Swedish Bankers´ Association

Svenska Bankföreningen

POSITION PAPER

22 July 2003

.

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

The New Basel Capital Accord – Consultative Document (April 2003)

Swedish Bankers´ Association welcomes the opportunity to comment on the Basel Committee´s third consultative document on a new Capital Accord.

Summary of Swedish Bankers´ Association's main comments

Swedish Bankers´ Association's main comments on the Basel Committee´s proposal are the following:

As regards credit risk

- The proposal to set a floor of 10% on LGD for retail exposures secured by residential properties should be deleted.
- The proposal to have a "SME use test" for retail treatment in the IRB approach should be deleted.
- The wide range of minimum requirements under the IRB approaches should be reduced.

Postadress	Gatuadress	Telefon	Telefax	Bankgiro	Postgiro
Box 7603 SE-103 94 STOCKHOLM www.bankforeningen.se	Regeringsgatan 38	08-453 44 00	08-796 93 95	700-1779	505-8

As regards operational risk

- The proposal to recognise the risk mitigating impact of insurance under the Advanced Measurement Approach should be extended to the other approaches.

- -

GENERAL REMARKS

There is a wide range of national discretions in the new Accord. Most of these national discretions are needed due to for instance differences in business behaviour and differences in cultural and legal environment between countries. However, it is very important for level playing field reasons that banks, which have business activities in a foreign jurisdiction, are allowed to use the different approaches that the local supervisor has implemented in its jurisdiction.

SCOPE OF APPLICATION

<u>Paragraph 18:</u>

<u>The Basel Committee</u> proposes that "Deduction of investments in deconsolidated entities will be 50 % from Tier 1 and 50 % from Tier 2".

<u>Swedish Bankers' Association</u> would like to emphasize that in the 1988 Basel Accord it is stated "investments in unconsolidated banking and financial subsidiary companies" should be deducted "from total capital" (Annex 1., C.). In the Accord's paragraph 24 it is stated that such investments should be deducted "from the capital base".

The proposal to deduct 50 % of the investment from Tier 1 (core capital) - instead of the present deduction from total capital - would imply a reduction of Tier 1 capital for many banks.

The proposal for a New Basel Capital Accord does not deal with any need to reform the definition of the capital base. Because of this, our opinion is that at present no changes should be made as regards the capital base.

If the Basel Committee is going to change the present rules for the capital base, we propose that the deduction for goodwill should be made 50% from Tier 1 and 50% from Tier 2 – instead of 100% from Tier 1 as is proposed in paragraph 19.

CREDIT RISK – THE STANDARDISED APPROACH

Paragraph 45:

The Basel Committee proposes a risk weight of 35% for lending fully secured by mortgages on residential property.

Swedish Bankers' Association welcomes the proposal to reduce the risk weight for lending fully secured by mortgages on residential properties to 35% but is of the opinion that the risk weight still is too high with regards to the low loss rates associated with such lending in countries like Sweden. This is especially the case for such loans with low LTV ratios. When comparing the proposed 35% with the present 50%, it must be taken into consideration that on top of these 35% new capital requirements for operational risk will be added.

CREDIT RISK – THE INTERNAL RATINGS BASED APPROACH

Paragraph 200:

In the IRB Approach, exposures to small businesses are eligible for retail treatment provided the bank meets the requirements of a "SME use test". The Basel Committee requires that exposures to SMEs "shall not be managed individually in a way comparable to corporate exposures, but rather as part of a portfolio segment or a pool of loans with similar risk characteristics for purposes of risk assessment and quantification." At the end of the paragraph 200 it is also added: "However, this does not preclude retail exposures from being treated individually at some stages of the risk management process. The fact that an exposure is rated individually does not by itself deny the eligibility as a retail exposure." In the Standardised Approach there is no "SME use test" requirement for the treatment of SME loans as retail.

Swedish Bankers' Association is of the opinion that the proposal to have a "SME use test" in the IRB Approach is inadequate and harmful since it creates incentives for banks to avoid proper and adequate management of SME credit exposures. In our view a close follow up of borrowers is good risk management practice, which should be encouraged and not "penalised". Differences in requirements between the Standardised Approach and the IRB Approach in this area are also harmful because they will create disincentives for banks to move to the more sophisticated IRB Approach.

The logic behind the proposed rule, that a well diversified portfolio of loans to SMEs may be included in the retail portfolio, is that the volatility in losses in a portfolio of loans to SMEs is lower than in a portfolio of loans to large corporates. For several reasons, this seems reasonable. There is usually a close link between the owner and the management of a SME. Hence the same kind of personal events like personal accidents, illness, family problems, etc. that might cause losses in a retail portfolio is also expected to have a substantial impact on losses in a portfolio of loans to SMEs. Since this kind of events can be expected to be evenly spread out in time in a large sample, volatility in losses created by them will be low in a well diversified portfolio. Against this background Swedish Bankers' Association thinks that criteria for treating a portfolio of loans to SMEs in the retail category when calculating capital requirements should be based on granularity and borrower characteristics, as is the case under the Standardised Approach, and not on the proposed "use test". A close follow up of loans to SMEs is usually driven by the fact that:

- expected losses will be lower when borrower problems are recognised early,
- loans to SMEs on average are larger than loans to private persons,
- the economy of a SME is more complex than that of a private person
- and that a close follow up might create a stronger relationship to the customer.

None of these drivers can be regarded as an indicator of high volatility in losses in a portfolio of loans to SMEs or in a portfolio of loans to any other customer segment. Hence there is no reason to regard a close follow up of individual borrowers as an indicator of high volatility in loss rates in any loan segment.

Paragraph 235:

The Basel Committee proposes that LGDs for retail exposures secured by residential properties, under a transitional period, cannot be set below 10% for any sub-segment of exposures to which the formula in paragraph 298 is applied.

Swedish Bankers' Association is of the opinion that the introduction of a floor on LGD in the Advanced IRB Approach is against the whole idea of this approach. The evaluation of banks' LGD estimates will be an important part of the Supervisory Authorities authorisation process of IRB models. Long-run cycles in house prices ought to be taken into account in the authorisation process. In this case it is better to have more comprehensive requirements than to introduce a floor on LGD. We therefore suggest that competent authorities, in countries where sufficient data is available, at national discretion should be allowed to waive the proposed floor on LGD.

Paragraph 331-337:

The Basel Committee's rules for purchased receivables refer among other things to so called "purchase factoring", which is a common form of financing in Western Europe.

Swedish Bankers´ Association would like to emphasize that in Sweden, however, factoring usually takes the form of asset-based lending, with the receivables held as collateral by the factoring company. Factoring in this sense could be offered with or without recourse, but usually with recourse, e.g. the credit risk is born by the client company. According to the Basel Committee also "Purchased receivables" may be offered with or without recourse. In reality the difference between the Swedish form of factoring and the kind of financing referred to by the Committee is insignificant from a credit risk perspective. On this ground both ways of financing should be treated equally under the new Accord.

We therefore proposes that the wording of paragraph 331 should be amended as follows:

"331. Part F presents the method of calculating capital requirements for purchased receivables and for receivables held as collateral under factoring agreements (asset-based lending)".

Paragraph 344:

The Basel Committee proposes that all exposures are measured as the amount legally owed to the bank, i.e. gross of specific provisions or partial write-offs. This rule also applies to assets purchased at a price different than the amount legally owed. For purchased assets, the difference between the exposure and the net value recorded on the balance sheet of institutions is denoted discount if the exposure is larger, and premium if the exposure is smaller. In paragraph 344 the Basel Committee stipulates how to treat discounts and premiums on purchased assets. Here it is stated: "Any discounts on purchased assets can be treated in the same manner as partial write-offs. Any premium on purchased assets must be multiplied by 12.5 and added to the EL portion of the risk-weighted assets.".

Swedish Bankers' Association is of the opinion that the guiding principle for the amount of an exposure should be the booked value instead of the amount legally owed since this is the amount that will affect the capital base in the event of default. Another reason behind our suggestion is that the price institutions pay for a loan ought to reflect the market value of the future cash flows generated by the loan. To treat premiums on purchased assets as a loss does not take into account the fact that the future cash flows that a loan is expected to generate cover Expected Loss (EL). Further, the Basel Committee's proposal does not say anything about the treatment of lending measured at fair value. From 2005 and onwards, when International Accounting Standards (IAS) will be compulsory for listed companies within the EU, it will be possible for institutions to measure lending at fair value. Even today lending can be measured at fair value when it is subject to hedge accounting. The presently proposed treatment creates different capital requirements depending on valuation principles within the institution as well as depending on if the institution has originated the loan, if the loan has been purchased, or if the coupon is standardised or decided individually when originated the loan though the credit risk is the same.

Paragraph 349 - 500:

The Basel Committee proposes a very long list of detailed minimum requirements that a bank must demonstrate to its supervisor that it meets if it wants to use an IRB approach. These requirements are primarily focused on how institutions must act or organise their work in order to qualify for an IRB approach.

Swedish Bankers' Association supports the principle that a bank that wants to use an IRB approach shall meet certain requirements. However, we are of the opinion that the focus should be directed towards certain important principles that should be followed and towards the ability of the model to estimate probability of default and other relevant parameters (goal-oriented approach) – but not towards how this exactly shall be achieved. We believe that a goal-oriented approach has several advantages. Most importantly, it would stimulate institutions even more to continuously think in constructive ways and to develop their risk management systems. A system built on detailed descriptions on exactly how an institution shall do, and organise itself, would run the risk of promoting a "tick-box-behaviour" rather than critical thinking. Furthermore, detailed descriptions might soon become outdated or be ill suited for the particular context and needs of the individual institution. It is also important that institutions have the possibility to take account of their own experience of their own specific situation, organisational structure and risk management culture. This is also important because of legal, cultural and other differences between all the countries in which these recommendations shall be applied. We therefore strongly hold the view that the risk management process is better promoted by focusing on the actual performance of the models used. For supervisors it should be more important to get an overall impression that the outcome of the model is reliable rather than to look into the details of all minimum requirements. It is therefore better to have guidelines in the new Accord instead of detailed and prescriptive requirements.

Paragraph 470 and related footnote 83:

The Basel Committee has introduced footnote 83, which stipulates that national supervisors may under certain circumstances recognise mortgage on multifamily residential real estate as eligible collateral for corporate exposures.

Swedish Bankers' Association welcomes the introduction of the footnote, which will help national supervisors to take into account regional differences in housing markets when implementing the new Accord.

Paragraph 485:

In order for an institution to receive recognition for other physical collateral it must meet certain minimum eligibility requirements proposed by the Basel Committee. One of these requirements is that an institution must have a first lien on, or charge over, the collateral. As such, the institution must have priority over all other lenders to the realised proceeds of the collateral.

The rights of holders of junior liens differ between countries. Swedish Bankers' Association is therefore of the opinion that it should be possible also to take junior liens into consideration in countries like Sweden where there is no doubt that the claim for collateral is legally enforceable and constitutes an efficient risk mitigant. Furthermore, we do not see any good reasons why the requirements for recognition of other collateral in essence should diverge from the operational requirements for eligible CRE/RRE.

OPERATIONAL RISK

Paragraph 615:

The Basel Committee stipulates in Annex 6 under "Principles for business line mapping" (e) that the mapping of activities into business lines for operational risk capital purposes must be consistent with the definitions of business lines used for regulatory capital calculations in other risk categories, i.e. credit and market risk.
Furthermore, the Basel Committee writes in footnote 155 that it is aware that some banks would welcome further guidance on how to map their activities to the eight business lines.

Swedish Bankers' Association is of the opinion that regulatory capital calculations for credit risk focus on counterparts rather than on business lines. It is therefore confusing to propose that the mapping of activities into business lines for operational risk capital purposes must be consistent with the definitions of business lines used for regulatory capital calculations in other risk categories

The objective of operational risk management is to make sure that the quality of relevant processes is adequate. Processes are closely linked with products rather than with customers. In footnote 155 the Committee mix product characteristics with customer characteristics. Swedish Bankers' Association is of the opinion that it is better only to use product characteristics in the mapping process and sees no value added by mixing it with customer characteristics. It would only make an already complicated area even more complicated and also add an element of confusion.

Footnote 91:

The Basel Committee proposes that a supervisor, at national discretion, can choose to allow a bank to use the Alternative Standardised Approach (ASA) provided the bank is able to satisfy its supervisor that this alternative approach provides an improved basis by, for example, avoiding double counting of risks.

Swedish Bankers' Association welcomes the introduction of the ASA approach in the new Accord. Furthermore, we are of the opinion that a bank should be permitted to use the ASA approach for some parts of its operations (partial use). It is particularly important for banks to be able to partial use the ASA approach on a geographical basis for activities in emerging markets.

Paragraph 637:

The Basel Committee proposes that the risk mitigating impact of insurance only will be recognised under the Advanced Measurement Approaches (AMA).

Swedish Bankers' Association is of the opinion that the risk mitigating effect of insurance also should be recognised under the Basic Indicator Approach, the Standardised Approach and the Alternative Standardised Approach. The rationale behind this is that it will give banks incentives to protect themselves from losses arising from operational risks.

THE SECOND PILLAR – SUPERVISORY REVIEW PROCESS

Sections B and C

The Basel Committee writes under Principle 3 (Paragraph 715) that supervisors should expect banks to operate above the minimum regulatory capital ratios and should have the ability to require banks to hold capital in excess of the minimum. Furthemore , under section C there is a list of important issues that banks and supervisors should particularly focus on when carrying out the supervisory review process.

The new Accord has been calibrated on the basis that the requirements under Pillar 1, in the normal case, should be adequate. Swedish Bankers' Association is therefore of the opinion that the specific issues under section C should not lead to an automatic addition of capital requirements beyond those in Pillar 1. The focus under Pillar 2 should be on how well capitalised a bank is and not on possible deviations from specific issues. Furthemore, we are of the opinion that there should be a possibility for netting within Pillar 2, i.e. it should be possible to offset an additional capital requirement in respect of one risk against over-provision in respect of another risk.

SWEDISH BANKERS´ ASSOCIATION

Bengt G. Löwenthal Mikael Holmberg