simple financial

[24] Exception: Single-parameter distributions such as Poisson

indicators or the like. Adapting data in this way would be an arbitrary approach that would make the use of such data for internal purposes questionable. Risk-adequate adaptation of data is not in sight at present.

It should be ensured that extreme events or significant, non-recurrent changes to the character of PE/LGE do not unreasonably increase a bank's capital charge for operational risk. A "capital penalty" reaching into the future would, we feel, be inappropriate in such cases, as the bank concerned will have taken action to prevent similar events. Supervisors could satisfy themselves of the adequacy of such action within the framework of the Supervisory Review Process, for example.

Quality factor

The Internal Measurement Approach should be given a component that takes the quality of internal operational risk management into account (see section 4 of our preliminary remarks).

Correlations

Inclusion of correlation/diversification in a risk-sensitive approach would be desirable. The correlation/diversification would, however, have to be determined for banks on a stand-alone basis. General inclusion via the gamma factor would not be helpful, on the other hand.

Risk Profile Index

In Annex 5 of the Supporting Document on Operational Risk, the Basel Committee outlines an approach by means of which the standardised gamma factor in the IRB approach could be replaced in future by a risk profile index (RPI). This RPI will be used to capture the difference between a bank's own loss distribution and the industry-wide loss distribution for each business line/loss type combination. The RPI reflects the perception that pooled loss data cannot necessarily be applied to individual banks and, in particular, that the factor (γ) obtained from the pooled data is not generally valid.

The introduction of a RPI could, in principle, mean a welcome improvement of the Internal Measurement Approach. However, we believe it is to be expected that the data needed to determine banks' individual RPIs will make the inadequacy of the Internal Measurement Approach as a whole increasingly obvious. It should also be borne in mind that the "low

frequency/high severity" nature of operational risk loss distributions resulting from strongly negative individual fluctuations does not automatically mean poor management of such risk.

Loss Distribution Approach

Methodically, and from the angle of risk-sensitivity, the Loss Distribution Approach is the most promising of the Basel Committee's proposals for quantification of operational risk:

- Unexpected losses are assessed directly and not via an assumption about the relationship between expected loss and unexpected loss.
- The structure of business lines and risk drivers can be adapted internally by banks to accommodate their specific situation.
- Differences between the bank's own loss distribution and the industry-wide loss distribution are reflected.

Because of its advantages as a concept, the Loss Distribution Approach should not be outlined merely as a "distant target" but set alongside the other approaches as an equivalent, attainable option. Non-recognition of the Loss Distribution Approach would create disincentives for investment in such an approach. This would be at odds with the Basel Committee's aim of encouraging banks to enhance their operational risk management and measurement.

Internal Operational Risk Models

Any risk-sensitive method of measuring the regulatory capital charge for operational risk must aim to determine the true operational risk loss potential on the basis of a given probability for each business line or the bank as a whole. There are several basic methods for doing so:

- Assessing the risk by means of a function that reflects the correlation between risk and risk indicators. To do so, the functional correlation and the risk indicators must be known. This method is applied under the Basel Committee's proposals for the Basic Indicator Approach, the Standardised Approach and the Internal Measurement Approach.
- Assessing the volume of risk from a loss distribution. This is essentially what the Basel Committee's Loss Distribution Approach does.
- Scenario-based risk measurement by experts on a self-assessment basis or the like.

To enable banks to quantify operational risk in a manner accommodating their specific situation, the Basel Committee should establish banks' internal operational risk models as a

generally attainable option in Basel II. Banks should be able to use the described methods or combinations of these for internal modelling purposes. In this context, the banking industry is prepared to enter into a constructive dialogue with supervisors with a view to elaborating the requirements for banks' internal operational risk models (model approval).

4. The "Floor" (paragraph 559)

Under the Basel Committee's proposals, banks applying the Internal Measurement Approach will have to adhere to a **floor** below which the capital charge for operational risk is not allowed to fall.

The "floor" concept must be rejected. Setting a minimum capital requirement under the Internal Measurement Approach would create disincentives for reducing the operational risk exposure. The Basel Committee's aim should instead be to make to make the Internal Measurement Approach risk-sensitive. If the capital charge is geared to the true volume of risk, there is no recognisable need for a floor.

The proposed floor illustrates the Basel Committee's uncertainty about the capital charge created by the Internal Measurement Approach. If a floor is set, the introduction of a ceiling should therefore also be called for in order to avoid inadequate fluctuations.

As regards the Basel Committee's idea of setting the floor for the Internal Measurement Approach at a fixed percentage of the capital charge under the Standardised Approach, it should be noted that the "double counting" this would make necessary not only imposes a considerable extra burden but is also diametrically opposed to the evolutionary nature of the Basel Committee's continuum concept.

C. Qualifying criteria (paragraphs 560-565)

1. The Basic Indicator Approach (paragraph 561)

The Basel Committee stresses that no criteria for use of the Basic Indicator Approach will, in principle, apply. However, the Committee intends to urge "Option 1" banks as well to comply with certain minimum qualitative standards. For this purpose, *Operational Risk Sound Practices* are currently being developed by the Basel Committee.

We share the view that every bank should meet minimum operational risk management standards. It should, however, be ensured that the requirements set in the Operational Risk Sound Practices are appropriate for an “Option 1” approach. The Operational Risk Sound Practices should not go beyond the following requirements:[25]

- The board of directors knows the internal definition of “operational risk” and has checked whether additional measures to control or reduce operational risk or individual operational risks within the bank may be necessary. Documentation can be ensured by way of the minutes of a board meeting or a board memorandum.

- The individual business units carry responsibility for the “day-to-day” management of operational risk. This would be communicated to the business units alongside, or together with, a definition of operational risk specific to each unit. Documentation can be ensured by way of written instructions to the heads of the business units.

- The auditing unit explicitly checks compliance with the principle of dual control, segregation of responsibilities and the risk management processes. Documentation can be ensured by way of the auditing unit’s audit plan or audit reports.

- Operational risk management resources (such as reporting, system development or implementation, monitoring or the like) have been made at least partly available by the bank. Documentation can be ensured by way of job descriptions, staff plans, organisational charts or a management memorandum.

- The bank has units to which loss events that exceed a loss threshold set by the bank and do not have to be reported within the framework of credit and market risk control must be reported. The board of directors is informed in certain cases specified internally by the bank. Documentation can be ensured by way of instructions to staff or a report to the board of directors on such a loss event.

2. The Standardised Approach (paragraphs 562-563)

It should first be noted that the qualifying criteria set for the Standardised Approach are not necessary for technical implementation of the approach. Given their level of complexity, we

[25] For the minimum requirements for the Basic Indicator Approach, see also footnote ...

believe that these criteria are only appropriate from the Internal Measurement Approach onwards.

Designing the qualifying criteria for the Standardised Approach as preparatory measures for application of the Internal Measurement Approach backs our demand that, when banks move on to a more complex quantification method, the qualitative standards they have to meet should entitle them to appropriate capital relief (see section 1 of our preliminary remarks).

As regards the criteria for use of the Standardised Approach, may we comment in detail as follows:

(i) Effective risk management and control (paragraph 563)

One of the criteria called for in this connection is the establishment of an independent operational risk management and control process which covers the design, implementation and review of the risk measurement methodology.

"Independence" should merely be called for in regard to the risk control process. Management are not, as a rule, independent; they carry responsibility for both performance and risk.

(ii) Measurement and validation (paragraph 563)

Banks are to have, among other things, appropriate risk reporting systems to generate data used in the calculation of a capital charge and the ability to construct management reporting based on these results.

As a condition for application of the Standardised Approach, this criterion must be rejected in its present form as going too far. It is not necessary, or not even possible, under the method of calculation used in the Standardised Approach for the data generated by "*appropriate risk reporting systems*" to be fed into the calculation of the capital charge at present. This criterion should be altered so that banks are encouraged to "*establish appropriate risk reporting systems, the data generated by which can be used (under a more advanced approach) to calculate the capital charge*".

3. Internal Measurement Approach (paragraphs 564-565)

(i) Effective risk management and control (paragraph 565)

Banks are to be required, among other things, to establish the accuracy of loss data and confidence in the results of calculations using such data (particularly PE and LGE) by means of “use tests”.

In its present form, this criterion does not appear fulfillable. Because of low-frequency events that may occur, validation of PE is not possible as such under back-testing. The use of other suitable methods for validating operational risk measurement methods should be allowed. This criterion should therefore be opened to other methods of validating operational risk reports.

It is also to be made a condition for use of the Internal Measurement Approach that banks freely integrate their internal measurement methods into their day-to-day activities and major business decisions.

It should be made clear that this criterion does not oblige banks to adopt the Internal Measurement Approach used for prudential purposes for internal use on a one-to-one basis. Moreover, this criterion should not cover daily risk measurement but should be confined to integration into strategic risk management and major business decisions. Because of its design (pre-set business lines, pre-set gamma factor, possibly stipulation of minimum expected losses), the Internal Measurement Approach is unable to properly reflect a bank’s specific operational risk characteristics. Mandatory use of the Internal Measurement Approach for internal allocation of capital, for example, would mean that inadequate capital allocation would be systematically generated. Banks should be able to integrate individual operational risk characteristics and, as the case may be, management knowledge going beyond the Internal Measurement Approach requirements into their internal processes. The requirement that banks using an Internal Measurement Approach for prudential purposes should have an “*equivalent system*” (e.g. an internal model) for internal use therefore appears appropriate. The equivalence of systems should be determined mainly by the fact that these systems use the same data/input parameters.

(ii) Measurement and validation (paragraph 565)

Banks are to have an operational risk measurement methodology, knowledgeable and skilled staff, and an appropriate systems infrastructure capable of identifying and gathering comprehensive operational risk loss data necessary to create a loss database and calculate appropriate PEs and LGEs. Systems must be able to gather data from all appropriate sub-systems and geographic locations. Missing data from various systems, groups or locations must be explicitly identified and tracked.

The requirement to have an "*appropriate **systems** infrastructure*" capable of identifying and gathering comprehensive loss data should be dropped and limited instead to the requirement to have an "*appropriate infrastructure*". Of sole importance for prudential purposes is "*identifying and gathering comprehensive operational risk loss data*", i.e. a database including all sub-units of a bank (banking group). Whether and to what extent a bank uses systems for this purpose or, for example, also employs manual processes must be left to the discretion of the bank.

A further condition for use of the Internal Measurement Approach is that the operational risk loss databases for major business lines must extend for a number of years (to be set by the Committee)

To allow banks to plan and prepare properly, the Basel Committee should announce the minimum history for loss data as soon as possible. To avoid any distortions of competition, the minimum history should also be set uniformly by national supervisors without allowing any discretionary leeway. The required data history should also be measured in such a way that a bank can apply the Internal Measurement Approach when Basel II comes into force in 2004.

Under the Basel Committee's proposals, banks are also required to develop specific criteria for assigning loss data to a particular business line and particular risk types. A process has to be developed to identify and incorporate plausible historically large or significant events into the database, which may range beyond the observation period.

The incorporation into the database of "*plausible historically large or significant events*" ranging beyond the reporting period must be rejected. The integration of such events would lead, via the PE/LGE that is determined, to a higher capital charge for operational risk under the Internal Measurement Approach, i.e. banks with historical "low frequency/high severity"

losses would be “punished” prudentially. The mechanism is inappropriate. It ignores that particularly banks with such loss experience will have taken action to prevent similar events.

Outsourcing

The Basel Committee stresses that there should be a “*clean break*” between banks outsourcing activities and outside service providers so that the operational risk resulting from outsourced activities can be ignored in the regulatory capital regime. This clean break should be ensured mainly through arranging a robust Service Level Agreement with outside service providers.

Risk transfer and Mitigation

The Basel Committee recognises that certain risk transfer and mitigation products basically have the potential to reduce the operational risk exposure and the frequency or severity of loss events. It intends to discuss possible prudential recognition of such products with the industry over the next few months.

To create incentives for prudent operational risk management, broad capital-effective recognition of operational risk transfer and mitigation techniques is of major importance. Prudential recognition of risk transfer and mitigation techniques should not be limited to certain, more sophisticated approaches. This goes particularly for products whereby an effective transfer of risk takes place. There are already products today where an effective transfer of risk to third parties can be verified quite clearly. We therefore also refer to papers submitted by the insurance industry in this connection. The banking industry would be pleased to take part in the discussion of this issue suggested by the Basel Committee.

Also important in this connection is that the relevant rules are formulated flexibly so that, even after adoption of Basel II, results of the dialogue between the industry and supervisors can be integrated or further products approved.

Operational Risk Management Standards

As the proposals for requirements and action by supervisors apply in similar form to all types of risk, we shall refrain from commenting at this point and refer to our remarks on the Basel Committee’s proposals for the Supervisory Review Process (Pillar 2) following this section.

ANNEX to the GAE Approach

To avoid any duplication of work, the majority of the ZKA associations took the deliberations and findings of other bodies into account, where possible, when elaborating the GAE Approach proposed as an alternative to the Basel Committee's Basic Indicator Approach.

Of importance for the Basic Indicator Approach is a paper by Working Group A of the IFF, which examines the suitability of different indicators for the Basic Indicator Approach according to certain criteria. Among the indicators examined are also Averaged Gross Income and Costs.

The IFF Working Group identifies Averaged Gross Income as the best indicator, while rejecting the Costs Indicator as unsuitable. This finding is wrong in our opinion. It should therefore be re-analysed critically. In particular, the reasons for classifying certain indicators as "unsuitable" ("considered to fail criteria") are generally missing.

In the following, the original IIF Working Group table is therefore shown once again (Table 1). Then the relevant indicators "Averaged Gross Income" and "General Administrative Expenses" are compared again using the IIF criteria and judged (Table 2).

In conclusion, it should be pointed out that, according to our information, the IIF paper is merely the result of a brainstorming session of the Working Group in question. It was not agreed in the IIF Working Group on Operational Risk and is not a consensus position within the IIF.

Table 1

Basic Indicator Approach (Draft output of Working Group A)

Single Indicators	**Non Interest Income**	**Number of Accounts**	**'Averaged' Gross Revenue (Income)**	**Balance Sheet Assets**	**Costs**	**Operational Losses**	**% of other Capital Charge**
Criteria for Single Indicators							
Risk Sensitive (e.g. to loss)	3rd	5th	2nd	4th	X	1st	X
Easy to obtain	✓	✓	✓	✓	✓	?	✓
Easy to verify/audit	✓	✓	✓	✓	?	X	✓
Simple and transparent	✓	✓	✓	✓	✓	✓	✓
Objective/reliable	✓	✓	✓	✓	✓	X	✓
Common/consistent e.g. accounting standards	✓	✓	✓	✓	✓	✓	✓
Difficult to manipulate	✓	✓	✓	X	X	?	?
No perverse incentives	✓	✓	✓	✓	X	✓	✓
Fair to all	?	?	✓	X	X	✓	X

KEY

✓ broadly meets criteria

X considered to fail criteria

? unproven

NOTES

- A selection of potential Single Indicators have been selected (with reference to the RMG Survey 1 results) and graded against a set of criteria (see table above).
- Whilst it is the strong consensus of Working Group A that, with the exception of operational losses, none of the single indicators are risk-sensitive, the single indicators have been graded from 1st (least risk-insensitive) to 5th (most risk-insensitive)
- Averaged Gross Revenue (Income) meets the criteria closer than any of the other Single Indicators. In order to smooth the potential volatility of Gross Revenue and avoid large fluctuations in charges, an averaged Gross Revenue figure is used (say, averaged over a 3 or 5 year period).
  - Non-interest income, which is often quoted as the potential single indicator, is not considered as 'fair to all' since commission-earning businesses are likely to be disadvantaged.
  - Whilst operational losses are thought to be risk-sensitive (Working Group H is investigating), the other weaknesses highlighted above do not make this a suitable indicator.
- The standard entry point to the Spectrum Approach for internationally active banks will be the Standardised Approach (Option 2), based on business lines, or higher.

Table 2

We took the criteria selected by IIF Working Group A, added a new criteria 'Compatibility with overall business strategy' and divided them into main and sub-criteria; then we tried to comment on our judgement in detail. The most important arguments are printed in bold letters.

Single Indicators **Criteria for Single Indicators**	**Averaged Gross Income (AGI)**	**General Administrative Expenses (GAE)**
Main criteria		
Risk sensitive (e.g. to loss)	Occurred losses decrease income → the more losses, the less capital needed **→ negative correlation between losses and capital needed** ➔ considered to be ***less risk sensitive***	main parts of GAE are costs for people and for IT-systems which are main risk drivers for OR; occurred losses included in costs → the more losses, the more capital needed ➔ considered to be ***more risk sensitive***
Compatibility with overall business strategy	***Goal of minimising gross income hard to communicate***	***goal of decreasing expenses is a general part of business strategies***
Sub-criteria		
Easy to obtain	Yes (from P&L account, on all relevant organisational levels)	Yes (from P&L account, on all relevant organisational levels)
Easy to verify/audit	Yes	Yes

Simple and transparent	Yes	Yes
Objective/reliable	Mostly (freedom to apply accounting rules differently)	Mostly (freedom to apply accounting rules differently)
Common/consistent e.g. accounting standards	Yes (depending on definition)	Yes, verified
Difficult to manipulate	Yes	Yes
No perverse incentives	***Operational losses lead to less AGI and therefore to a lower capital charge for OR***	***reduction in expenses for controls or investments in new systems would be addressed through Pillar II+III (SRP/Disclosure)***
Fair to all	Yes (all business areas covered)	Yes (all business areas covered)

NOTES

- The majority view within the ZKA is that overall GAE meets the criteria closer than AGI (Table 2).
- As outlined in footnote 5 in the consultative document on operational risk, the Basel Committee recommends the use of income *before* deduction of operational losses. This would correct the disadvantage of AGI as noted in table 2. But then a loss database is needed, which cannot be a requirement on a Basic Indicator Approach level.
- Considering Indicator 'Costs' from table 1 to be GAE, the ”?” set for the criterion 'Easy to verify/audit' is not comprehensible on the level of the Basic Indicator Approach. Perhaps it gets more difficult on higher levels of the Continuum Approach.
- The majority of the ZKA associations do not agree with IIF Working Group A's judgement that AGI is a better indicator than GAE concerning the following criteria (Table 1):
  - difficult to manipulate: There is no indication of AGI being more difficult to manipulate compared to GAE.

- no perverse incentives:	Obviously it is a perverse incentive to reduce gross income in order to reduce your OR charge.
- fair to all:	There may be a disadvantage for institutions with many branches compared to "no branch institutions"; but this is believed to be the absolute minority compared to the number of 'high income/good OR management' institutions.

- Using quality factor 'QF' (see ZKA proposal) could reduce possible perverse incentives (e.g. rising expenses for a better risk management) (Table 2).
- Another potential enhancement concerning the reduction of perverse incentives within the GAE indicator would be the deduction of expenses for predefined investments in control systems (e.g. IT systems, projects, additional staff). These expenses could be verified by external auditors.

VI. Trading book issues (paragraphs 566-585)

We have no comments on this section at the moment.

Part 3: The Second Pillar – Supervisory Review Process

A. Importance of Supervisory Review (paragraphs 587-591)

The remarks contained in paragraph 590, which qualify the importance of increased capital as a suitable instrument within the supervisory review process, go in the direction we called for under the first consultation process and are expressly welcomed by us. We still hold the view that qualitative supervision should generally also provide for the use of qualitative measures to remove any shortcomings identified and that increased capital should only be considered as a last resort.

Even though the Basel Committee therefore appears to be moving in the right direction as regards the importance of increased capital, its subsequent remarks show that – contrary to this perception – increased capital is to remain an integral part of Pillar 2. This is evidenced by the remarks in paragraph 591, according to which the main areas suited to treatment under Pillar 2 are risks that are not adequately addressed (operational risk) or not addressed at all (interest rate risk in the banking book and business cycle effects) under Pillar 1. Increased capital would have to be expected particularly in these main areas. This hardly seems justified, however, particularly for risks already addressed in Pillar 1. Where the Basel Committee lays down generally binding capital rules for certain risks, such as operational risk, under Pillar 1, it makes no sense to invalidate these rules by way of a kind of "shadow set of rules" in Pillar 2. With the idea of a level playing field in mind, such an approach continues to meet with serious reservations on our part, reservations which we voiced already during the first consultation process. To avoid any repetition, we therefore refer to the ZKA comments of 10 March 2000, to which we still subscribe even after publication of the Second Consultative Document. The Basel Committee's remarks suggest that the Committee regards the Pillar 1 capital requirements it drafted itself as too low and that it is now trying to remedy this situation through Pillar 2 by ultimately establishing capital requirements for banks on an individual basis. We continue to reject such capital requirements.

B. Four Key Principles of Supervisory Review (paragraphs 592-627)

Despite the clarification provided in footnote 59, paragraphs 596 – 598 are still misleading. This goes particularly for the wording in paragraph 598 to the effect that the bank's board of directors has the responsibility for setting the bank's tolerance for risks and for adopting

internal controls, written policies and procedures. These tasks are the responsibility of management. The supervisory board or supervisory council, on the other hand, is responsible for checking and monitoring whether the bank's board of directors has introduced a risk management and controlling system tailored to the bank's needs. The relevant remarks in the Consultative Document should be worded more clearly along these lines.

The remarks in paragraph 602 in connection with the monitoring of credit risk are geared solely to a bank's internal ratings system. Particularly the requirement that the ratings system should provide detailed ratings for all assets completes ignores the possibility of "partial use". In line with our demand outlined above (see page 46), paragraph 602 should also take into account the possibility of partial use.

The first sentence of paragraph 603 is worded very broadly. It states that the analysis of credit risk should adequately identify any weaknesses at the portfolio level, including any concentrations of risk. Such a broadly worded requirement would mean that every bank would have to have a complex risk model which, according to the Basel Committee, does not exist at present and thus cannot be recognised as a tool for measuring capital requirements. This paragraph also calls for the analysis of credit risk to include whether each borrower's banking supervisor complies with the Core Principles of Effective Banking Supervision. To make it easier for banks to implement this requirement, banking supervisors should publish an appropriate list.

The remarks on Principle 3 contained in paragraph 623 et seq. meet the reservations already outlined above concerning increased capital requirements set individually for banks. The yardstick for prudential assessment of a bank's capital adequacy should be the solvency requirements laid down in Pillar 1. Binding minimum regulatory ratios exceeding these requirements must be rejected. The examples set out in paragraph 624 which, according to the Basel Committee, will provide incentives to banks to hold more capital than the minimum regulatory amount raise the general question why prudential requirements are needed in this connection and why it should not be left instead to the markets to produce the desired results. We believe that such an approach is at any rate clearly preferable to the proposals made in paragraph 625, e.g. classification of banks by supervisors as "well capitalised" or "adequately capitalised". Due to their lack of international comparability, such classifications are ultimately completely vague and must therefore be rejected.

As regards the remarks on Principle 4 (paragraphs 626-627), the reservations already outlined apply to paragraph 627 in particular.

C. Other Aspects of the Supervisory Review Process (paragraphs 628-632)

With regard to the treatment of interest rate risk in the banking book, the Basel Committee has now dropped the mandatory regulatory capital charge called for in the First Consultative Document. By moving the rules on interest rate risk in the banking book to Pillar 2 of the Consultative Document, the Basel Committee has accommodated the reservations we expressed at the time, which is expressly welcomed. However, paragraph 630, final sentence, of the Second Consultative Document still allows national supervisors to establish a mandatory minimum capital requirement where they consider that there is sufficient homogeneity within their banking populations regarding the internal methods for measuring risk. The final sentence of paragraph 630 should be deleted, as otherwise there is the danger of unequal treatment because of different prudential requirements in different countries. Above all, it is to be feared that, as a result, particularly more advanced markets and banks will be put at a disadvantage in that they will develop risk measurement methods which are basically similar in concept. The present-value methods in particular, by means of which the interest rate risk in the banking book is to be quantified and managed, are basically identical in concept. If banks have to fear that the enhancement of systems for management and supervision of interest rate risk in the banking book in the direction of homogeneous structures may lead to national banking supervisors then raising the capital requirements for this risk area, disincentives for system enhancement will ultimately be set.

The Basel Committee still sticks to its “outlier approach” in connection with the treatment of interest rate risk in the banking book. The Committee intends to assume that an outlier exists where a parallel shift in the yield curve by 200 basis points would reduce liable capital by 20% or more. This definition of outlier on the basis of qualitative criteria still meets the reservations we expressed in our comments of 10 March 2000 on the First Consultative Document. To avoid any repetition, may we therefore also refer to these in this connection. Besides the criticism we expressed at the time, the Basel Committee’s proposal to make an upward and downward 200 basis point parallel interest rate shock the basis for identifying an outlier situation is unreasonably restrictive. While this is not absolutely clear from the remarks in paragraph 632, page 35 of Annex 3 of the Supporting Technical Document “Principles for the Management and Supervision of Interest Rate Risk” does make clear that the Basel Committee wants to adopt an upward and downward 200 basis point parallel rate shock and thus a range of 400 basis points as the assessment basis. First sample surveys of banks have shown that if such a crash scenario were taken as a basis a not insignificant number of banks would have to be classified as outliers. This would mean that the basic approach of providing for capital

requirements only for extreme losses would be stood on its head. To avoid this consequence, the definition urgently needs correcting. We suggest that, instead of a 200 basis point parallel rate shock, a 100 basis point parallel rate shock should be taken as the basis.[26] We shall not be commenting separately on the Supporting Technical Document at present. We assume that, irrespective of the interest rate shock requirement, we can use the internally employed management systems and parameters to define an outlier situation. We therefore do not regard the Supporting Technical Document as decisive.

[26] This would also be in line with the interest rate shock that is to be assumed under German Audit Report Regulations.

Part 4: The Third Pillar – Market Discipline

A. General Considerations (paragraphs 633-641)

Disclosure requirements are, in principle, an important part of an effective system for monitoring and steering the continued growth of open, competitive capital markets. The banking industry is independently developing external regulatory reporting into capital market-oriented business reporting in order to improve both the position and reputation of institutions and to give current or potential investors a sound basis for investment decisions. May we cite by way of example in this context disclosure of derivatives and risk reporting. We see our banks' disclosure policy as an integral part of their business strategy.

Against this background, some of the Basel Committee on Banking Supervision's ideas on external reporting reflect this development, while some unfortunately mean a reversion to regulatory reporting. However, the Committee will not achieve market discipline with these ideas. The proposed disclosure requirements would in fact mean supervisory discipline. This is unnecessary in our view, as the supervisory review process (Pillar 2) already gives supervisors sufficient insight into a bank's individual capital situation and risk exposure.

The proposed scale of risk disclosure is decidedly problematic. We believe that the wide circle of addressees of annual reports and interim reports and their different information requirements should be taken more strongly into account. The disclosure called for is so detailed in many areas that investors, and even analysts in some cases, will no longer be able to filter out the information that is important for their investment decisions ("information overkill"). The unqualified adoption of all proposals would for this reason impose a reporting overload at the expense of transparency. We believe in this connection that more importance should be attached to the materiality principle cited by the Basel Committee itself.

For this reason, all Pillar 3 requirements should be checked to see whether they give market participants an accurate picture of a bank's risk exposure. Such an approach is in line with the "*accurate picture of the bank's position with regard to assets, liquidity and earnings*" stipulated under commercial reporting rules. Under these, information is only of use to the addressee if it is relevant, reliable, comparable and understandable.

The Basel Committee's disclosure proposals also imply that market participants have a practically unlimited right to information. This is out of the question, however. We believe that each requirement should also be checked to ensure that it does not lead to disclosure of

business secrets or information about individual customer relations. We see in particular the danger that the detailed information requirements and the communication of confidential customer data and sensitive business data to third parties will encourage negative economic developments going beyond the level of market discipline pursued in Pillar 3.

Where small and medium-sized banks are concerned, detailed disclosure can mean that the information they disclose may allow more conclusions about their business structure within an economic region and possibly even about individual borrowers. Besides the impairment of banking secrecy that is to be feared, these banks would be put at a serious competitive advantage by the “information edge” competitors would have in this case.

Disclosure by banks should be not be prescribed by the Basel Committee (“requirements”) but only recommended (“recommendations”). It should be restricted to core information, provided it is important in individual cases. We believe that the desired market discipline would be strengthened much more if banks could publish flexible, market-oriented information and in this way provide market participants with information of importance for their investment decisions. The unqualified adoption of all proposals would leave banks no room to make their own disclosure arrangements.

Pillar 3 disclosure should be based on the IAS and US GAAP/European and national accounting standards and harmonised. The Basel Committee’s ideas create the impression that it is competing, on the one hand, with national or supra-national legislators (e.g. the European Union) and, on the other hand, with the relevant capital market bodies, i.e. International Accounting Standards Board and the International Organisation of Securities Commissions. Any additional disclosure basis resting on prudential rules is out of the question, as this uses different consolidation rules, assessment bases and definitions. The different information resulting from dual disclosure would not be communicable to addressees and of little use. On the contrary, dual disclosure would jeopardise the clear and timely reporting that is so important to investors.

We assume that the Basel Committee’s additional disclosure requirements going beyond accounting standards apply solely to the parent company of a group, particularly as consolidated financial statements are the internationally accepted medium. Full communication of information at sub-group or individual institution level offers no prudential or other benefit. As disclosure is not an end in itself, we firmly reject such disclosure.

May we now comment specifically as follows on the proposed rules:

The Basel Committee talks in paragraph 633 about disclosure requirements and strong disclosure recommendations. It also makes clear that the requirements are pre-conditions for the use of a particular methodology or instrument for regulatory capital purposes, particularly for measuring credit risk and for asset securitisation. We reject compliance with disclosure requirements as a pre-condition for the use of a particular method or instrument. We only accept detailed disclosure to supervisors in connection with vetting of eligibility to use internal systems. Disclosure of eligibility to use internal systems ("seal of approval") should be sufficient for market participants in terms of core information.

As regards the "*overarching principle*" for all banks laid down by the Basel Committee in paragraph 634 and according to which banks should have a formal disclosure policy approved by the board of directors, we refer to our remarks on the definition of "board of directors" in footnote 32 to paragraph 248 (see page 60).

1. Core and supplementary disclosure requirements (paragraph 635)

The Basel Committee expects sophisticated internationally active banks to make the full range of core information and supplementary information publicly available. We believe that disclosure of information should be determined solely by the materiality principle and not by a bank's level of sophistication. The remarks on supplementary information are contradictory and in some cases misleading.

2. Materiality (paragraph 636)

It should be made clear that in all disclosure requirements – no matter whether they concern core information or supplementary information – application of the materiality principle should be given top priority. The materiality of information should be assessed according to a bank's position in the marketplace, the potential addressees of the information concerned and the importance of the information for investment decisions by the user.

3. Frequency (paragraphs 637-639)

Generally speaking, only an annual disclosure requirement within the framework of the certified annual accounts should be imposed. More frequent disclosure should be limited to exceptions or legally specified cases. Extending the scope of disclosure requirements for semi-annual reports is inappropriate in our opinion, as it would jeopardise the timely reporting that

we are trying to achieve. Where disclosure more often than annually is stipulated or necessary, the disclosure rules for interim reporting set out in IAS 34 and GAS 6 are a suitable basis in our opinion. Under these rules, only substantial changes in significant positions that influence a bank's earnings position or risk exposure need to be disclosed on a more than annual basis.

The example of the market risk area illustrates that disclosure of only one segment cannot be representative for the entire bank, with the result that wrong conclusions about the situation of the bank as a whole may be drawn. Just as unclear is whether quarterly reporting reflects the relevant figures specifically for this quarter or shows them on an aggregated basis from the beginning of the year until the end of the quarter.

To ensure a level playing field, attention should be paid to consistency and compatibility with existing disclosure practices. We therefore basically welcome the Basel Committee's intention to continue working together with the internal accounting bodies. On no account should the Basel Committee go further than existing rules or pre-empt current or future developments in these areas.

4. Templates (paragraphs 640-641)

The templates contained in the Supporting Document are only useful in that in many cases the disclosure requirements only become clear through them. Banks should not, however, be obliged to use them, as features specific to individual banks could not be taken into account and future enhancement of disclosure requirements might be impeded. To make things clearer, we also suggest numbering the tables in step with the paragraph numbers in the document.

B. Disclosures – Scope of Application of the New Accord (paragraphs 642-643)

As explained above, it should be made clear here that compliance with the disclosure requirements is only required at the level of the parent company for the whole group. We reject disclosure for sub-groups. It has no additional benefit as compared to group reporting. Moreover, internal management is no longer based on legal entities but, increasingly, on group divisions.

1. Core disclosures (paragraph 643)

We have no reservations about disclosure of the particularities of how entities that are not included within the consolidated approach are captured for capital adequacy purposes (see bullet 4), provided this is only qualitative disclosure. The same goes for disclosure of the impact on the group's capital adequacy position in the event that surplus capital is recognised/given credit for (bullet 6).

Bullet 5 says that, in the event that a method other than the deduction method is used, the impact of this method as compared to the deduction method should be disclosed. This requirement would be tantamount to dual reporting and impose an unnecessary administrative burden. Apart from this, full consolidation is a much more accurate method than deduction of capital.

We reject detailed disclosure of shareholding levels (bullet 7). For materiality reasons, these shareholding levels should be confined to inclusion of "*qualified participating interests*" pursuant to Section 1(9) of the German Banking Act.

In bullets 8 and 10, disclosure should be confined to deductions from overall capital.

In bullet 9, the definition of materiality should be based on paragraph 16 (*Part 1: Scope of Application*; *E. Significant Investments in Commercial Entities*) or a provision similar to that of Section 1(9) of the German Banking Act.

2. Supplementary disclosures (paragraph 643)

Information on non-consolidated subsidiaries is to be disclosed. As subsidiaries that are not included in consolidation for materiality reasons are involved, this information is of subordinate importance for addressees. We therefore reject disclosure of such information. Moreover, the prudential requirements are irrelevant for most non-consolidated subsidiaries, as they are not included in the scope of consolidation.

C. Disclosures – Structure of Capital (paragraphs 644-646)

1. Core disclosures (quantitative) (paragraph 645).

The separate disclosure of paid-up share capital/common stock, disclosed reserves and minority interests in the equity of subsidiaries that is called for in bullet 1 is unnecessary. This information can be obtained directly from the annual accounts.

We also request clarification that the amounts in templates 2.2 and 2.4 on pages 22 and 24 of the Supporting Document are aggregate amounts.

We understand the term “*minority interests in the equity of subsidiaries*” in the sense of third-party capital investments.

2. Core disclosures (qualitative) (paragraph 645)

Information on whether unrealised gains or unrealised losses are included in Tier 1 capital (see bullets 3 and 4) is implicitly provided on disclosure of the general valuation rules. There is therefore no need for any further explanation.

3. Supplementary disclosures (paragraph 645)

The disclosure requirements should generally be confined to disclosure of overall capital.

4. For both core and supplementary disclosures (paragraph 646)

Disclosure of the information set out in paragraph 646 already takes place to a great extent under the prospectus publication requirement and should not be called for again. Further information could only be accepted vis-à-vis banking supervisors.

D. Disclosures – Risk Exposures and Assessment (paragraphs 647-669)

1. Credit risk in the banking book (paragraphs 648-661)

(i) Disclosures applicable to all banks (paragraph 650)

(a) Core disclosure (paragraph 650)

The requirement set in the first bullet for disclosure of total unweighted credit exposures before and after recognised credit risk mitigation, plus total risk-weighted assets, in current and previous period, is too complex. It is sufficient if credit exposures are only disclosed after credit risk mitigation. All that matters for measuring risk is the net risk exposure of a bank.

A breakdown according to loans, securities and OTC derivatives is too much. Disclosure in a single amount is sufficient.

Note on template 3.I.1 (Supporting Document, p. 28): The desired average figures should be based on the portfolios held on the respective reporting dates so that data stocks do not need to be extended due to additional requirements. We request that wording to this effect be incorporated in the document.

We reject the geographical distribution of credit exposures called for in addition to the cross-border distribution of such exposures (bullet 2). This distribution is at odds with internal risk management practice. We are therefore in favour of disclosure on an individual reporting segment basis.

An industry sectors or counterparty types distribution of credit exposures (bullet 3) must be rejected because of the limited information value of such a distribution. Moreover, there is the danger that this would allow conclusions about individual borrowers.

We also reject the maturity distribution of credit exposures called for in bullet 4. It is inconsistent with the requirements of the European Bank Accounts Directive. If a maturity distribution is not dropped, the distribution scheme provided for in this Directive should at least be used. New maturity grids should not be created.

The requirement in bullet 5 to disclose the amount of past due/impaired loans before deduction of provisions, broken down by counterparty type or industry sector, must be categorically

rejected as too complex. Where certain regionally focussed lenders are concerned, conclusions about individual borrowers cannot be ruled out and are therefore problematic from a protection of confidentiality angle. Moreover, economic consequences are possible if, for example, disclosure of high loan loss provisions leads the capital market to revises its expectations for a particular sector. We therefore suggest that only a single sum should be disclosed to the general public.

We understand the requirement in bullet 6 to disclose the amount of the allowance for credit losses, including specific and general provisions, to mean that only a single amount needs to be disclosed for specific provisions and for general provisions in each case. We also believe that such disclosure should only be required annually.

(b) Core disclosures (qualitative) (paragraph 650)

Disclosure of strategies should by no means go as far as to give competitors a detailed insight into internal business affairs or business secrets.

(c) Supplementary disclosures (paragraph 650)

The disclosure of average exposures called for in supplementary disclosures (bullet 1) means a much heavier administrative burden without any accompanying increase in information value. This information is therefore unnecessary.

The detailed breakdown of exposures by type, e.g. loans, investments, etc. (bullet 2) is of no additional benefit either.

The information about significant concentrations of credit risk called for in bullet 3 should continue to be disclosed only to supervisors under the EU provisions/the regulations relating to large loans and loans of three million deutsche mark or more pursuant to Section 13 of the German Banking Act. Generally speaking, we reject disclosure of specific individual, business-related information.

We reject disclosure of information on the number of days overdue with respect to past due and/or impaired loans (bullet 6). This requirement is geared to the US market situation and ignores the structure of products available on the German market (e.g. current account) and German accounting standards. It is an obstacle to harmonisation of IAS, US GAAP and, for

example, German accounting standards. Moreover, such information is not compiled by German banks.

Information about the volumes of credit risk transferred into securitisation vehicles (bullet 7) should, for systematic reasons, be made available in the disclosure section for ABS transactions.

Information about the credit protection purchased using credit derivatives (bullet 8) is unnecessary, as we are in favour of reporting of net risk positions only. Moreover, separate disclosure of this type of credit protection means unjustified discrimination of credit derivatives as compared to other methods of credit protection.

The information about credit scoring or portfolio credit risk measurement models is called for in the following sections (i) and (iii). This bullet should therefore be deleted.

(ii) Disclosures applicable to banks using the standardised approach (paragraph 651)

(a) Disclosure requirements (qualitative) (paragraph 651)

The requirement in bullet 2 to disclose the different types of exposure for which each rating agency is used must be rejected. The benefit for addressees of annual accounts is not clear. Supervisory recognition of an ECAI must suffice as adequate information. This is already provided for in bullet 1.

The alignment of different agencies' alpahnumerical scales with risk buckets that is called for in bullet 3 of the qualitative disclosure requirements (see in this connection our remarks on pages 21, 63) should be carried out centrally via national supervisors. To obtain recognition, rating agencies must fulfil qualitative and quantitative requirements, monitoring compliance with which is the task of supervisors and not banks. Comparisons of different risk weights lead to an unreasonable burden compared with the benefit. If a comparison is nevertheless desired, it should be published by the rating agencies.

(b) Disclosure requirements (quantitative) (paragraph 651)

Details of the percentage of outstandings in each risk bucket have no additional information value and should therefore be dropped.

(c) Disclosure recommendations (paragraph 651)

Information about changes in the list of rating agencies used by a bank (see bullet 1) is already contained in the regularly disclosed list of agencies itself (see paragraph 651 (a), bullet 1).

The information on average default rates that banks are recommended to disclose (bullet 4) must be rejected, as the use of different definitions of default will considerably diminish its value. There is also the danger that disclosure of average default rates per rating category – separated into rated and unrated exposures – will allow conclusions about individual borrowers.

(iii) Disclosures applicable to banks using IRB approaches (paragraph 652)

The Basel Committee only intends to allow the IRB approach if a bank fulfils the disclosure requirements for the internal foundation approach specified in Pillar 3 (see in this connection paragraph 309 – IRB approach). We categorically reject this condition. The sole criterion for the admission of an IRB approach must be the prudential assessment of this approach. The requirement for extremely detailed information on banks' internal risk-measurement models should be dropped. Instead, a reference to the fact that the model has been found to be sufficiently conservative for investor protection purposes should be enough. In this way, disclosure would be limited to key information. What matters to the general public is not the details of individual methods but whether the model has been checked and approved by supervisors.

(a) Qualitative disclosures: general information on methodology and key inputs (paragraph 652)

The information on key bank inputs set out here involves the danger of misinterpretation and misjudgement by other participants that may have negative consequences for the bank in question for no real reason. It should therefore be provided solely to supervisors. Supervisor's acceptance of the approach referred to in bullet 1 is self-evident and thus replaces bullets 2-4.

The requirement in bullet 7 to indicate the definitions of default employed for each portfolio is complicated, and also irrelevant for investors. For this reason, we also reject disclosure of reference definition mapping (see our remarks on paragraph 272 on page 62 f.).

Under bullet 8, the bank must fulfil certain additional disclosure requirements during a supervisory-approved transitional phase. We believe that such disclosure requirements may be anti-competitive. What matters is whether banking supervisors have approved a transitional phase. Disclosure should therefore be limited to general qualitative information.

(b) Quantitative disclosures part (i): required information for risk assessment (paragraph 652)

In bullet 1, the word "*nominal*" should be deleted. In certain cases, credit equivalents must be indicated.

We have reservations about disclosure of PD (and LGD) assumptions related to each IRB grade shown (bullet 2), should quantitative disclosure be required. Qualitative disclosure should be sufficient in this connection.

Bullet 3 stipulates that for each portfolio, for each PD and LGD bucket, the nominal exposure amount, before and after recognised credit risk mitigation, as well as weighted average maturity and the granularity adjustment for the whole portfolio, must be disclosed. Details of the nominal exposure amount by PD buckets for each portfolio are competition-sensitive, however, and may lead to misinterpretations.

Moreover, only a bank's net risk position, i.e. its exposure after recognised risk mitigation, matters. In addition, the weighted average maturity has no great value. The phrase "*related to each grade*" would also mean compilation of data with no information benefit. This bullet should therefore be deleted.

The information called for in bullet 4 should be dropped. It only matters to banking supervisors.
We reject disclosure of EAD assumptions, nominal exposure amounts and EAD estimates both before and after recognised credit risk mitigation in the advanced IRB approach (bullet 5). Details of model-based assumptions relating to individual types of product have no information value for the general public.

We also reject the disclosure of nominal exposure amounts and retail portfolio PD, LGD and EAD values called for in bullet 6.

We also reject disclosure of the distribution of external rated obligors over internal rating classes (bullet 7). External rating may already be taken into account within the framework of internal rating but is not, on its own, of any use for risk management purposes.

(c) Quantitative disclosures part (ii): *ex post* performance as an indication of quality and reliability (paragraph 652)

We reject the disclosure requirements in paragraph 652 (c) as a whole. The requirements are an example of the "information overkill" already referred to above. In our view, they are much too detailed and do not help to assess a bank's total risk exposure. The addressees of annual accounts do not lose any information, as supervisory recognition of the rating system already reflects the quality of the system. Moreover, the mere fact that the actual number of defaults differs from the estimated default figures does not allow the conclusion that the quality of the system is poor. This information may thus be misleading.

(iv) Credit risk mitigation techniques (paragraphs 653-658)

(a) Requirements

Qualitative disclosures (paragraph 655)

Here, too, a bank's legitimate interest in protecting its business secrets must be weighed up against the interest of third parties in disclosure of credit risk mitigation techniques.

Quantitative disclosures (paragraph 656)

The requirements set here would give direct competitors a close insight into sensitive areas of a bank and must therefore be rejected.

Template 3.IV.1 in this connection (see page 44 of the Supporting Document) should also be dropped or merely contain a "*Total risk weights*" column.

(b) Recommendations (paragraphs 657-658)

Quantitative disclosures (paragraph 658)

Under bullet 1, the net exposure amounts used for internal risk management purposes must be disclosed by risk weight bucket/internal risk grade. Supervisors will remain free to obtain this information directly from banks for their own purposes; we reject disclosure. In addition, it should be borne in mind that more collateral than that allowed by supervisors is used internally by banks.

The total annual recovery amounts from collateralised transactions called for in bullet 2 are to be interpreted to mean only the proceeds from liquidation of collateral.

We reject the breakdown of exposure amounts into risk-weighted assets excluding/ including collateral called for in bullet 3. Only the net exposure amount matters for investment decisions. It should be made clear that disclosure should, as a whole, be geared to parameters that are important for risk management purposes.

The same goes for the requirements in bullet 4. These, too, should be based solely on the net exposure amount. Moreover, separate disclosure of positions by internal rating grades makes little sense because of the lack of comparability. This bullet should be limited to disclosure by risk weights.

The final bullet, according to which a bank must disclose information on its main guarantors/credit protection providers, is a breach of the confidentiality of relations between banks and customers. We therefore firmly reject this bullet.

(v) Asset securitisation (paragraphs 659-661)

The information on how assets are securitised is unnecessary. The offering circulars published in this connection already contain most of the information called for by the Basel Committee and are made available to potential investors before conclusion of a transaction. In addition, under current practice each individual ABS transaction must be notified to the German Federal Banking Supervisory Office. Finally, when auditing the annual accounts, auditors are required to check information on the commitments in question and ascertain whether transactions were executed, settled and documented properly.

(a) Disclosures by originators (paragraphs 659)

Risks that have been legally transferred from a bank no longer constitute a risk on the part of the bank. The underlying transactions therefore do not need to be disclosed as well. Indication of the aggregate amount of loans securitised (item 1, bullet 1) where the "clean break" requirements are fulfilled would imply to the reader that there is an obligation by the disclosing bank that does not in fact exist.

The requirement under item 1, bullet 3, that, in the case of revolving loans and commitments, the amount of seller interest should be disclosed is unclear and must be worded more precisely.

The information required under item 1, bullet 4 is of no use to addressees, as it covers only a sub-element of bank funding. It should therefore be dropped.

It should be made clear in connection with the disclosure requirements under items 2 and 3 that only qualitative data are called for.

We reject the disclosure of aggregated data regarding the size and nature of liquidity facilities called for under item 5. Permissible liquidity facilities in favour of a special-purpose vehicle constitute, in economic terms, loan commitments which are included in the loan commitments position. They are also subject to risk reporting under the heading "liquidity risk".

(b) Disclosures by sponsors/third parties (paragraph 660)

See in this connection our remarks on paragraph 659 – Disclosures by originators, which apply likewise.

(c) Disclosures by issuers (i.e. SPVs) (paragraph 661)

Special-purpose vehicles (SPVs) are not banks, so that the disclosure requirements set under the Basel Capital Accord are not applicable to them. On no account can banks be held responsible for SPV compliance with the disclosure requirements. This would be categorically rejected by us.

2. Market risk (paragraphs 662-664)

The Basel Committee's requirements for disclosure of market risk, operational risk and interest rate risk in the banking bank go much further than the requirements under recognised accounting standards. We regard this as excessive ("information overkill").

(i) Disclosure applicable to banks under the standardised measurement method (paragraph 663)

(a) Core disclosures (paragraph 663)

See our general remarks (above) on disclosure of market risk positions.

(b) Supplementary disclosures (paragraph 663)

It is not possible for banks to compare the movement of portfolios between the standardised approach and internal models approach (bullet 1). This requirement should therefore be dropped.

We also reject the requirement in bullet 3 to disclose the daily variability of profits and losses on the trading positions concerned, as such positions have no bearing on investment decisions by interested outside readers. The same goes for disclosure by banks under the Internal Models Approach (paragraph 664 (b), bullet 4).

(ii) Disclosures applicable to banks under the Internal Models Approach (IMA) (paragraph 664)

In the case of a bank using its own internal models, a comparison of the internal models approach and the standardised approach (see (b)) is neither strategically desirable nor economically sensible. We therefore also reject such comparative disclosure.

The description of "outliers" and presentation of backtesting results called for in bullet 6 are directed mainly at internal addressees or intended as information for supervisors. They may be subject to misinterpretation by the general public.

3. Operational risk (paragraphs 665-666)

See also our general remarks on the disclosure of operational risk in section 2. Market Risk (above).

(i) Core disclosures (paragraph 666)

We have no objections to disclosure of key elements of the operational risk management framework (bullet 2), as long as disclosure of the risk management system does not go beyond the scope of recognised accounting standards.

A final assessment of the requirements in bullets 3 and 4 (disclosure of the operational risk exposure and the operational risk regulatory capital charge) is not yet possible, as no method has been stipulated.

(ii) Supplementary disclosures (paragraph 666)

We reject disclosure of actual losses. Such disclosure harbours the danger of misinterpretations and thus an unreasonable loss of reputation, since the general public has no benchmarks for measuring the “customary” size of operational losses. The size of losses also does not allow any reliable assessment of a bank’s operational risk profile (e.g. low frequency/high impact events). In particular, we reject the demand in Annex 5 of the Supporting Document (see page 52 therein) that publication of loss data should, in the longer term, be made part of the qualifying criteria to internal measurement approaches.

4. Interest rate risk (IRR) in the banking book (paragraphs 667-669)

We reject the disclosure requirements for interest rate risk in the banking book in their present complexity (see in this connection our remarks above on section 2. Market Risk.

(i) Qualitative disclosures: general information on methodology and key inputs (paragraph 668)

(a) Core disclosure (paragraph 668)

We have no fundamental objections to disclosure of the risk management structure and the nature of IRR in the banking book (bullet 1) and of key assumptions employed in its

measurement (bullet 2), provided that only general information is to be provided in this connection. On the other hand, we reject disclosure of expectations in regard to interest rate risk for competitive reasons.

(ii) Quantitative disclosures part (i): required information for risk assessment (paragraph 669)

(a) Core disclosure (paragraph 669)

We have no objections to disclosure of the size of the standardised interest rate shock by currency (bullet 1), as long as this information only has to be disclosed for the major currencies.

On the other hand, we categorically reject information about the bank's internal limits on IRR exposure (bullet 6). This data is highly competition-sensitive and, moreover, cannot be compared.

(iii) Quantitative disclosures part (ii): ex post performance as an indication of quality and reliability (paragraph 669)

(a) Core disclosure (paragraph 669)

It should be made quite clear here that only qualitative data on the goodness of fit of the models and/or validation of assumptions used need to be provided by banks. Further details should only be disclosed to supervisors.

(b) Supplementary disclosure (paragraph 669)

The requirement to break down the central information into different currencies and/or portfolios is obsolete if core disclosure merely calls for the provision of qualitative data.

E. Disclosures: Capital Adequacy (paragraphs 670-674)

1. Core disclosure (quantitative) (paragraphs 671-672)

We do not understand the requirement to disclose capital requirements for market risk, including capital charges for component risk elements (bullet 3). Individual types of risk are not assigned capital charges. Such a requirement must under no circumstances be allowed to restrict the freedom of banks to segment within the scope of their internal risk management.

2. Supplementary disclosures (paragraphs 673-674)

It should also be made clear here that banks are only required to provide general qualitative information. Quantitative data would be competition-sensitive and would thus have to be rejected. The requirement to provide information about contingency planning (bullet 2) must be completely rejected.

We categorically reject the requirement to provide information about the amount of economic capital (a) as a whole and (b) allocated to different transactions, products, customers, business lines or organisational units (see bullet 4). The Basel Committee made clear under its proposals that credit risk models may not be used at present for prudential purposes. Regulatory capital must be determined using the methods stipulated by the Committee. This capital is not, as a rule, identical with the economic capital requirement determined by banks' internal models. However, disclosure of the amount of economic capital implies its comparability with the capital determined or called for by supervisors and can therefore lead to misinterpretations. Moreover, this information is also competition-sensitive.

This also goes for a summary comparison/analysis of internal estimates of aggregate economic capital requirements versus reported capital amounts.

For the
ZENTRALER KREDITAUSSCHUSS
Association of German Savings Banks