28 July 2003 (trz03-559)

Mrs. Danièle Nouy
Secretary General
Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
CH-4002 BASEL

Dear Mrs Nouy,

Reference: **<u>Comments NVB on Consultative Paper 3 (CP3)</u>**

The Netherlands Bankers' Association (NVB) welcomes the opportunity to comment on the version of the New Basel Capital Accord contained in CP 3. Below you will find our main issues and suggestions for updating the Accord text; more detailed explanation is provided in the annex. In the annex we will also address some other technical issues and suggestions.

<u>Implementation of the Accord</u>

We especially appreciate the paragraphs on the Implementation of the New Accord in the Overview text provided with CP3. We would welcome the incorporation of those paragraphs of the Overview into the text of the Accord. We refer to the paragraphs 56 to 67 in the Overview about:

- (par 56) transition measures: banks not implementing Basel 2 will be subject to prudent capital adequacy, comparable with Basel 2;
- (par 60 & 64) forward looking aspects: define permanent future role of CTF and AIG;
- (Par 65, 66 & 67) cross border implementation: home supervisor should at all times be "leading".

In the annex we give detailed suggestions.

Below we refer to paragraphs in the CP3 text.

<u>Scope</u>

We plead for recognition of guarantee schemes within a bank holding and for the adequacy of consolidated capital, so we suggest that:

- (par 4) stand alone capital testing should not be obliged if entities are sufficiently guaranteed by and consolidated in the parent;

- (par 18) "Capital deductions" should be from total capital, or alternatively formulated 50% or more from tier 1 capital;
- the Accord should not be applied to non-bank subholdings if the parent itself falls within the scope of the Accord, and the non-bank subholding is consolidated within the ultimate parent.

Pillar 1: Credit risk

- (par 55-57, par 286) We propose to add the list of products for which Credit Conversion Factors (CCF) less than 100% apply in paragraphs 55-57 (Refer CP2: Internal Ratings-Based Approach paragraph 113 table 2). In addition the application of the regulatory CCFs of the Standardized and Foundation IRB-approach should be allowed in the advanced IRBA in case own estimates of CCFs as mentioned in paragraph 286 proves to be impossible.
- (par 66-99) The minimum requirements for eligible rating systems should, we believe, be viewed as guidelines. In the annex we give a few specific suggestions for textual changes to better align the requirements with current good practice.
- (par 202) The definition of qualifying revolving retail exposures (QRRE), should consider retail exposures to be "uncommitted" if the terms permit the bank to cancel them to the full extent allowable under consumer protection legislation. We propose that either overdrafts under current account facilities and revolving retail credits are explicitly included in the definition of QRRE or, alternatively, that a similar note as note 25 is added to criterion a) of paragraph 202.
- (par 235) The introduction of a general floor on the LGD for retail mortgages appears overly conservative for mortgages with conservative loan-to-value ratios. At national discretion loan-to-value ratios could be determined below which the floor is not applicable.
- (par 264) In our opinion the thresholds for CRE/RRE and other collateral should be deleted.
- (par 422) For conceptual and practical reasons "indirect costs" should be excluded from the definition of economic losses for estimating LGD.

Pillar 1: Equity

- (par 53, 315, 318,323) The risk weights in par 318 and 323 are neither aligned to those in par 53, nor to those in 315; see the annex for our suggestion.
- (par 322) The reduced risk weights should apply to all instruments with the same characteristics, so the word "private" should be deleted.
- (par 325) An LGD of 45% for hedged PD/LGD exposures would be more consistent with the overall framework.

Pillar 1: Securitisation

We refer to the comments of ASF, ESF and ISDA, but would like to make two specific suggestions:

- (par 589) delete the floor under SFA to reduce the overall conservatism;
- (par 539, 600-601) CCF for eligible liquidity facilities in par 600-601 should be 50% as in par 539.

Pillar 1: Operational risk

Many important issues have been addressed. The NVB believes that further dialogue will help ensure the effectiveness of the regime for operational risk. Our comments in the annex focus on issues where we believe that further discussion is required:

- (Par 612, 617) to provide economic incentives to progress along the continuum of approaches, as for some lines of business betas (Par 617) are higher than the alpha (Par 612) and the additional investments required for AMA might not be off-set by the potential capital gain.
- to find a practical solution to home / host supervision issues under AMA. The NVB believes regulators should accept firms to calculate capital at the group level and either allocate per jurisdiction or remain locally on BIA or SA.
- (Par 638 sixth bullet point) to extend the recognition of insurance for operational risk to insurance capacity held in captives and to reconsider that capital investments in insurance captives should be deducted from the group capital.
- (Par 638 second bullet point) to reconsider the application of the haircuts. In practice the usage of haircuts on the notional is inappropriate.
- (Par 637) to extend the scope of risk mitigators. Risk mitigation should not be limited to insurance products, as financial markets will evolve.

Pillar 2

Most important for the NVB is that no mandatory disclosure provision of Pillar 2 will be considered as proposed by accounting bodies; no bank level disclosure of measures under Pillar 2 should be made, just as these measures are not disclosed under the current regime. Our suggestions for the Pillar 2 text are the following:

- (par 690, 691, 695) In Pillar 2 all risks should be considered in a comprehensive judgmental process, including their interdependencies, compensation and portfolio effects. Par 691 should include “credit risk diversification effects” and Par 695 should include “operational risk correlation effects”.
- (par 707, 708) Just the same, the overall capital requirement under Pillar 2 should be based on the balance of a series of capital add-ons and offsets in a comprehensive judgmental process.
- Additional regulatory capital under Pillar 2 should only be required in exceptional cases, given capital levels of banks in the international peer group. This guideline should be mentioned in a separate paragraph as part of Part 3, item A regarding the importance of the supervisory review and under Principle 4.
- (par 756) For the cross-border implementation of Pillar 2 the Basel Committee should include in Pillar 2 a set of guiding principles for supervisors. We suggest adding to paragraph 756 that the home supervisor of the parent is leading and thus guides host supervisors in their Pillar 2 assessment. We propose to include in such a set of principles at least the requirement that Pillar 2 will be applied at the top consolidated level and the home state supervisor will exercise supervisory responsibilities. Only in exceptional circumstances a host state supervisor should exercise Pillar 2 requirements.

- (par 700) In case risks are not measurable, they should be deleted from the capital assessment process. Paragraph 700 should be deleted.

Pillar 3

The NVB supports the purpose of Pillar 3, market discipline, and thus welcomes the reduction of the number and level of detail of disclosure requirements. However, a major concern remains the impact of new IAS.
The International Accounting Standards will cause fluctuations in ratio outcomes, which must be investigated. Views on differentiating between capital ("own funds") for supervisory purposes and own funds for accounting purposes must still be explained.

Finally, it is quite important to the NVB that:
- national supervisors keep the impact of the national discretions under review,
- regulators explain publicly how national discretions are being used, and
- over time, national discretions will be removed by consensus.

We look forward to your wording of the final Accord and again thank you for considering our ideas regarding banks' capital adequacy.

Yours sincerely,

Mr. H.G.M. Blocks

ANNEX DUTCH BANKERS' ASSOCIATION'S DETAILED SUGGESTIONS

Implementation of the Accord

The NVB urges the Committee to consider to incorporate in the Accord the general principles and the high level guidelines with regard to the implementation. As those issues largely have been addressed in the Overview document we would suggest including the following paragraphs in the Overview text into the Accord's articles**:**

- Overview Par 56 (last part):
  "National supervisors in the G10 will ensure that banks not implementing Basel II will be subject to prudent capital adequacy regulation".
- Overview Par 60 and Par 64 (last sentence)
  "The Committee sees frequent exchanges of information between banks and supervisors and between supervisors in different jurisdictions as critical for the successful implementation of Basel II. To promote consistency in the implementation of the New Accord across jurisdictions, the Committee established the Accord Implementation Group (AIG) for national supervisors to exchange information on the practical implementation challenges of Basel II and on the strategies they are using to address these issues. The AIG also will work closely with the Committee's Capital Task Force (CTF), the body responsible for considering substantive modifications to and interpretations of the New Accord."
  "Future exchanges of views between banks and supervisors on developments in risk management will help the Committee to make decisions that will keep the new framework relevant for years to come."
- Overview Par 65 (part):
  "The Committee believes existing cross-border responsibilities of supervisors, as set out in the Basel Concordat and Minimum Standards documents *) will continue to apply as the New Accord is being implemented." "Nevertheless, the new Accord will require enhanced cooperation between supervisors on a practical basis especially for the cross- border supervision of complex international banking groups. In particular, the Committee believes that wherever possible, supervisors should avoid performing redundant and uncoordinated approval and validation work in order to reduce the implementation and maintenance burden for banks, and to conserve supervisory resources. Consequently, the Committee believes that supervisors should communicate as clearly as possible to affected banking groups about the respective roles of home- and host-country supervisors so that practical arrangements are understood. [*) Footnote referring to the documents].
- Overview Par 66 (part):
  "Cross-border implementation of the Accord will not change the legal responsibilities of supervisors for the regulation of their domestic banking organizations and the arrangements of consolidated supervision." "The AIG is developing and maintain a set of principles to facilitate closer co-operation and information exchange between supervisors."

- Overview Par 67:
  "The Committee broadly supports the principle of "mutual recognition" for internationally active banks as a key basis for international supervisory co-operation. This principle implies the need for recognizing common capital adequacy approaches when considering the branching of internationally active banks into host jurisdictions, as well as the desirability of minimizing differences in the national capital adequacy regulations between home and host jurisdictions so that subsidiary banks are not subjected to excessive burden."

The NVB is in favor of an efficient and univocal solution to home/host issues. Without denying host country supervisors their authority to supervise banking establishments in their jurisdiction, we consider it important that international banking groups have only one counterpart to discuss and rule on IRB approval related issues, Pillar 2 supervisory review issues, and the application of the Accord to sub-groups within a consolidated banking group (solo-supervision). The main counterpart should preferably be the home supervisor; he would have to be able to convince host supervisors of the adequacy of both capital base and risk management systems of banks. We suggest that the AIG come forward with ideas to form consultation groups or a college of supervisors for each major international banking group. Such consultation group should agree together, coordinated by the home supervisor, on important supervisory issues. We suggest adding a specific new paragraph that addresses this issue.

Scope of application (CP3, Part 1)

Adequacy of stand alone capital

Paragraph 3 states that the New Basel Capital Accord will apply to all internationally active banks at every tier within a banking group, also on a fully consolidated basis. Paragraph 4 states that supervisors should test that individual banks are adequately capitalized on a stand-alone basis. For banking groups that consist of multiple individual banking entities, these requirements not only significantly increase the overall administrative and regulatory burden but also deny the guarantee schemes between the entities within a holding and would require unreasonably high cumulative buffers at higher consolidation level.

Therefore, the NVB urges the Committee to review its viewpoint on the stand-alone testing of capital adequacy. The NVB proposes for paragraph 4 to exempt banking groups from stand-alone capital adequacy testing of an individual banking entity, in case this entity complies with the following conditions:

- The liabilities of an individual bank within a banking group are guaranteed by the holding company that is the parent entity within a banking group, and
- The financials of the individual bank are consolidated in those of the banking group.

If the holding company is itself a subsidiary (a non-bank sub-holding) of a parent which:

(a) falls within the scope of the Accord and

(b) the non-bank sub-holding and its subsidiaries are consolidated within the ultimate parent,
we believe that separate application of the Accord at the level of the non-bank holding is disproportionate.

Banking, securities and other financial subsidiaries
Paragraph 6 states that supervisors will adjust the amount of minority interests that may be included in capital in the event the capital from such minority interest is not readily available to other group entities. According to the NVB minority interests should be recognized as consolidated capital to the extent that capital in the subsidiary covers the required capital. Correcting measures if needed should be taken within - the balanced - overall capital adequacy evaluation under Pillar 2.

Deduction of investments pursuant to this part
The NVB remains concerned about the adverse impact of the proposal that deductions of investments should be 50% from Tier 1 capital and 50% from Tier 2 capital, prior to the planned re-definition of capital. The 1988 Accord states that "investments in unconsolidated banking and financial subsidiary companies" should be deducted "from total capital", and paragraph 24 of the Accord states that such investments should be deducted "from the capital base".

We suggest in this stage not to alter the current regime on capital via the backdoor and to consider to abolish Par 18 or to rephrase paragraph 18 into: "deductions of investments should be made 50% or more from tier 1 capital and at most 50% from tier 2 capital", until a final solution will be defined within the context of the re-definition of eligible capital.

Pillar 1: Credit risk
Scope of the qualifying revolving retail exposures (QRRE) asset class
In the definition of QRRE (paragraph 202), a part of the first criterion explicates that these exposures are uncommitted (both contractually and in practice). In paragraph 27 of the Overview of the New Basel Capital Accord document, explicit reference is made to credit card relationships.

In the Netherlands, the use of credit cards is relatively limited. The function of credit cards is partly fulfilled by other facilities like current account facilities and revolving retail credits. These facilities comply with most of the criteria (a) through (f) in paragraph 202 of CP3. However, if uncommitted exposures (both contractually and in practice) under 202 (a) are interpreted strictly as facilities that are unconditionally cancelable without prior notice, this requirement cannot be met due to consumer protection laws in The Netherlands. In the Standardized Approach the Basel Committee has recognized a similar issue. Indeed in note 25 to paragraph 56 it is explicated that "In certain countries, retail commitments are considered unconditionally cancelable if the terms permit the bank to cancel them to the full extent allowable under consumer protection and related legislation."

We propose that either overdrafts under current account facilities and revolving retail credits are explicitly included in the definition of QRRE or, alternatively, that a similar note as note 25 is added to criterion a) of paragraph 202.

Credit Conversion Factors
In paragraphs 55-57 we miss some of the credit products eligible for a CCF less than 100% that are included in the Current Accord and were also mentioned in CP2 (January 2001), in particular performance bonds, bid bonds, NIFs, etc that currently have a CCF of 50%. We note that in paragraph 56 the word "commitments" is used to describe the products that can have a CCF less than 100%, but the word "commitments" has different meanings throughout the Accord (e.g. compare paragraph 280) and therefore might be interpreted differently than intended. We ask that this be clarified, preferably by providing the list of applicable products including at least the current list of products where a CCF less than 100% applies.

Next, paragraph 286 allows banks to use their internal estimates for CCFs for products that have a CCF less than 100% in the Foundation approach, provided they meet the requirements for the use of own estimates of EAD. However, we note that contrary to PD and LGD, the document does not give directions how CCFs should be validated. Furthermore we have reason to believe that validation may prove to be elusive, because:

- No operational definition of CCF is provided, which makes it unclear what exactly needs to be validated and what should be measured. As CCFs are a rather alien concept in the economic capital models known to us, no guidance is forthcoming from this source either.
- There are some product-specific measurement problems that will make validation extremely difficult. For example, performance bonds are seldom drawn, because it is in the interest of the lender and the company to complete the project and have the performance bond returned. However, completion may require additional funds under another credit facility. The credit loss, if any, may then not be connected with the performance bond, but with this other credit facility.
- Given the relatively low risk of these types of facilities, it is unlikely that banks have enough loss data to validate CCFs for these products.

We therefore propose that under the Advanced IRB approach banks are allowed to use the CCFs applicable in the Standardized and Foundation IRB approach if they cannot "validate" their own CCF-estimates.

Removal of the Floor on LGD for retail mortgages
Paragraph 235 introduces a 10% floor for LGDs for residential mortgages. This floor comes on top of another floor of PD=0.03%. The NVB believes this is overly conservative for portfolios with low loan-to-value ratios (to be determined by national supervisors). Also the floor would give the incentive to choose a relatively late default definition.
Although the NVB acknowledges that some of the outcomes of the QIS3 may have appeared too optimistic to regulators, it requests that these concerns not

be translated in a general floor that applies to the whole portfolio and industry.

Thresholds for eligible collateral

Paragraph 264 requires for CRE/RRE and other collateral a minimum collateralization level of the exposure. We believe that this requirement is cumbersome, can easily be circumvented (by splitting facilities) and thus only adds to banks' implementation costs while being ineffective for risk management purposes.

Also we find the underlying reason for introducing thresholds as presented in CP2 (Internal ratings document paragraph 95), that relatively low collateral values would not be a proper incentive for the bank to monitor and collect the collateral, unconvincing and in contradiction with actual bank practice. In particular for larger facilities relatively small collateral values can be quite significant in absolute amounts. We propose to abolish these minimum collateralization levels all together.

Indirect costs in the loss definition conflicts with accounting principles

The definition of economic loss for estimating LGD, as set out in paragraph 422 of CP 3, includes the "indirect costs associated with collecting on the exposure". In practice, these costs are fixed in nature, are independent of the level of risk and cannot be allocated to individual clients or portfolios. Typical examples of the indirect costs we refer to are personnel salaries, office space and IT systems. Moreover, these costs are already included in the income statement. Since changes in the level of dynamic provisions will influence the income statement as well, including the indirect costs in these provisions will lead to 'double counting', obviously being inconsistent with accounting principles in force.

In practice it is proven impossible to maintain the loss definition as stated in paragraph 422 and have it approved by external accountants. There will be inconsistencies in case of loss pooling initiatives and with regard to loan loss allowances.

We propose to exclude the indirect costs from the economic loss-definition. This way, the requirement of paragraph 422 to be "able to compare accounting and economic losses" can still be met. We are worried that otherwise, banks will be forced to design, implement and run parallel systems for, on the one hand, compliance with accounting regulations and, on the other hand, the determination of LGD according to the New Basel Capital Accord loss definition.

Rationalization of minimum requirements

It is our understanding that not all minimum requirements should be interpreted as requirements but that some of these are to be taken as guidelines and examples. If this would not be the case, quite a few of these minimum requirements would be unclear, contradictory and/or not in line with the intention of the Basel Committee, namely banks' best practices.

In the table below we provide some examples of paragraphs, which we believe are either too prescriptive or not in line with banks' best practices. We would like the Committee to exclude such requirements from the final version of the Accord, or alternatively, rephrase these paragraphs in order to clarify that these are guidelines supporting the theoretical framework.

Paragraph	Minimum requirement	Reason
396/399	Stress testing used for the assessment of capital adequacy.	We believe that Par 396-399 should be part of Pillar 2. If maintained as part of Pillar 1, this should not be done in the current context of rating systems.
405	Internal audit (…) must review at least annually the bank's rating system and its operations, including the operations of the credit function and the estimation of PDs, LGDs and EADs.	This paragraph is unclear. We believe that annual reviews of processes by internal audit are feasible, as opposed to e.g. reviews of the estimation of the risk components which is not the responsibility of internal audit.
421	Authorized overdrafts must be brought to the knowledge of the client	We recommend the paragraph be rephrased that only authorized overdrafts that are subject to an external limit be brought to the knowledge of the client.
430/437	LGD and EAD estimates that are appropriate for an economic downturn should be used when LGDs and EADs are volatile over the economic cycle	As LGDs are expected to be volatile to some degree the paragraphs are either redundant or if a strict interpretation is intended will lead to overly conservative estimates (i.e. worst case LGDs instead of default-weighted LGDs). It is our strong believe that long run default-weighted averages should be sufficient. We propose to delete sentences in par 430 & 437 starting with "moreover.." and ending "more conservative than long term average".
481	Continuous monitoring process for pledged receivables	The use of the word "continuous" is unfortunate, as it implies a monitoring frequency that is highly impractical and hence very

		undesirable. We suggest that this requirement be rephrased in order to reflect a more reasonable frequency/approach.

Leasing
The NVB wants to point to a few issues specific to leasing:
1. The assumption that EAD may not be lower than current outstandings is unduly conservative for leasing contracts with steep redemption schedules.
2. Annual re-rating of all leasing contracts is not always customary in particular for small-ticket leasing contracts given the fixed nature of the underlying contract.
3. The 100% risk weight for residual risk is not risk-sensitive and as such should (in time) be replaced by a more risk-sensitive measure like VaR.

Procyclicality
The NVB recognizes that the more risk-sensitive nature of CP3 when compared with current regulations will lead automatically to an increased procyclicality of the capital requirements. Although it is expected that banks will be able to manage this increased procyclicality, little is yet known with certainty regarding the degree of the procyclicality. The NVB requests that the Basel Committee evaluate this aspect when more reliable data become available.

Pillar 1: Equity
Paragraph 322 states that a minimum risk weight applies to private equities where the return on the investment is based on regular and periodic cash flows, not derived from capital gains, and where there is no expectation of future (above-trend) capital gain or of realizing any existing gain (e.g. preference shares). This reduced minimum risk weight should apply to all equity instruments with the same characteristics, public or private. We propose to delete the word “private” in paragraph 322.

The minimum risk weights for each equity position defined in paragraph 323 are higher than the risk weights in the Standardized approach mentioned in paragraph 53. We would suggest lowering these minimum risk weights in the Market based and the PD/LGD-approaches (par 318 and 323) at least to the same level as in the Standardized approach (we propose: 150%), which still leaves the treatment of Equity under the Standardized approach better off. Also the risk weights of the simple risk weight method should be better aligned with those in the Standardized approach by lowering the risk weights in paragraph 315 to more comparable levels (e.g. 200% and 300% respectively).

Paragraph 325 states that for hedged PD/LGD equity exposures the LGD to be used is (still) 90%. Given the fact that the potential claim to the hedge provider is normally senior unsecured an LGD-percentage equal to that of unsecured exposures, i.e. 45%, would be more consistent with the overall framework.

<u>Pillar 1: Securitisation</u>

Although we recognize that the Committee has taken account of some comments of the industry we believe that more should be done to address the general overly conservatism of the calibration of risk-weights and some more practical issues. We refer to comments of ASF/ESF/ISDA. Also we note that several industry initiatives are underway to gather more data to support the claims of conservatism and we hope that the Committee will take these into consideration.

Below we provide two issues that from an analytical point of view diminish the risk-sensitivity of the Accord and are too conservative:

- The floor capital charge applicable under the Supervisory Formula Approach (par 589) imposes an arbitrary minimum capital level for very low risk tranches that adds to the overall conservatism of regulatory capital for securitisations. The NVB believes that this conservatism has been taken too far and therefore proposes that this floor be deleted.
- In the IRB-approach all liquidity facilities, except for market disruption, receive identical Credit Conversion Factors of 100%, thereby also being the same as that for a direct cash exposure (paragraphs 600-601). We believe that the CCFs for liquidity facilities in the (assumedly more advanced) IRB-approach should be at least as risk-sensitive as in the Standardized approach (paragraph 539) by distinguishing between eligible and non-eligible liquidity facilities (par 538). If the CCFs of the Standardized approach are believed to be too low then at least the CCFs mentioned in paragraph 603 for the specific IRB-approach (when no top-down or bottom-up calculation of Kirb is possible) should be applicable. This implies amongst others a CCF of 50% for eligible liquidity facilities.

<u>Pillar 1: Operational Risk</u>

Incentives

Based on the current calibration, insufficient incentives might exist to make the investments necessary to progress along the continuum of approaches outlined in CP3. The additional investments required for AMA might not be offset by the potential capital release.

Standardized Approach

The NVB appreciates that, compared to CP2, the minimum criteria for the Standardized Approach have been considerably reduced. Nevertheless, the odd situation of having betas which are higher than the alpha remains. This provides a disincentive for applying the Standardized Approach (SA). Particularly, for banks active in Corporate Finance, Trading & Sales and Payment & Settlement, the incentive is to remain on the Basic Indicator Approach (BIA). In other words, the areas with the highest inherent operational risk (indicated by a higher beta of 18%) have an incentive to stay in BIA at 15%. This inconsistency should be removed.

The NVB would like to obtain more clarity on the purpose of Alternative SA as it appears to be attractive to banks with a high interest margin and could create capital arbitrage possibilities.

Advanced Measurement Approaches
The Basel proposal indicates that Advanced Measurement Approaches (AMAs) will be required to meet quantitative standards comparable to credit risk. Specifically, AMAs must capture severe tail events using a one-year holding period (and a 99.9%) confidence interval. In practice, this might prove to be too conservative, given the shape of the operational loss curve (i.e. a fat tail due to low frequency high impact events that could have a significant impact on capital levels). This will be especially relevant during the current build-up phase.

Recognition of insurance
The NVB appreciates the continued willingness to work on recognition of insurance, including the development of clear and fair standards against which the acceptability of a given insurance policy may be tested. Recognition of risk mitigation helps the new Capital Accord to be risk-sensitive. Insurance may only be recognized under the AMA. The NVB would like to make the following comments to the recognition criteria provided:

- CP 3 states that insurance is to be provided by a third party. We recommend a change in wording, such that the capital held in insurance captives is also recognized. This is especially relevant given the requirement that capital investments in insurance captives should be deducted from the group capital.
- The proposed requirement that coverage be explicitly mapped to operational risk loss exposures will be extremely difficult, as this is currently not supported by the insurance policies. We fear that the insurance market will require much additional time to develop such policies and therefore suggest deleting or softening this requirement.
- The usage of haircuts on the notional seems inappropriate as insurance is based on the occurrence of an event i.e. if an event occurs, insurance exists up to the amount of the notional. A solution would be to remove the haircut.
- The criterion of the length of insurance contracts is not appropriate. In practice, insurance contracts are often renewed annually. This implies that over a one-year period a bank does not benefit from coverage over the next one-year period. A solution would be to apply original maturity.
- Overall, risk mitigation should not be limited to insurance products. We can envisage the creation of financial market products, that offer equal risk transfer capabilities as insurance.

Home Host
The NVB is convinced that the AMA will simply not be practical without the ability to calculate capital requirements at group level and allocate (downwards) per jurisdiction. Key factors restricting the ability to calculate individual AMA requirements for multiple entities within a group are as follows:

- Data insufficiency at the level of individual entities (or, for that matter, groups of entities) will be particularly relevant, given that this is already an issue at group level.
- Excessive capital will result to the extent that there is a failure to recognize the significant levels of risk-diversification that firms achieve. The sum of the

individual-entity capital requirements is likely to be considerably more than the group requirement.
- There will be a major and, in a group context, duplicative management burden, if each individual entity (or group of entities) is required to meet AMA standards in full.

The NVB believes that the practical solution to this dilemma is for regulators to accept that firms calculate capital at the group level and either allocate per jurisdiction or allow local calculation of the capital requirement for Operational risk on the basis of the BIA or SA.

Temporary Partial Use
The NVB appreciates that partial use of AMA is permitted. However, the current text reads as if the entire bank on a certain moment in time should qualify for AMA. The NVB believes that banks, if well argued, should be allowed to have certain entities remain on BIA or SA.

External data
As concerns the use of external data (para.634) we do not appreciate the conditional statement "when there is reason to believe that the bank is exposed to infrequent, yet potentially severe losses". Since AMA is (to be) applied by larger sized international active banks, those banks are – by definition - exposed to infrequent/severe losses. Thus the use of external data should be a "must" to AMA applicant banks. Thus, according to par 634, the use of external data becomes an automatic requirement to AMA applicant banks. We suggest to rephrase into" when there is reason to believe that use of external data will lead to more and better insight into the risks and implementation efforts are in balance with the gains".

Treatment of correlation
Banks will be permitted to use their internal correlation assumptions in AMAs, but only if they can "demonstrate to a high degree of confidence and to the satisfaction of the national supervisor that its systems for determining correlation are sound, implemented with integrity and take into account uncertainty surrounding any such correlation estimates (particularly in periods of stress)." (Par 629d)

This requirement appears to be too technical and in practice might prove to be too onerous.

Pillar 2

Use of Pillar 2 framework

Under Basel I, banks were required to hold regulatory (Tier 1 and Tier 2) capital for at least 8% of their risk-weighted assets. The 8%-criterion addressed risks that were specifically quantified (credit risk, market risk), but also addressed risks that were not specifically quantified. Under Basel II, Pillar 1 requires an 8% minimum of risk-weighted assets for credit, market and operational risk. Pillar 2 considers risks that are not (fully) considered under Pillar 1 and factors external to the bank. To avoid an overestimation of required minimum capital, the NVB requests the Basel Committee to urge supervisors to use the Pillar 2 framework with the utmost care. Additional capital charges under Pillar 2 should only be required in exceptional cases.

The NVB is concerned that Pillar 2, with the specific issues to be addressed under Pillar 2 that were introduced, could lead to a system of automatic additional capital requirements driven less by the specific circumstance of each bank and more by a general regulatory requirement. This would be an unacceptable outcome, not least because these requirements have not been included in the calibration of the Accord. In fact, a capital requirement under Pillar 2 should not be the outcome of a series of capital add-ons, but the balance of a series of capital add-ons and off-sets. The offsets under Pillar 2 could for instance be based on an exceptional level of diversification of the credit portfolio or the outcomes of economic capital models. The NVB proposes the following:

- A capital requirement under Pillar 2 should be based on a comprehensive judgmental process, resulting in a balance of a series of capital add-ons and offsets, and recognizing diversification effects.
- Additional regulatory capital under Pillar 2 should only be required in exceptional cases, where risks within a particular bank are excessive.
- We support the Committee in proposing that no bank level disclosure of measures required under Pillar 2 should be made.

Comprehensive judgement should be mentioned in Part 3, item A regarding the importance of the supervisory review, and under Principle 1, Par 707 in an additional bullet point. In addition in Par 708 the word “also” could be removed, as this would suggest “in addition to” while Par 708 prescribes a specific detail of Par 707.

Cross-border implementation of Pillar 2

The NVB urges the Committee to include in the Pillar 2 framework a set of guiding principles for supervisors with respect to the cross-border implementation of Pillar 2. The NVB proposes to include in such a set of principles at least the requirement that Pillar 2 would apply at the top consolidated level and the home state supervisor exercises supervisory responsibilities. Only in exceptional circumstances a host state supervisor should exercise Pillar 2 requirements.

Other risks
The NVB proposes to exclude the so-called “other risks”, such as strategic and reputational risk, from the risks that need to be addressed in the capital assessment process under Pillar 2. We suggest deleting par 700.

Pillar 3
Details of disclosure requirements
The NVB acknowledges that the proposed disclosure requirements in CP 3 meet some important concerns of the banking industry, as the number and level of detail of the requirements have been further reduced:
- The Committee stated they recognized the need for the disclosure framework to align with international accounting standards. We understand that this means that mandatory disclosures under IAS-guidelines will supersede the same requirements under Pillar 3.
- Pillar 3 is only applicable at the top consolidated level of the banking group. Disclosures related to individual banks within the group will not generally be required, except for disclosures of total and Tier 1 ratio.
- The disclosure requirements have been reduced especially for securitisation transactions.
- The disclosure requirements take into account the confidentiality (sensibility, propriety) of the disclosure. For example, the disclosure of the bank's strategy of assessing the capital adequacy is no longer required.

However, it is important to us that the Accord is explicit that firm-specific thus confidential technical information about PD, LGD, EAD in the IRB approaches should only be disclosed to supervisors. We are concerned that IAS developments will imply mandatory disclosure of individual Pillar 2 capital add ons.

Furthermore we encourage the Committee to enhance supervisory convergence in general, and with respect to national choices of disclosure details specifically.

Impact IAS
The NVB is very concerned about the impact of IAS 39 on the calculation of regulatory capital (or “own funds” in the EU-area) for supervisory purposes. Further investigation could be necessary of the impact on risk-weighted assets, fluctuations in capital and resulting volatile Tier-1 and Tier-2 ratios. If IAS current standards (fair value accounting) were applied without significant changes, they would have a great impact on prudential ratios. When it comes to applying IAS/fair value to Basel I and II calculations and requirements, this could result in undesirable results. Potentially this could lead to misunderstanding by the public in interpreting the volatile swifts of the Tier-1 and Tier-2 ratios, undermining the confidentiality in the banking system.

The Basel Committee should investigate fluctuations in ratio outcomes and to explain their views on differentiating between own funds for supervisory purposes and own funds for accounting purposes.