FEDERATION BANCAIRE DE L'UNION EUROPEENNE

Le Secrétaire Général

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N°1213

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

Brussels, 18 December 2002

Dear Mrs Nouy,

Subject: Comments on the QIS 3 Technical Guidance Note

The European Banking Federation (FBE) would like to take the opportunity to comment on the capital adequacy framework set out in the Quantitative Impact Study 3 technical guidance note issued by the Basel Committee on Banking Supervision in October.

The FBE is the united voice of the banks of the European Union and the European Free Trade Association (EFTA) countries. The FBE represents the interests of over 4,000 banks, with total assets of more than 20,000 billion euros.

The FBE awaits with interest the results of the QIS 3 calibration exercise. This will be crucial in determining the impact of the proposals in the Committee's paper. The FBE will offer more comprehensive comments on the new Accord in its response to Consultative Paper 3 next year.

Summary

At this stage, the FBE's comments are focussed on:

- promoting convergence by ensuring transparency in the application of the areas of national discretion and removing them over time;
- ensuring that the scope of application of the Accord is proportionate and reducing implementation costs through the elimination of artificial boundaries;
- the need to clarify the criteria against which a judgement would be made to retain the transitional floor beyond 2008;

- ensuring that banks have an incentive to move gradually towards the most risk sensitive approaches and thus at the same time strengthen their risk management capabilities;

- delivering a treatment of trade finance that reflects the low loss experience to avoid a negative material impact on world trade;

- applying minimum data standards that take account of the specific features of specialised lending and acknowledging the role that the expert judgement of market practitioners plays in calculating the correct capital weights;

- encouraging the Committee to signal a pragmatic interpretation of the quantitative boundaries included in the welcome treatment of SMEs announced in July 2002 and confirmed in the QIS 3 document;

- avoiding the distortions caused by the introduction of the third retail exposure class;

- encouraging the proportionate treatment of equity portfolios;

- removing the option to apply the maturity adjustment on a national basis, which should be applied in all cases or deleted;

- delivering appropriate IRB minimum standards, including a mechanism to review cash values used in the Accord to take account of movements in interest rates and exchange rates;

- ensuring that the measurement methodology for operational risk can be operated in practice.

Areas of National discretion

The number and scope of national discretions proposed in the Accord is a major source of concern for the FBE. We believe that this will result in an unlevel playing field.

If national discretions cannot be removed at this stage, the impact of the discretions should be kept under review. Regulators should explain publicly how national discretions are being used to ensure transparency. Over time, the majority of national discretions should be removed by consensus.

Pillar 2: Supervisory review

The introduction of the supervisory review process under Pillar 2 will be a major innovation for some banks and also for some supervisory authorities. It is likely that Pillar 2 will be critical in determining the impact of the Accord on individual banks. For some, the impact could be substantial.

The FBE believes that in order for our members to have confidence in the calibration of Pillar 1, it must take account of average capital requirements under Pillar 2. Without this, the Committee’s objective of not increasing global capital requirements may be undermined.

The FBE understands that additional proposals have been added to Pillar 2, including potential capital requirements for residual risk, concentration risk and pro-cyclicality. However, the form and scale of any required Pillar 2 adjustment is not known. The FBE is also concerned about the impact of stress-testing in practice.

The FBE urges the Committee to consult on the requirements of Pillar 2 before publication of CP3.

The FBE’s views on the other issues highlighted above are explained more fully in the attached paper.

Yours sincerely,

Nikolaus Bömcke

Enclosure: 1

Enclosure to letter No. 1213
H2001CEH

EUROPEAN BANKING FEDERATION'S (FBE'S) COMMENTS ON THE QIS 3 TECHNICAL GUIDANCE

Scope of application

Treatment of non-bank sub-holdings

The FBE notes that the Committee proposes that the New Accord be extended to include, on a fully consolidated basis, any holding company that is the parent within a banking group to ensure that the risk of the whole banking group is captured.

2. 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

the *FBE believes that separate application of the Accord at the level of the non-bank holding is disproportionate*.

Deductions of investments from capital

3. The FBE is concerned that the Committee has not given full consideration to the impact of the proposal that deductions of investments should be made 50% from Tier 1 capital and 50% from Tier 2 capital. This would be more onerous than justified by a risk based approach to the calculation of capital requirements and have a disproportionate impact on banks with low Tier 2 capital, producing a perverse incentive.

4. The 1988 Accord (Annex 1, C) states that "investments in unconsolidated banking and financial subsidiary companies" should be deducted "from total capital". Paragraph 24 of the Accord states that such investments should be deducted "from the capital base". We note that the New Accord does not make any proposals to reform the definition of the capital base.

5. Taking these points together, *the FBE believes that the deductions of investments proposed in section F of Part 1 should be revised so that the deduction would be made from total capital*.

Calculation of Minimum Regulatory Capital

Introduction of a transitional floor

6. The FBE understands the concerns underlying the Basel Banking Supervision Committee's proposal in paragraph 23 of the QIS 3 Technical Guidance document to introduce a single capital floor for the first two years following implementation of the new Accord for banks using either one of the Internal Ratings-based Approaches for credit risk, or the Advanced Measurement Approaches for operational risk.

7. The FBE therefore understands the need for a floor for IRB capital requirements for credit together with operational risk charges set at 90% of the current minimum required in the first year and 80% of this level in the second year. *The FBE believes, however, that clear criteria should be developed against which the judgement should be made whether to retain a floor beyond 2008*. This will help to ensure that the Accord is truly risk based and the incentives for banks to move towards more sophisticated approaches (for both credit and operational risk) are maintained.

8. The FBE notes that if experience suggests that some banks are benefiting from a reduction in capital requirements that cannot be justified by a reasonable assessment of the risks, supervisors will have the opportunity to address this under Pillar 2 of the Accord.

Standardised Approach

Claims on banks

9. *The FBE believes that it would not be appropriate to retain two options for the treatment of claims on banks as proposed in paragraph 37 of the Technical Guidance*. This would result in claims on the same bank being treated differently depending on the jurisdiction in which they arose. Furthermore, the risk weights applying to Option 2 are arbitrary and may correlate poorly with actual default experience. In addition, the risk weight for single A rated banks in Option 2 would lead to distortions relative to both the current Accord and to the Option 1 and IRB approaches.

10. The FBE believes that the *short-term claims* currently in Option 2 *should be defined as a having an original maturity of 6 months or less* and not 3 months as proposed.

11. *The FBE believes that one option should be mandatory. On balance, the FBE believes that option 1 should be retained but with the risk weight for short-terms claims in option 2 being made a feature of option 1*.

Impact on capital required for trade finance

12. The FBE believes that the Committee's proposals on the treatment of trade finance under both the standardised and foundation IRB approaches:

- fail to reflect the low loss experience in trade finance;
- would lead to a significant increase in capital required;
- and are an unintended consequence of the Committee's credit risk proposals.

13. The impact of this proposal should not be underestimated. It could lead to banks withdrawing from this activity (especially from markets which are perceived as being more risky), which would have a material impact on world trade in regions where it is economically and politically sensitive.

14. To deliver an equitable treatment for trade finance as part of the final Accord and given the difficulties of recognising within the Foundation IRB approach the factors that make trade finance low risk, *the FBE proposes*:

- *a definition of trade finance based on UCP 500 documentation reinforced by parameters such as maximum maturity of 6 months*;
- *a 20% risk weighting for all qualifying exposures*.

15. *If this is not acceptable to the Committee, the FBE would propose a differentiated treatment of trade finance which seeks to achieve consistency between the Standardised and IRB approaches and reflects the true loss exposure for this product line*:

- ***Standardised Approach:***

  (a) 20% risk weight should apply both for issued and confirmed Letters of Credit. Confirmations are not Direct Credit Substitutes, but contingent liabilities which only crystallise on the failure of another contingent liability;

  (b) As noted in paragraph 10 above, the benchmark for short-term claims on banks should be extended to 6 months.

- ***Foundation IRB approach:***

  (a) "short-term" should again be defined as 6 months or less;

  (b) the credit conversion factor for issued and confirmed Letters of Credit should be brought into line with the Standardised Approach at 20%;

(c) for exposures within the definition and for banks meeting given risk management standards, an LGD should be set at 20%.

IRB Approach

Specialised lending

16. *The FBE supports the proposal in paragraph 213 and 214 of the Technical Guidance note* which allows banks meeting the requirements for the estimation of PD and LGD to use the foundation or advanced approach to corporate exposures to derive risk weights for these exposures.

17. It is important that the proposed approach can be delivered in practice. To achieve this, *the FBE believes that the application of minimum data standards should take account of the specific features of specialised lending.* For example, project finance re-negotiations do not constitute distressed restructurings.

18. *The expert judgement of market practitioners is a key factor in calculating the correct capital weights*; validated methods for the corporate portfolio should be applicable to Specialised Lending areas when data are scarce and without further specific data requirements.

19. The *FBE believes that the treatment of specialised lending in the supervisory IRB approach is disproportionate to the loss experience. The supervisory risk weights should be reviewed and at least a "Very Strong" risk weight category of 50% should be introduced*.

20. *The FBE would encourage the Committee to provide clarity on the intended purpose and scope of application of the High Volatility Commercial Real Estate asset class*. It is not clear what assets would be included in this class or what the boundary would be between HVCRE and income –producing real estate.

21. More generally, the FBE questions the desirability of creating such sub-portfolios and thus increasing the complexity of the Accord. The approach adopted cannot be justified by an assessment of the risks.

Treatment of SMEs

22. *The FBE welcomes the amendments in the treatment of exposures to SMEs announced in July 2002 and confirmed in the QIS 3 document*. The treatment of SME exposures is a critical issue, in terms of its consequence for systemic stability and the impact on economic growth. The proposals and calibration contained in CP 2 did not strike the right balance. The FBE, and a number of its member associations, strongly advocated change. We are pleased to note that the Committee has acted in line with industry recommendations. Feedback from our members now suggests that the Committee is pursuing broadly the right approach.

23. *The definitions of SMEs are based upon absolute limits such as the aggregate €1 million exposure test*. This solution has the positive aspect of being objective but also has some drawbacks in terms of practical implementation for that

part of the portfolio that might fluctuate around the boundary. *The FBE would request, building on the final paragraph of paragraph 192, that the Committee clearly signal that interpretation should be pragmatic*. It is not in the interest of banks, SMEs or supervisors if exposures, immaterial in the context of the overall retail portfolio, regularly cross this boundary. If exposures cross the absolute boundary but are not material in the context of the overall retail portfolio, and are part of the same risk process, then banks should not be made to lift these exposures out, calculate a different capital requirement and apply very different risk management standards.

Treatment of qualifying revolving exposures

24. The FBE believes that capital treatment should be determined by reference to volatility and not by reference to product type. The FBE notes that the Committee's proposed treatment of qualifying revolving exposures reflects the structure of some markets and not others. Furthermore, the differentiation between different product offers is not justified by an assessment of the risks.

25. The FBE accepts that revolving exposures might exhibit low loss-rate volatility, but the same is true of this segment of the retail market in Europe, which has been served via the medium of overdrafts and unsecured personal loans in addition to credit cards.

26. The FBE is concerned that *the addition of a third retail exposure class for qualifying revolving exposures would*:

- *distort the market* by producing a cliff effect between the capital treatment for similar products;
- encourage banks to define their product offer to fit the regulatory rule;
- *increase complexity* in the treatment of retail assets.

27. The FBE would encourage the Committee to delete the third exposure class. But if it is retained, the FBE believes that its *negative consequences could be mitigated by deleting the references to product type in the definition of the third retail exposure class* and focusing solely on the level of the portfolio volatility.

Treatment of securitisations

28. The FBE notes that the Committee is consulting separately on the treatment of securitisation and the FBE will not comment in detail in the context of QIS3.

29. The FBE would stress that asset securitisation promotes better capital management. It is important that the Basel Committee's proposals on securitisation do not provide a disincentive for banks to manage their risks via asset backed or synthetic structures. Securitisation potentially transfers risk out of the banking system, bringing a net increase in systemic stability. The imposition of further capital to the ABS process would act as a brake on this beneficial risk transformation.

Equity treatment

30. The FBE believes that the internal models method for calculating capital requirements for equity portfolios produces a disproportionate result, particularly when viewed against long-term debt exposures and the proposed risk weight floors. This creates a disincentive to move from the standardised approach to the internal models method.

31. The approach proposed by the Committee exceeds the requirements based on a reasonable assessment of the risks and would penalise a banking strategy model common to many countries.

32. *To mitigate this, the FBE suggests*:

- *removing the proposed risk weight floors in internal models* - or at least the proposed floors (200%-300%) for the market-based approach – which are not justified by an assessment of the risks;

- at the option of the bank, *retaining a PD/LGD treatment for permanent equity investments, but lowering the proposed LGD factor of 90%*. The floor of 100% is not justified and would disproportionately penalise high credit quality equity exposures;

- *using monthly instead of quarterly returns for market based approaches* to take account of the liquidity of equity markets. This would partially ease the overstatement of capital requirements and permit the availability of a longer sample series;

- *eliminating the simplified market model* or using it as a ceiling for capital requirements for other approaches;

- *applying to equity portfolios using either the PD/LGD or market based methods the grandfathering provisions* (10 years from publication date on a national discretions basis).

Impact of the effective maturity adjustment

33. The FBE is concerned about the potential impact of the maturity adjustment on both pricing and the prospect of delivering a level playing field. But if there is such an adjustment, it should be applied in all cases and should not be a national option.

34. *The FBE's preference would be to delete the maturity factor. However, if the Committee decides to continue to apply a maturity factor, the FBE believes that it would be appropriate to flatten the curve*. This could be achieved by taking into account the UL part, as the expected loss part of the credit risk (one year horizon) has already been covered in the risk weight function.

IRB Minimum standards

35. The FBE welcomes the Committee's intention that banks should have an incentive to move gradually towards the most risk sensitive approaches and thus at the same time strengthen their risk management capabilities. The FBE notes, however, that this incentive has been undermined by the introduction of inconsistencies into the framework, with elements of the standardised approach now more favourable than the IRB foundation approach.

36. The *FBE believes that the data requirements for the IRB approaches are too onerous* and would encourage the Committee to make the following adjustments:

- *the data requirements for Advanced IRB approach should be brought within the scope of the transitional arrangements* to deliver an LGD data requirement of 4 years at implementation rather than the 7 years currently proposed;

- *the minimum data storage standard should be to hold the current rating and rating history*. The requirement for banks to retain sufficient data to be able to conduct a retrospective rating is disproportionate.

37. *The FBE believes that it is unnecessary to require at least two distinct and identifiable categories for pools of loans that are in arrears* (but not in default). This would increase the cost of data processing, without a material improvement in risk differentiation.

38. *The FBE would encourage the Committee to explain how it intends to revise cash values in the Accord and compensate for inflation and exchange rate volatility when applying the Accord at national level*.

Operational risk

Measurement methodology for operational risk

39. The proposed treatment of operational risk continues to raise fundamental concerns for FBE members.

40. A key issue is *the qualifying criteria for the Standardised Approach*, which the FBE believes *represent a high hurdle for some banks*. The criteria are too prescriptive and result in little distinction between the STA and the AMA. There is also little incentive for banks to move from the Basic to the Standardised Approach, undermining the Committee's intention that the Accord should encourage banks to move to a more risk sensitive approach.

41. In addition, the FBE believes that:

- if a bank opts for partial use of AMA, the qualifying criteria should apply to those parts of the bank which will be subject to the AMA;

- in respect of model validation, supervisors should rely as far as possible on internal validation processes;

- the 99.9% confidence interval is inappropriate and may be impossible to achieve.