REPORT OF THE IIF STEERING COMMITTEE ON REGULATORY CAPITAL

Table of Contents

Preface

The reform of the credit risk capital framework is nearly complete. The Institute of International Finance and its Steering Committee on Regulatory Capital have been pleased to participate in the policy dialogue concerning the reform proposals. At the beginning of this year, the Basel Committee on Banking Supervision released a consultative document spanning over 600 pages for consideration by the financial industry. We are pleased to offer our comments on the document and to contribute to the continued dialogue through this report and the supporting reports from the Working Group on Capital Adequacy and the Working Group on Operational Risk.

The Basel Committee proposals will stimulate innovation within both the supervisory process and the financial system itself. There is much to commend in the principles of the proposed framework, as it appears likely to create a series of incentives for banks to enhance their data-gathering capacities and their internal risk control processes. However, there is much to discuss regarding practical application. The January 2001 consultative papers advanced the reform proposals in a number of important aspects. However, they also contained a number of new ideas, particularly concerning the treatment of operational risk, collateral and maturity, project finance, and equity holdings in the banking book. This report addresses many of these ideas, some of which raised questions within the banking industry regarding their final shape and application.

The Institute would like to express its appreciation for the candor, transparency, and mutual exchange that have been the hallmark of the informal dialogue with the Basel Committee to date. The creation of a risk-sensitive capital framework that creates incentives for improved risk management is a goal that banks and their supervisors can both support strongly. We believe the Basel Committee is taking a major step toward this goal, but the attached report highlights a number of areas in which additional work is needed if this goal is to be met. We hope that the efforts of the Steering Committee and the Working Groups continue to provide constructive feedback to the Basel Committee as it seeks to finalize this far-reaching reform of the regulatory capital framework.

P. Jan Kalff
Chairman
IIF Steering Committee on Regulatory Capital

Sir John Bond
Chairman of the Board
The Institute of International Finance, Inc.

Peter C. Godsoe
Vice Chairman
IIF Steering Committee on Regulatory Capital

Charles H. Dallara
Managing Director
The Institute of International Finance, Inc.

Institute of International Finance, Inc.

IIF STEERING COMMITTEE ON REGULATORY CAPITAL

Chairman: **Mr. Jan Kalff**
Member of Supervisory Board
ABN AMRO Bank N.V.

Vice Chairman: **Mr. Peter C. Godsoe**
Chairman of the Board and CEO
Bank of Nova Scotia

Members:

Mr. Antony Elliott
Group Risk Director
Abbey National Plc

Dr. Tom de Swaan
Member of the Board of Managing Directors
ABN AMRO Bank N.V.

Mr. Ghazi Abdul-Jawad
President and Chief Executive Officer
Arab Banking Corporation

Dr. Mark Lawrence
Group General Manager, Risk Management
ANZ Bank

Dr. Roberto Setúbal
President
Banco Itaú S.A.

Mr. Gustavo A. Marturet
Chairman and Chief Executive Officer
Banco Mercantil C.A., S.A.

Mr. Jose del Valle
Director General
Banco Santander Central Hispano

Mr. J. Chandler Martin
Executive Vice President
Bank of America Corporation

Mr. Mao Xiaowei
General Manager
Bank of China

Mr. Masaharu Hamakawa
Member of the Board of Directors
Bank of Tokyo-Mitsubishi

Ms. M. Eileen Kennedy
Head, Treasury Department
Bank One

Sir Andrew Large
Deputy Chairman
Barclays Bank PLC

Mr. Daniel Dumas de Rauly
Executive Vice President
BNP Paribas Group

Mr. Guy Whittaker
Treasurer
Citigroup

Mr. Wolfgang Hartmann
Member of the Board of Managing Directors and Chief Risk Officer
Commerzbank AG

Mr. Hans-Ulrich Doerig
Vice Chairman
Credit Suisse Group

Mr. Jesper Ovesen
Chief Financial Officer
Danske Bank A/S

Dr. Thomas Fischer
Member of the Board of Managing Directors
Deutsche Bank AG

Dr. Heinrich Linz
Member of the Board of Managing Directors
Dresdner Bank AG

Mr. Erik van de Merwe
Advisor
Fortis Bank

Mr. Tosaku Harada
Deputy President
The Fuji Bank, Ltd.

Mr. M. Bert McPhee
General Manager
HSBC Holdings plc

Mr. Dieter Rampl
Member of the Management Board
HypoVereinsbank AG

Mr. Cees Maas
Executive Board Member and Chief Financial Officer
ING Group N.V.

Mr. Michael Green
Director of Group Risk Management
Lloyds TSB Group plc

Sir David Walker
Senior Advisor
Morgan Stanley International

Ms. Suzanne Labarge
Vice Chairman and Chief Risk Officer
Royal Bank Financial Group

Mr. Fred Watt
Group Finance Director
Royal Bank of Scotland Group

Dr. Rainer Masera
Chairman
Sanpaolo IMI S.p.A.

Mr. Didier Hauguel
Director of Global Risk Management
Société Générale

Mr. David Edwards
Head of Group Risk Management
Standard Chartered Bank

Mr. Christopher Roberts
Joint Chief Executive Officer
Tokai Bank Europe plc

Mr. Walter Stürzinger
Group Chief Risk Officer
UBS AG

Mr. Jiri Kunert
Chairman of the Managing Board
Zivnostenska Banka a.s.

EXECUTIVE SUMMARY

Last year, the Steering Committee on Regulatory Capital ("SCRC") strongly endorsed the decision by the Basel Committee on Banking Supervision ("Basel Committee") to develop a new regulatory capital framework for banks. The Steering Committee then offered a number of suggestions for how to ensure that the new capital framework could enhance banking system safety and soundness while also creating incentives for banks worldwide to improve the caliber of their risk management systems.

One year later, both banks and regulators have sharpened their thinking about the scope and structure of the new capital framework. Much progress has been made by the Basel Committee toward creating a capital framework that can meet the needs of a rapidly evolving banking business. This has been accomplished in an atmosphere of unprecedented and close informal dialogue among banks and supervisors at the international level. The Steering Committee especially appreciates the care with which the Basel Committee has undertaken the regulatory capital reform effort. In particular, the use of two different commentary periods over the course of the past two years, with the second set of proposals presenting significantly more detailed and comprehensive proposals, should ensure that the new capital framework will be able to reflect better the context in which it will operate.

The Steering Committee is pleased to note that a number of its recommendations have been accepted by the Basel Committee. These include:

- Elimination of the link between sovereign and bank ratings in the Standardized Approach
- Reliance on internal bank ratings (and, ultimately, internal loss given default and exposure at default estimates) for setting regulatory capital
- Creation of separate capital assessment processes for different portfolios
- Expanded recognition of credit risk mitigation
- Recognition of maturity as a second-order driver of credit risk
- Preliminary agreement on a definition of operational risk
- Clarification of how Pillar Two supervisory assessments should be concluded.

These elements should facilitate the creation of a regulatory capital framework that reflects risk and creates incentives for banks to improve their risk management processes. It also puts in place the building blocks for credit risk modeling processes that should further enhance risk assessment and risk management within the banking community.

At the same time, however, the Steering Committee notes that a number of new elements have been incorporated in the Basel Committee proposals that could detract from the good progress made so far. These include:

- Requiring capital to cover expected as well as unexpected loss
- Assigning risk weights based on an assumption that all banks will systematically underestimate all default probabilities
- Assigning risk weights and, thus, requiring capital, to compensate for perceived weaknesses in Tier Two capital structures

- Requiring banks to implement a costly "Granularity Index" that calculates a capital charge to reflect portfolio concentration without taking into account diversification benefits
- Imposing a "*w* factor" that discounts severely the value of all collateral
- Failing to recognize physical collateral, third-party guarantees, and accounts receivable
- Insufficient attention to the impact that the proposed capital framework will have on small and medium-sized enterprises
- Possible deterioration of level playing fields among banks, as well as between banks and financial services providers operating in different regulatory regimes.

Taken together, these elements could create an excessively conservative and costly capital framework that overestimates the amount of risk on banks' balance sheets. We express our desire to continue a dialogue on these issues and to exchange views on concerns that remain in the Basel Committee.

With respect to operational risk, the Steering Committee notes that quantitative measurement of operational risk is still in its infancy, in comparison with credit and market risks. Over the past eighteen months, much progress has been made. At this stage, however, the Steering Committee believes **it is too early to identify a specific methodology for measuring operational risk for regulatory capital purposes. The Steering Committee is also interested in ensuring that any regulatory capital methodologies for operational risk not create excessive regulatory compliance requirements.** Steering Committee members recognize that a capital adequacy framework needs to be finalized quickly. However, the issues related to assessing regulatory capital for operational risk are too important to risk making hasty decisions on the specifics of individual methodologies that could be codified into regulatory frameworks and legislation that could prove difficult to amend in the future. **Therefore, the Steering Committee strongly recommends that the Basel Committee support a framework for operational risk that contains a placeholder for quantification under Option 3 without making methodological choices at this point in time, before the industry and regulators have had a chance to test the validity and relevance of the methods under consideration.**

Implementation of the **new capital framework will be expensive** for all banks around the world, regardless of their sophistication level, as well as for regulators. The validation requirements for the Internal Ratings-Based (IRB) Approach are voluminous and generate cost concerns, although on balance they are perceived to increase the likelihood that the capital framework will be implemented in a consistent manner internationally. Implementation of those requirements on a globally consolidated basis as contemplated in the proposals may require "rules of reason" to guide banks and regulators during the transition period.

The proposals also raise **significant level-playing-field concerns** among banks worldwide. It is possible that the cost of implementing the IRB Approach may create disincentives for banks to use internal ratings for many banks, especially for those operating in emerging markets or for banks operating in over 20 different jurisdictions. This is especially the case since early tests suggest that capital requirements may increase as a bank moves from the Standardized to the IRB Approach. The Steering Committee will await the results of the Quantitative Impact Study now under way through the Basel Committee before making more detailed comments on this issue.

By far, the most significant level-playing-field concerns arise with respect to bank competition with nonbanks. Firms not regulated as commercial banks will not need to comply with the validation and transparency requirements proposed within the new capital framework. Rating agencies also will not be subject to the rigorous supervisory assessment process for assignment and validation of ratings. Real questions exist concerning whether the cost of implementation will accelerate disintermediation trends.

Concerns with the impact on banks relative to other credit intermediaries are accentuated by the failure to recognize the majority of collateral types used by banks to secure their lending: physical collateral, accounts receivable, and third party guarantees. The Steering Committee would like to underscore the importance of expanding collateral recognition to these instruments. Recognition would create a more risk-sensitive framework because regulatory capital would reflect better the true risk of a credit. Recognition would also provide appropriate incentives for banks to continue their centuries-long tradition of seeking security to minimize risks.

Serious concerns also exist with the technical capacity of banking regulators to implement the new framework in a consistent manner. The Steering Committee reiterates the crucial importance of supervisors worldwide seeking the educational and training services of the Toronto Centre and the Financial Stability Institute. Staffing structures should also be reviewed to ensure that sufficient numbers of appropriately trained staff are ready, willing, and able to implement the new capital standards. Finally, to minimize the inevitable conflicts among national supervisors in implementing the capital framework, the Steering Committee recommends that the Basel Committee create or serve as an "ombudsman" for banks and regulators to help resolve possibly contradictory implementation standards applicable to an individual bank and any level-playing-field issues that may arise.

On the whole, the Steering Committee supports the broad direction and intent of the Basel Committee's proposals since the expectation is that implementation will result in regulatory capital requirements more closely aligned with risk profiles. This should foster the development of banking systems that are more resilient, with capital cushions more appropriate to risk profiles if the remaining concerns are addressed properly. Further analysis of the proposals will need to be undertaken based on the calibration work currently under way as well as the results of the Quantitative Impact Study. The Steering Committee looks forward to continued dialogue with the Basel Committee to address the remaining open issues as the new regulatory capital framework for banks is finalized.

Summary of Steering Committee Positions

This section summarizes the Steering Committee positions on regulatory capital reform. The firs section highlights improvements in the proposed regulatory capital framework that incorporate the Steering Committee's recommendations last year. The second section summarizes the positions the Steering Committee has taken with respect to the January 2001Basel Committee proposals, the details of which are discussed in the body of this Steering Committee report and the accompanying reports from the Working Group on Capital Adequacy and the Working Group on Operational Risk

Improvements

- The Steering Committee is pleased to see that the Basel Committee has eliminated the sovereign link for risk weights in the Standardized Approach. This should make the Standardized Approach a more reliable tool for assessing the relative risk of different obligors without introducing a distortion based on a simplistic assessment of country risk.

- The Steering Committee broadly welcomes acceptance of the IIF's recommendations that a Spectrum Approach be created permitting banks to rely on progressively more advanced components of their internal credit risk measurement systems for regulatory capital purposes, using a single continuous risk function.

- The Steering Committee supports the decision by the Basel Committee to generate capital requirements for different portfolio types using different processes, particularly differentiating among corporate, retail, sovereign, bank, equity, and project finance portfolios.

- The Steering Committee supports the Basel Committee's intention to recognize maturity in the Internal Ratings-Based (IRB) Approach.

- The Steering Committee welcomes the Basel Committee's efforts to expand the recognition of collateral for regulatory capital purposes beyond those categories of collateral currently recognized (residential homes, sovereign guarantees, bank guarantees).

- The Steering Committee strongly supports the emerging consensus between banks and supervisors on an agreed definition of operational risk, as it will help ensure that the regulatory capital framework targets losses that are concrete and can be measured.

- With respect to the Pillar Two proposals, the Steering Committee is pleased to note that the majority of its recommendations last year concerning process and transparency were accepted.

Concerns and Recommendations

- The Steering Committee would like to be clear: capital serves to cover unexpected loss, which is defined as the volatility of expected loss estimates. The Steering Committee therefore endorses and underscores the importance of the Basel Committee making the following structural adjustments to the regulatory capital framework:

    - In the IRB Approach, the credit risk capital charge should be clearly disaggregated between the amount of regulatory capital allocated to EL and the amount of minimum regulatory capital to cover volatility of the EL estimate (i.e., to cover UL). The different amounts of a bank's regulatory capital allocated to those components should be disclosed separately. Such transparency would create a mechanism whereby banks with good risk management practices for managing EL and UL would receive a benefit because it would be transparent to the markets and reflected in the capital requirement.

    - Also in the IRB Approach, the maturity adjustments and the Granularity Index should not be applied to the EL calculation since these adjustments are more properly related to UL.

    - In the Standard Approach, banks should not be required to apply a 150% risk weight against extremely low quality loans that have already been subject to provisioning and, thus, are already covered by a cushion. The same is true regarding extremely low quality loans in the IRB Approach.

    - If EL is included with the definition of capital, then 100% of general loan loss reserves should be recognized as part of Tier Two capital.

- The Granularity Index should be eliminated. Imposing a charge for portfolio construction based solely on the negative issues (concentration) without taking into account the positive aspects (diversification) is inappropriately one-sided.

- Similarly, the granularity requirement limiting exposure to 30% in any one PD grade should be eliminated.

- The estimation error should not be applied to all banks and all default probability grades. It should instead be imposed as part of the Pillar Two review only on those banks whose internal systems have been proved deficient.

- The *w* factor should either be eliminated and concerns with collateral enforceability reflected in loss given default haircuts, or at a minimum it should be adjusted to avoid the anomalous situation where collateral such as cash receives a haircut of 0.15.

- The Steering Committee remains concerned with the binary approach to the treatment of maturity generally in the Standardized Approach, believing that "the regulatory framework should not provide excessive incentives or penalties for banks to offer credit within a specified maturity band." The Steering Committee continues to believe that short-term interbank credit is being penalized unfairly compared with current guidelines. The Steering Committee therefore recommends that the definition of "short-term" remains at 12 months.

- One of the most serious shortcomings of the Basel proposals is the failure to recognize physical collateral, third-party guarantees, and accounts receivable. The Steering Committee strongly recommends that the Basel Committee make final decisions on the eligibility and value of these collateral types in the fall of this year, based on the IIF's global survey that is currently under way.

- The Steering Committee urges regulators and banks together to develop an acceptable approach to the treatment of small and medium-sized enterprises (SMEs) before the fall. It is critical that any mispricing of regulatory capital for SME lending be corrected to avoid the cost of credit to these companies from increasing unnecessarily to cover the regulatory capital charge.

- The number of risk weights in the Standardized Approach should increase by adding a 75% risk weight to the framework. This would increase the risk sensitivity of the Standardized Approach.

- The new regulatory capital framework should recognize local currency ratings in both the Standardized and IRB Approaches for purposes of setting regulatory capital risk weights for obligations in local currency as well as trade finance credits.

- The Basel Committee should create an "ombudsman" function for the implementation of the regulatory capital framework to facilitate discussion of implementation plans with individual banks as well as level-playing-field issues.

- The Steering Committee believes that the data points requested by the Basel Committee under the Pillar Three proposals are excessively broad and not likely to enhance transparency even if they do increase the amount of information disclosed by banks. Instead, banks should provide the following data points under Pillar Three:

    - <u>Quantitative Disclosures</u>: All of the following from IRB banks, by PD band:
        1) Funded amount
        2) Unfunded amount
        3) Weighted average EAD
        4) Weighted average LGD
        5) Weighted average maturity
        6) Expected loss
        7) Regulatory capital

    - <u>Qualitative Disclosures:</u> Descriptions of the following
        8) PD validation process
        9) LGD methodology
        10) EAD Methodology

    - <u>Additional Disclosures</u>: Top 5 geographic and industry segments as a percent of total exposures.

- The Steering Committee urges the Basel Committee to seek comparable treatment of credit risks in other regulated sectors to ensure that credit risks are appropriately priced, regardless of the corporate form undertaking the extension of credit. Appropriate fora for pursuing comparable standards include the Joint Forum on Financial Conglomerates and the Financial Stability Forum.

- It is essential that the Basel Committee promote increased cooperation and coordination in the application of the regulatory capital framework worldwide. The Steering Committee thus reiterates its previous recommendation that the Basel Committee expand its role to serve as a clearinghouse for guidelines, interpretations, and implementation processes related to the new regulatory capital guidelines.

- The Steering Committee also recommends that Pillar Two supervisory reviews should be used to evaluate the speed with which implementation is proceeding at individual banks. This would enable supervisors to urge banks long with implementation plans without creating arbitrary deadlines.

- All assets that expose the bank to loss due to obligor default or bankruptcy should be assessed in a conceptually consistent manner. All assets that expose the bank to loss due to trading, where the assets in question are valued on a mark-to-market basis, should be assessed in a conceptually consistent manner.

- Assessing internal ratings for project finance is substantially similar to the process used to assign country ratings in banks, where both qualitative and quantitative processes are used to assign risk ratings. The appropriate method for calculating regulatory capital for all project finance exposures should be a modified PD/LGD/EAD structure. The necessary modifications are:

    - Specialized LGD values should be crafted to reflect loss experience in each portfolio segment. Thus, LGDs associated with infrastructure projects would be different from those assigned to asset-backed projects.

    - Validation procedures for PD and LGD values must be amplified to take into account the special structures of the projects in question and the role that cash flows play in assessing risk. It is also possible that procedures specific to project finance lending affiliated with multilateral development banks may be necessary to reflect the relative lack of experience with defaults in these instruments.

- Equity holdings held by banks indefinitely or for sufficiently long periods of time that expose the bank to loss only in the event of the issuer's bankruptcy should be subject to a regulatory capital charge using a modified default-type of analysis. Those equities held for shorter periods of time that expose the bank to risk of loss associated with market downturns should attract a regulatory capital charge based on a market risk/ stress testing framework.

    - The term PD should be replaced by the term "probability of loss" (PL) and should be determined as the probability that the company in which the bank has the strategic investment will experience a default event in any senior debt instrument held by the bank. Thus, the PL value for a strategic investment would be identical to the PD estimate made by the bank for any senior debt.

    - The term LGD should be replaced by the term "loss" (L) and should be set at 100%. Thus, the bank would be assumed to suffer a complete loss of its strategic investment at the time of the credit default event.

    - To avoid cherry-picking in the designation of where equity holdings are placed in a bank's portfolio, the Steering Committee additionally recommends that each bank articulate a policy for placing equity holdings in the banking book based on (a) its underwriting role or (b) its intention to acquire bargaining leverage or control over the company's affairs such that the bank's investment would be recovered or (c) the lack of a traded market for private equity or (d) establishment of strategic alliances through cross-shareholdings.

- Within the Standardized Approach, the current treatment should continue to apply to these holdings (i.e., they should be subject to an 8% risk-weighted capital requirement).

Chapter 1: Background

In July 1999, the Board of Directors of the Institute of International Finance (IIF) formed a Steering Committee on Regulatory Capital (Steering Committee) chaired by Jan Kalff, who was then Chief Executive Officer and Chairman of the Managing Board of ABN AMRO Bank, with Peter Godsoe, Chairman of the Board and Chief Executive Officer of the Bank of Nova Scotia, as Vice Chairman. The Steering Committee was created to increase the Institute's commitment and involvement in the process of reforming the regulatory capital framework that had been initiated by the Basel Committee the previous month.

Specifically, the Board of Directors sought to ensure that the Institute's response to the Basel Committee represented the broad consensus of the banking industry, including both the perspective of the most senior officers at leading global banks and the views of senior risk managers with daily responsibility for measuring risks and managing a bank's portfolio. The IIF Board asked the Steering Committee, composed principally of chief executive officers and chief risk officers of the leading globally active banks in the world, to undertake two tasks:

- First, the Steering Committee was asked to guide the technical work of the senior risk managers in the Institute's Working Group on Capital Adequacy (WGCA) in response to a consultative paper issued by the Basel Committee on Banking Supervision (Basel Committee) proposing reform of the regulatory capital framework for banks.

- Second, the Steering Committee was asked to develop an overall response to the Basel Committee's reform proposals, taking into account the recommendations of the WGCA.

The Steering Committee additionally created two working groups to address specific issues in detail. These are:

- A Working Group on Country Risk (WGCR), to focus on the measurement of country risk in banks' portfolios and to identify the components of a prudent internal control system concerning the measurement and management of country risk. It was chaired by William R. Rhodes, Vice Chairman of Citibank/Citigroup.

- A Working Group on Operational Risk (WGOR), to determine how best to approach the regulatory capital treatment of operational risk and to articulate some best risk management practices for this category of risk. The Chairman of the WGOR is Dr. Thomas Fischer, Member of the Board of Managing Directors and Chief Risk Officer at Deutsche Bank. The Vice Chairman is Mr. Christopher Roberts, Joint Chief Executive Officer at Tokai Bank (Europe) plc.

Through these working groups, as well as through direct meetings with the Basel Committee, the Steering Committee has been actively engaged in dialogue with supervisors on the regulatory reform proposals for the past two years. In addition to meetings, the IIF Steering Committee and working groups issued formal responses to the first set of consultative documents. Specifically, the Steering Committee, the WGCA, and the WGCR each issued reports during 2000.[1]

---

[1] *Report of the Steering Committee on Regulatory Capital* (March 2000) [*hereinafter*, "SCRC 2000"]; *Report of the Working Group on Capital Adequacy* (March 2000) [*hereinafter*, "WGCA 2000"]; *Report of the Working Group on Country Risk* (October 2000) [*hereinafter*, "WGCR 2000"]. The WGOR has been actively engaged in dialogue with the Basel Committee but has not yet published any documents.

In January 2001, the Basel Committee issued a more detailed set of consultative documents addressing a broader range of issues associated with regulatory capital reform. Comments on this second set of proposals are due on May 31, 2001. This Steering Committee report, and the companion WGCA and WGOR reports, is issued in response to the January 2001 detailed proposals.

The consultative process within the banking community has been intense, owing in part to the scope of the proposals and the short four-month commentary period. Nonetheless, the Institute and its member banks have devoted significant attention to the various issues raised in the consultative papers. The discussions have included the following meetings:

- The Steering Committee on Regulatory Capital met twice (March in Zurich; May in New York).

- The WGCA has met three times, each time with over 20 global banks in attendance (January in Frankfurt; March in New York; April in Rome).

- The WGOR has met four times, each time with over 20 global banks in attendance (January in Amsterdam; February in New York; March in Zurich; April in Rome).

Numerous meetings between regulators and these IIF groups have also occurred during the four-month commentary period. Four regional emerging market meetings also were held to ensure that the views of leading banks in those areas were included in the IIF process. These meetings were as follows:

- Central and Eastern Europe (Budapest, Hungary on January 31)
- Middle East/North Africa (Doha, Qatar on February 7)
- Asia (Singapore on February 9)
- Latin America (Miami, Florida on March 2).

In addition, the chief executive officers of IIF member banks in two emerging market regions (Middle East/North Africa and Latin America) considered the Basel Committee proposals during the annual meetings of those IIF groups, in Jordan and Mexico, respectively. The Asian Working Group also met with some members of the Basel Committee and regional banking regulators in February in Hong Kong.

The IIF Board of Directors has reviewed this Steering Committee report, as well as the working group reports, and approved their release. A list of IIF Board members appears as Appendix A to this report. A list of WGCA members appears as Appendix B to this report. A list of WGOR members appears as Appendix C to this report. A list of WGCR members appears as Appendix D to this report.

Consequently, the views presented in this Steering Committee report and the companion working group reports represent the considered views of the leading banks worldwide on the regulatory capital reform proposals.

Chapter 2: Specific Issues

Banks and supervisors share an interest in developing a safe and sound banking system in which competition encourages efficient intermediation and economic growth within a framework of transparent and stable rules. This is best accomplished by creating a regulatory framework that provides incentives for prudent behavior and rewards good risk management practices by establishing level playing fields and enhancing transparency. The Steering Committee therefore strongly supports the Basel Committee's efforts to reform the regulatory capital framework in a manner that encourages and rewards banks that improve their internal risk measurement practices.

Crafting a regulatory capital framework that promotes the safe and sound operation of the banking system presents a variety of challenges for policymakers, especially given the evolution of the industry. As noted in the previous Steering Committee report, financial innovation and competition with financial services providers that operate in different or n regulatory environment create a moving target for regulatory policymakers.

The new proposals present in many ways dramatic improvements from the first set of proposals. They also present significantly more detail than the previous proposal, providing proposals in over 600 pages of detailed text. Increased detail, while daunting to sift through, represents a good faith effort on the part of supervisors to ensure that market participants clearly understand the assumptions and processes contemplated for creation of a regulatory capital charge. This permits both banks and regulators to debate issues in an informed manner.

The Steering Committee also commends the Basel Committee for its focus. In particular, Steering Committee members support the Basel Committee's decision to focus on banking book items, leaving the Market Risk Amendment "largely unchanged."[2] This ensures that efforts and comments will remain targeted to the banking book and enhances the possibility of generating conceptually consistent methods for assessing regulatory capital in the banking book.

A review of the proposals therefore demonstrates a number of improvements to the original outline as well as a number of areas where concern exists within the banking community. This section will first assess the improvements before addressing the concerns.

A. Improvements

1. Standardized Approach: Sovereign Link Eliminated

As originally proposed, the Standardized Approach would have assigned risk weights to banks and corporates in relation both to their external rating and to the rating of the sovereign of incorporation. In addition, the proposal indicated that no bank or corporation could receive a risk weight better than or equal to the risk weight assigned to the sovereign. This proposal caused a great deal of concern within the banking community since the sovereign link eliminated a great deal of the risk sensitivity in the Standardized Approach and it was likely to exacerbate systemic stresses during crises.[3] **The Steering Committee is pleased to see that the Basel Committee has eliminated the sovereign link. This should make the Standardized Approach a more**

---

[2] *Overview of the New Capital Accord*, Basel Committee on Banking Supervision (January 2001), para. 67.

[3] SCRC 2000, p. 14; WGCA 2000, pp. 13-15; WGCR 2000, pp. 30-31.

reliable tool for assessing the relative risk of different obligors without introducing a distortion based on a simplistic assessment of country risk.

This does not mean, however, that the Steering Committee is completely comfortable with the use of external ratings as the key determinant of regulatory capital for banks. Risk assessment is a core competence of banks. For those banks without well-developed internal rating systems that will be required to use the Standardized Approach, it is possible that some might choose to outsource their credit decisions to external rating agencies and not seek to progress to the IRB Approach. Such an outcome could have potentially problematic systemic effects, since ratings tend not to migrate slowly downward during times of crises and since excessive use of ratings could increase pressures toward herd behavior and procyclicality in the capital framework. The Steering Committee and WGCA addressed in detail their concerns on this issue in their responses to the Basel Committee last year.[4]

2. IRB Approach: Reliance on Internal Ratings

Where the original Basel proposals presented a few paragraphs on the possibility that internal ratings might be used to assess regulatory capital in the new framework, the January 2001 proposal devotes hundreds of pages to the standards that will be used to create and validate a capital framework based on banks' internal ratings. The breadth and detail associated with the proposals present some cost concerns. Nonetheless, **the Steering Committee broadly welcomes acceptance of the IIF's recommendations that a spectrum approach be created permitting banks to rely on progressively more advanced components of their internal credit risk measurement systems for regulatory capital purposes, using a single continuous risk function.**

This proposal demonstrates a significant step forward by the Basel Committee toward a capital framework that can reflect real risks in banks' portfolios. The Steering Committee would like to emphasize that the concerns with the risk-weighting function and the overall calibration of the regulatory capital framework should not be interpreted as a rejection of the basic premise that internal ratings should form the backbone of the new capital framework. The Steering Committee hopes that the concerns articulated in this report, together with those raised in the WGCA report, provide helpful suggestions for how to craft a better proposal.

3. IRB Approach: Creation of Separate Portfolios for Different Exposure Types

The Steering Committee supports the decision by the Basel Committee to generate capital requirements for different portfolio types using different processes, particularly differentiating among corporate, retail, sovereign, bank, equity, and project finance portfolios. This separation was not contemplated in the original proposals, prompting the Steering Committee and the WGCA to request different standards for different portfolios, in light of the fact that "the drivers of credit risk, the performance of obligors, and the contours of good risk management differ substantially across portfolio types generally."[5]

Much work remains to be done on the proposals before they can be considered robust enough to be incorporated into the regulatory capital framework. As noted in the companion WGCA report, significant issues concerning the definitions used to segment each portfolio must

4 SCRC 2000, p. 13; WGCA 2000, pp. 9-13.

5 SCRC 2000 p. 16; WGCA 2000, pp. 10-11, p. 23, pp. 26-27, p. 35.

be resolved, and methodological issues surrounding appropriate risk measurement must be settled. It seems clear that portfolio-level statistical models should be used to assess the risks in retail portfolios. The WGCA report and Chapter 4 of this Steering Committee report provide some suggestions for how best to approach generating regulatory capital requirements for equity and project finance exposures. The important point to note in this section, however, is that the Basel Committee has improved the ability of the new capital framework to promote banking system safety and soundness by permitting differentiation and more targeted methodologies for assessing risk based on the underlying risk drivers. This trend is fully supported by the Steering Committee even if questions concerning the actual methodology exist.

4. <u>IRB Approach: Recognition of Maturity</u>

The Steering Committee supports the Basel Committee's willingness to incorporate a maturity component in the regulatory capital calculation. This is consistent with the Steering Committee's recommendation that "the capital framework should be expanded to include more maturity bands and that capital allocations associated with a particular maturity should correspond with the real risk in each maturity band, taking into account an obligor's credit quality and any relevant credit enhancements."[6] **The Basel Committee's intention to recognize maturity in the Internal Ratings-Based (IRB) Approach is therefore supported by the Steering Committee members as well as by WGCA members.** While the treatment of maturity in the Standard and IRB Approaches raised questions, as detailed below, it is important to note that the creation of a capital framework that recognizes the importance of maturity as a second-order driver of credit risk is a welcome step forward that banks around the world support.

5. <u>Expanded Recognition of Credit Risk Mitigation</u>

The Steering Committee welcomes the Basel Committee's efforts to expand the recognition of collateral for regulatory capital purposes beyond those categories of collateral currently recognized (residential homes, sovereign guarantees, bank guarantees). This is consistent with the recommendations made by the Steering Committee and the WGCA in 2000. Specifically, the Steering Committee noted that collateral "is a key component of good risk management practice that should be recognized in the regulatory capital framework in both the standard and internal-ratings-based approaches."[7]

Expanded recognition of collateral will permit banks to receive a capital benefit for seeking to ensure that their credit risk is mitigated in the event that an obligor defaults. Such a rule should create incentives for banks to accept collateral and ensure that collection on the collateral is not significantly in doubt. It is particularly helpful to note that the new collateral standards would apply to both the Standardized and IRB Approaches. Thus, benefits for good risk management practice would not be limited only to the more sophisticated banks participating in the IRB Approaches.

Although the Steering Committee supports this trend, it also notes that the full scope of the IIF's recommendation has not yet been accepted. While it is certainly helpful to expand the range of collateral recognized in the capital framework to a wide range of financial instruments beyond bank and government guarantees, such expansion does not cover the majority of collateral instruments used by banks to mitigate their credit risks. These include third-party guarantees as well as security interests in a wide range of physical collateral, including automobiles, planes,

---

6 SCRC, pp. 15-16.

7 WGCR, p. 16.

trains, and ships as well as tradable commodities and intangibles such as accounts receivable. The concerns raised by this omission are discussed below.

6. Operational Risk Definition

Much progress has been made by both regulators and banks concerning the appropriate regulatory definition of "operational risk" since the Basel Committee released the first set of consultative papers in June 1999. Following a productive and dynamic dialogue process on operational risk, banks through the WGOR and supervisors in the Basel Committee are reaching consensus on the exclusion of strategic and reputational risks from the regulatory capital definition of operational risk.

The Steering Committee strongly supports this development, as it will help ensure that the regulatory capital framework targets losses that are concrete and can be measured. This approach also avoids creating a situation where the roles of regulators are confused with the role of stakeholders in a bank (e.g., equity owners, bondholders, managers). This is accomplished by crafting a regulatory framework that does not require regulators to second-guess management decisions where such decisions did not result in a loss to the bank.

7. Pillar Two Clarifications

One major innovation in the regulatory capital framework proposed by the Basel Committee is the formal use of supervision to augment regulatory capital charges assessed on specific banks. This development is cautiously welcomed by the Steering Committee, as it should help ensure that capital requirements are indeed bank-specific. However, banks worldwide are concerned that inappropriate or overly zealous use of the Pillar Two provisions could result in inappropriate capital charges and procedures for assessing those charges as well as arbitrariness.

In its March 2000 response to the original consultative proposals, the Steering Committee expressed support for the Pillar Two concept as well as concern regarding the potential for differences in regulatory styles and juridical frameworks to undermine the fair and even implementation of the new capital framework. The Steering Committee last year recommended that the following four safeguards should be instituted to avoid creating distortions. These were:

- The Basel Committee should establish clear and unambiguous guidelines on how all three pillars of the regulatory capital framework should be implemented. These guidelines should include limits on how much additional capital could be required of any bank under Pillar Two.

- Supervisors should ensure that their staffs are comfortable and proficient in the analysis of risk management systems. The training services of the Toronto Centre and the Financial Stability Institute as well as internships with the Basel Committee and its members may be useful in this regard.

- The exercise of supervisory discretion should also incorporate a transparency component requiring written notice of the need to assess additional regulatory capital charges and a review process.

- The Basel Committee could expand its role and serve as a clearinghouse for guidelines, interpretations, and implementation processes related to the new regulatory capital regulations.[8]

The Steering Committee is pleased to note that the majority of its recommendations were incorporated into the January 2001 consultative proposals.

Specifically, the Basel Committee proposals contain 14 pages of detailed guidance for supervisors on how to approach use of Pillar Two for assessing regulatory capital. In addition, the consultative document specifically advises that "to facilitate transparency and accountability, the criteria used in the supervisory review of banks' internal capital assessment should be publicly available. Similarly, when a supervisor requires a bank to improve its internal capital assessment program, it should communicate to the bank the specific deficiencies of the program that were identified and the reason such deficiencies are material in view of the bank's business profile."[9] Steering Committee banks also support the Basel Committee's guidance that supervisors "should explain to the bank's management the risk characteristics specific to the bank which resulted in the (higher than minimum capital) requirement, why these risks are not adequately captured under Pillar One and the contribution of each of the identified characteristics to the additional requirement."[10] The Annex to the paper providing a list of documents and guidance produced by the Basel Committee over the past five years should also serve as a helpful reference for supervisors and goes a long way toward creating the kind of clearinghouse suggested by the Steering Committee last year.

B. Concerns

Whereas the second set of consultative papers contains many positive elements, the Steering Committee notes that a number of aspects of the proposal also raise serious concerns within the global banking industry. These concerns must be addressed if the capital framework is going to function effectively as a provider of incentives for good risk management behavior and establish a prudent capital cushion. Some of the elements of the proposal may have a counter productive effect by creating excessively large capital cushions and high compliance costs (thus decreasing the amount of capital available for productive purposes in the intermediation process) and creating distortions in risk measurement.

1. Expected Loss (EL) and Unexpected Loss (UL)

The Steering Committee notes with grave concern the Basel Committee's choice to create a capital charge that reflects both expected and unexpected loss estimates. This is a fundamentally misguided concept that could result in serious misunderstandings concerning the function of capital and the size of a bank's real risk profile. **The Steering Committee would like to be clear: Capital serves to cover unexpected loss, which is defined as the volatility of expected loss estimates**.[11]

---

8 SCRC 2000, p. 26.

9 Pillar 2 (Supervisory Review Process), *Supporting Document to the New Basel Capital Accord*, Basel Committee on Banking Supervision (January 2001), para. 65.

10 Id., at para. 66.

11 "Regulatory and economic capital seek to cover the unexpected losses (UL) in a bank's portfolio. Capital serves as a cushion to ensure that unanticipated market situations or deterioration in borrower credit quality do not present catastrophic challenges to any given bank's solvency. Capital does not, however, seek to ensure that banks will be immune from failure." WGCA 2000, p. 2.

The Basel Committee cites as a main reason for including expected loss within the capital cushion the difference in national accounting arrangements for general provisions[12] as well as an interest in being prudent. The Steering Committee notes the Basel Committee's desire to generate prudent capital cushions that protect the financial system from shocks. However, the Steering Committee shares the WGCA's concerns that requiring banks additionally to hold **minimum regulatory capital to cover EL would create double-counting**, especially for banks that hold general loan loss reserves to cover the aggregate possible losses associated with all credits. This approach is particularly harsh when applied to retail assets, which have comparatively high, but fairly stable, expected losses. The high margins available on these assets act as a buffer against losses, before recourse to general provisions.

The result is a **systematic overstatement of risk and capital for each obligor**. Failure to recognize the majority of risk mitigation instruments normally used by banks (e.g., physical collateral, third-party guarantees, accounts receivable) diminishes significantly the utility of assessing obligor-specific risk weights. The Steering Committee strongly endorses the WGCA's conclusion that a regulatory capital charge to cover EL is unnecessary if banks disclose EL amounts publicly as is contemplated in the response to the Pillar Three proposals.

Banks involved in both the Steering Committee and the WGCA believe that the Basel Committee's efforts to structure a capital framework around both EL and UL is based mostly on a practical desire to finalize the framework without waiting for compatible changes in tax and accounting rules, particularly related to provisioning. In this context, it is important to note that the international accounting standards are under review. Changes in accounting rules would necessarily have implications for provisioning policies and practices as well as the definition of capital since the Basel Accord currently permits Tier Two capital to include some general loan loss reserves. None of the banks active in the IIF working groups or the Steering Committee have an interest in delaying completion of the capital framework until the accounting rules have been finalized. However, it will be important to ensure that conflicts with accounting standards are not inadvertently created.

Capital market participants require certainty and many aspects of the proposal can be finalized this year if the conceptual basis is correct. The conceptual basis for establishing regulatory capital based on EL and UL together is not, however, correct. Confusing the two could create significant arbitrage opportunities, especially for those banks that have moved into pricing capital at the transaction level. It would also undermine the informational content of spreads and create uncertainty among analysts and bank counterparts since a combined capital amount would obscure which portion of the capital charge covered EL and which portion covered the volatility of that EL estimate. This could create distortions in the market since the key variable to consider when evaluating the relative riskiness of different banking institutions is the volatility of the EL estimates.

---

[12] "The proposed risk weights are based on calibration to assessments of EL plus UL. The effect of setting weights in this manner will vary depending on national definitions of provisions and loan loss reserves and on the extent to which banks have general provisions that are greater or less than the limit of 1.25% of risk-weighted assets that applies to the inclusion of general provisions in supervisory capital. The Committee welcomes comment on this specific issue as well as the broader issue of how to ensure adequate coverage of both EL and UL within the context of regulatory definitions." *The Internal Ratings Based Approach*, Basel Committee on Banking Supervision (January 2001), para. 259 [*hereinafter*, "IRB Proposal"].

The Steering Committee therefore endorses and underscores the importance of the Basel Committee making the following structural adjustments to the regulatory capital framework:

- **Regulatory capital should cover UL.**

- **In the IRB Approach, if regulators insist on covering EL with regulatory capital, then the credit risk capital charge should be clearly disaggregated between the amount of regulatory capital allocated to EL and the amount of minimum regulatory capital to cover volatility of the EL estimate (i.e., to cover UL). The different amounts of a bank's regulatory capital allocated to those components should be disclosed separately. Such transparency would create a mechanism whereby banks with good risk management practices for managing EL and UL would receive a benefit because it would be transparent to the markets and reflected in the capital requirement.**

- **Also in the IRB Approach, the maturity adjustments and the Granularity Index should not be applied to the EL calculation since these adjustments are more properly related to UL.**

- **In the Standardized Approach, banks should not be required to apply a 150% risk weight against extremely low quality loans that have already been subject to provisioning and, thus, are already covered by a cushion. The same is true regarding extremely low quality loans in the IRB Approach.**

- **If EL is included with the definition of capital, then 100% of general loan loss reserves should be recognized as part of Tier Two capital.**

These recommendations would not, however, address the underlying definition of capital directly. Both the definition of capital and the IIF recommendations are likely to need revision depending on the outcome of the accounting debate. These revisions can be contemplated and discussed at a different point in time, however.

2. <u>Excessive Conservatism/Calibration</u>

Banks in the Steering Committee accept that regulators will always want banks to maintain a minimum amount of capital to protect the resilience of the banking system. They also accept that regulators are unlikely to accept as sufficient the output of banks' internal processes used to allocate economic capital without some adjustment factor to represent a prudential cushion. However, there is a difference between establishing prudential cushions and systematically incorporating elements of conservatism in every aspect of a capital calculation.

The Basel Committee's January 2001 proposals for calculating regulatory capital in the IRB Approach in particular add multiple layers of conservatism on top of each other. The result is a process that systematically overstates the risk and the regulatory capital cushion. The systemic costs of generating an excessively conservative capital cushion are high. First, capital is diverted from productive purposes in the intermediation process to cover regulatory requirements. Second, risks are mispriced. Increased risk estimates will be passed along to bank obligors in the form of higher prices or spreads, thus systematically tightening access to credit for a wide range of borrowers. Good quality borrowers will then seek other sources of credit with nonbanks. Therefore, and third, as banks' profitability and competitiveness are reduced, disintermediation trends will be accelerated and banking regulators will lose the ability to exert prudential supervision over a growing range of credit intermediaries that operate without a banking license.

These outcomes are to be avoided. The elements of excessive conservatism in the Basel proposals are as follows:

- The risk-weighting function contains an adjustment of 30% for each default probability grade to protect against **"measurement error"** in the estimation of default probabilities.

- The risk-weighting function also contains an unspecified **adjustment factor** to protect against a situation where Tier Two capital cannot absorb losses sufficiently.

- A **blanket 20% asset correlation** is assumed in the corporate risk weight function, which would apply to all other portfolios. It is unclear whether such an assumption is valid for noncorporate portfolios in all countries.

- A **Granularity Index** would impose an additional capital charge based on portfolio concentration without taking into account diversification.

- A **granularity requirement** would prohibit a bank from using the IRB Approach if its portfolio had one rating grade that contained 30% of all exposures in the portfolio.

- A ***w* factor** would be imposed on all collateral instruments, limiting the amount of recognition provided to any risk mitigation tool.

- **Overly conservative haircut values for eligible collateral.**

- **Highly conservative and excessively large initial calibration for the operational risk capital charge.**

Taken together, these elements create an excessively conservative capital framework that systematically overestimates risk and the capital needed to cover that risk. They must be eliminated or modified to ensure that the capital framework does not inadvertently create capital requirements unacceptably inconsistent and incompatible with proper risk management.

Banks in the Steering Committee believe that the proposed capital framework effectively assumes that all banks will operate suboptimal risk management systems. It assumes that shareholders, market discipline, and supervisory oversight standards will not be sufficient to establish incentives for a bank to measure and manage its risks in a prudent and responsible manner. The Steering Committee would like to emphasize that it is neither appropriate nor desirable to assume that all banks will operate as "black sheep." Such an assumption creates inappropriately priced risks and capital charges that will distort pricing and risk management decisions, to the detriment of both shareholders and borrowers in an economy. Systematic over-pricing of risk will generate over time systematically higher credit costs, an outcome with major implications for economic growth and stability.

The Steering Committee would like to underscore the importance of resolving these problems. Creating a new regulatory capital regime that seeks to enhance incentives to improve risk management practices but creates serious discontinuities in the evaluation and pricing of risk could have a severely negative impact on credit markets worldwide as well as on banks' competitiveness. The Steering Committee therefore strongly endorses the recommendations made by the WGCA on how to address these problems. These are as follows:

- First and foremost, **the Granularity Index must be eliminated**. Imposing a charge for portfolio construction based solely on the negative issues (concentration) without taking into account the positive aspects (diversification) is inappropriately one-sided. **Similarly, the granularity requirement limiting exposure to 30% in any one default probability (PD) grade should be eliminated**.

- Second, **the estimation error adjustment should not be applied to all banks and all default probability grades**. Instead, regulators should use their Pillar Two supervisory review authority to take all necessary action to correct situations in which a bank's internal systems have been proved deficient. This can include, but not necessarily be limited to, assessing additional capital. Banks whose internal default probability process are systematically flawed likely will require more than higher capital requirements, including fundamental revisions of their rating systems.

- Third, **the *w* factor should either be eliminated and concerns with collateral enforceability reflected in loss given default haircuts, or at a minimum it should be adjusted to avoid the anomalous situation where collateral such as cash receives a haircut of 0.15**.

Making these adjustments should result in a capital framework more closely aligned with real risk and, therefore, better able to provide incentives for good risk management practice within banks around the world.

3. Treatment of Maturity

A capital framework that recognizes the term structure of credit risk can help facilitate development of good risk management systems by encouraging banks to focus on the issue. Therefore, the Steering Committee supports the use of a maturity adjustment in both the Foundation and Advanced IRB Approaches, since it should not present excessive implementation challenges relative to the benefits of having a maturity-adjusted capital cushion. The Steering Committee agrees with the WGCA that the appropriate transition matrix to use for this purpose is the default mode methodology outlined in the consultative proposal.

The Steering Committee cautiously supports the default mode adjustment factor. The Steering Committee's overriding goal is to foster the development of a capital framework that should present a coherent and consistent approach to measuring regulatory capital to avoid opportunities for regulatory arbitrage. The Basel Committee has chosen to use a single-factor model to establish the risk-weighting function in the capital framework and applies that model to bank assets that are valued mostly on a default mode basis. The Steering Committee believes that only a default mode adjustment for maturity is logically consistent with these choices made by the Basel Committee. Effective and appropriate use of a mark-to-market maturity adjustment factor would require banks to use credit risk models. The Basel Committee has made it clear that the use of credit risk models by banks to set regulatory capital is not up for consideration at this time. Consequently, the Steering Committee agrees with the WGCA that a mark-to-market maturity adjustment should be implemented only at the same time as credit risk models.

The situation with the Standardized Approach is more complex. Ideally, a maturity adjustment factor could also be applied in this context. However, concerns with the complexity of implementation and an awareness of the resource constraints in many emerging market banks and regulatory agencies (which are the most likely to implement the Standardized Approach widely) make imposition of a maturity adjustment in the Standardized Approach impractical.

The Steering Committee remains concerned with the binary approach to the treatment of maturity generally in the Standardized Approach, believing that "the regulatory framework should not provide excessive incentives or penalties for banks to offer credit within a specified maturity band."[13] Inappropriate treatment of short-term interbank credits in particular could have significantly adverse consequences on the stability of banks' funding activities, especially in the emerging markets. Last year, the Steering Committee expressed concern that shortening the definition of "short-term" in the Standardized Approach to six months from 12 months "could accelerate volatility at the short end of the maturity spectrum without achieving meaningful differentiation for exposures with tenors in excess of six months."[14] The Steering Committee is extremely concerned to find that the new proposals would shorten even more significantly the definition of "short-term" down to three months, without rollovers.

The Steering Committee continues to believe that short-term interbank credit is being penalized unfairly compared with current guidelines. The majority of banks in the world continue to rely on traditional interbank markets as tools for asset and liability management. Creating disincentives to participate in these markets will have seriously harmful effects on the business and risk management processes of many emerging market banks that cannot turn to the swaps markets to achieve similar asset and liability management effects. The Steering Committee believes that the changes in the treatment of short-term interbank lending are being made largely in response to the Asian financial crises. However, Steering Committee members would like to emphasize that macroeconomic imbalances are the fundamental drivers of financial system instability. These factors are well beyond the scope of issues that can or should be addressed through the regulatory capital framework applicable only to commercial banks. In particular, attempting to address the velocity of money without addressing the underlying cause of interbank activity would instill a policy that would be incapable of having the desired effect (increasing stability in the market) and would impose excessively harsh costs on banks relative to other providers of short-term finance. **The Steering Committee therefore recommends that the definition of short-term remains at 12 months.**

4. Failure to Recognize Most Collateral Types

One of the most serious shortcomings in the Basel proposals is the failure to recognize physical collateral, third-party guarantees, and accounts receivable. The majority of banks in the world use these tools to cover the risk in their lending portfolios. This provides banks with items of value to help mitigate their loss in the event of default. This is also an activity in which banks have been engaged for centuries, providing banks with useful leverage over recalcitrant borrowers and helping to ensure that obligors are aware of the consequences of default.

---

13 SCRC 2000, p. 15

14 Id.

Failure to recognize physical collateral in particular effectively requires a bank to indicate that the collateral has no value and to hold capital against the full credit risk without taking into account the value of the collateral. Many physical assets do, however, have a readily determinable value. A variety of external valuation agents exist that provide objective, third-party values for specific types of physical collateral; these values are used to determine the fair market value for resale of the assets in the event that a bank forecloses on a loan and seeks to sell the asset to cover its loss on the loan. Valuation sources exist for a large range of ships as well as for airplanes (often disaggregated by model and year) and farm equipment. In other words, trading markets exist for these assets even though they are not securities. These values should be recognized by the Basel Committee; otherwise a number of borrowers (especially individuals and small and medium-sized enterprises) may find that the price of their credit will increase substantially to reflect the fact that collateral values are not recognized within the capital framework. Failure to recognized tradable commodities in particular could reduce banks' ability to offer credit to this area, thus undermining trade flows.

Failure to recognize physical collateral may have a particularly harsh impact on trade finance. In cross-border trade finance, the lender often takes some control over the movement of goods. This gives the lender more control over EAD and LGD than would be the case with other forms of lending. While the Advanced IRB methodology would permit a bank to use its internal EAD and LGD estimates across portfolio types, the Steering Committee believes that the specific features of trade finance merit recognition in the Foundation IRB or in the collateral rules. Without such recognition, it is possible that the new capital framework could produce unintended adverse consequences on trade finance markets.

Third-party guarantees also represent an important source of credit risk mitigation with long track records within banks. Historical recovery rates on these instruments also should be recognized within the capital framework to ensure that time-honored and reliable methods for mitigating credit risk are not rendered valueless within the regulatory framework and, thus, discounted in the markets. Accounts receivable also provide a major source of credit risk mitigation, especially with respect to lending to small and medium-sized enterprises (SMEs). Small companies rely extensively on their income stream to help finance expansion. Failure to recognize accounts receivables as a reliable source of credit risk mitigation in the new capital framework could seriously undermine banks' ability to offer credit to these entities at a competitive rate, thus hastening disintermediation.

The Steering Committee strongly supports the WGCA's efforts to collect recovery rate data on a wide range of physical assets for consideration by the Basel Committee. It is expected that this global survey of recovery rates will be completed in late summer or early fall. It is also expected that the WGCA will deliver with the statistics some recommendations on how to assess the enforceability of the risk mitigant so as to ensure that reliable collateral arrangements and third-party guarantees are included within the capital framework. **The Steering Committee strongly recommends that the Basel Committee make final decisions on the eligibility and value of these collateral types in the fall of this year, based on the IIF's global survey.**

5. Treatment of Small and Medium-Sized Enterprises

SMEs are the backbone of most economies and often the engine of growth. They foster innovation and provide the majority of employment opportunities in most economies at all development levels. However, it is far from clear how extensions of credit to these companies should be assessed within the regulatory capital framework. Definitional issues complicate discussion, because most definitions associated with size (e.g., number of employees, turnover, assets) do not translate well across economies. A small company in a large economy will look like a large company in a small economy. Organizational structure also varies across countries, making a global standard difficult to reach.

All bankers seem to agree that the risk-weighting function for corporate obligors may generate an excessively high capital charge for SME lending. Opinions within the risk management community are divided, however, as to how to fit SMEs into the regulatory capital framework. Some would prefer to include them within the retail portfolio; others would prefer to include them in the corporate portfolio. Both of these groups believe that increased recognition of physical collateral and third-party guarantees would ease the severity of the capital charge by recognizing the types of collateral most often used by SMEs. A few members would prefer to create a separate portfolio with a different risk-weighting structure and a different asset correlation assumption.

Clarity is needed on how best to address this dilemma. **The Steering Committee urges the Basel Committee and the WGCA together to develop an acceptable solution before the fall. It is critical that any mispricing of regulatory capital for SME lending be corrected to avoid the cost of credit to these companies from increasing unnecessarily to cover the regulatory capital charge.**

6. Treatment of Operational Risk

Quantitative measurement of operational risk is still in its infancy, in comparison with credit and market risks. Over the past eighteen months, much progress has been made. Nonetheless, it is still too early to reach clear conclusions on many issues. Banks have always managed many aspects of operational risk, although the isolation of operational risk factors and attempts to quantify the scope of this risk are quite fairly new. The unbundling of risk types was perhaps an inevitable consequence of creating a more precise approach to calculating credit risk capital. However, crafting a regulatory capital framework for both credit and operational risks creates significant challenges for both banks and their regulators since the regulatory standard-setting process is occurring simultaneously with the banking industry's exploration of a variety of mechanisms for measuring and managing operational risk. This has generated a situation where the amount of operational risk relative to total risk has been overstated.

The Steering Committee questions seriously the proposal that operational risk should constitute 20% of regulatory capital. This initial calibration was set in relation to very preliminary industry estimates of the amount of economic capital held to cover a wide range of "other" risks including, but not limited to, operational risk. During the intervening eighteen months, the focus of quantification and regulatory attention has sharpened to include a definition that more properly targets clearly identifiable events that could fall within the scope of "operational" risk. This scope expressly excludes business, reputation, and strategic risks, which were incorporated into initial industry estimates. Consequently, the initial 20% calibration is clearly too high. It is expected that the true scope of operational risk will be substantially lower than 20% of total capital. The Steering Committee therefore urges the Basel Committee to revise its estimates in accordance with the newly agreed definition of operational risk and results from current studies.

The Steering Committee additionally believes it is too early to identify a specific methodology for measuring operational risk for regulatory capital purposes. After a year in existence, the WGOR is recommending a four-stage evolutionary approach for calculating operational risk regulatory capital. With respect to the third stage in that approach the WGOR has agreed a testing paradigm for a statistically based approach to calculating regulatory capital, based on internal loss data. The resulting capital amount would be adjusted to reflect the quality of the control environment. It is too soon to say whether this approach presents an appropriately robust methodology for assessing regulatory capital for operational risk because it has not yet been tested. The WGOR is also exploring a scorecard-based concept for calculating regulatory capital that would use internal loss data for validation purposes. Considerable interest exists in exploring this concept, although most Steering Committee members doubt at present about whether this methodology can provide an alternative to the statistical capital calculation methodology or whether a scorecard-based tool could be used as a qualitative adjustment to the statistical approach.

The Steering Committee understands that another consultative paper on the regulatory capital treatment of operational risk will likely be released by the Basel Committee in mid-summer. This would be welcomed, as it would provide another opportunity for banks and the Basel Committee to have a constructive dialogue on measuring operational risk for regulatory capital purposes. It would also provide an opportunity for both the WGOR and the Basel Committee processes to reflect the significant advances made in the last few months and those that are anticipated in the near term.

The Steering Committee thus supports conceptual work on both methodologies at this time, given the fact that insufficient evidence and lack of industry-wide testing make it difficult to justify endorsement of any one specific approach. **In particular, the Steering Committee is not willing to endorse any specific methodology prior to rigorous testing using real data and real bank portfolios. The Steering Committee is also interested in ensuring that any regulatory capital methodologies for operational risk not present excessive regulatory compliance requirements.**

Steering Committee members recognize at the same time that a capital adequacy framework needs to be finalized quickly. However, the Steering Committee believes that the issues related to assessing regulatory capital for operational risk are too important to risk making hasty decisions on the specifics of individual methodologies that could be codified into regulatory frameworks and legislation that could prove difficult to amend in the future. This is true with respect both to the quantification of operational risk and to the recognition of risk mitigation instruments (e.g., insurance), both of which should be included in any regulatory capital framework for operational risk. The Steering Committee therefore suggests the use of a "can" approach to finalizing the capital calculation for operational risk. This approach would establish the mandate and goal of arriving at a methodology or formula without making irrevocable commitments to any specific formula.

Therefore, the Steering Committee strongly recommends that the Basel Committee support a framework for operational risk that contains a placeholder for quantification under Option 3 without making methodological choices at this point in time, before the industry has had a chance to test the validity and relevance of the methods under consideration. This could be accomplished by supporting a legislative process in Europe that would not require finalized quantitative details in a draft directive before year-end.

The Steering Committee notes that **precedents exist for taking this approach**. When the market risk capital framework was being crafted in the early part of the 1990's, the main aspects of the new capital framework were finalized while the Basel Committee and bankers continued to work on the details of how to calculate specific risk. At the request of the Basel Committee, globally active banks undertook a testing exercise to demonstrate the validity, relevance, and robustness of their internal systems for estimating specific risk. The process lasted for about eighteen months. All policymakers were aware that additional research was being conducted and final details on calculation methods for specific risk regulatory capital were inserted toward the end of the process, after a rigorous testing program had been completed. As a consequence, regulators and legislators had a high degree of comfort that the revisions were both prudent and based on sound market practice.

The European legislative process has changed since the market risk rules were finalized. However, the interests of legislators, bankers, and regulators have not changed. All share a goal of creating a capital adequacy framework that is meaningful, relevant, and consistent with good risk management practice. Making those determinations with respect to operational risk regulatory capital will take 18-24 months as the banking industry undertakes a rigorous testing program.

The Steering Committee thus underscores the importance of a rigorous, transparent, and deliberative process concerning the establishment of a framework for setting operational risk regulatory capital charges. Mistakes in this area could fundamentally alter the cost structure of operating as a "bank" and could create fundamental misperceptions about the size of operational risk and how best to manage it. Banks in the Steering Committee believe that a framework can be finalized within the next 18 months. They urge regulators and legislators to work with the banks to develop a capital framework in this area that can truly be called "risk-sensitive" after a proper evaluation of the strengths and weaknesses of quantification mechanisms using real bank portfolios.

Within the context of operational risk, the Steering Committee would also like to express concern with the possibility that regulatory capital may be used to cover EL as well as UL. **The Steering Committee endorses the recommendation of the WGOR that if both EL and UL are to be covered by regulatory capital, then the capital framework must also recognize the capacity of a bank's current period revenue to absorb EL especially in the calibration of an overall operational risk minimum capital requirement.**

The Steering Committee would also like to underscore the importance of recognizing the risk-reducing effects of mitigation tools such as insurance. **The Steering Committee encourages the WGOR and the Basel Committee to collaborate in developing a capital framework in which regulatory requirements are reduced to reflect risk transfer through insurance products.**

Finally, the Steering Committee endorses the WGOR conclusion that operational risk is non-linear with respect to firm size or activity level. As a result, based on (a) the empirical research of PricewaterhouseCoopers, (b) the intuitive understanding of operational risk managers, and (c) mathematical indicators using reasonable distribution assumptions, both the Steering Committee and the WGOR recommend that all calculation methods be adjusted in the capital framework. **Specifically, the capital calculation methods in Options 1,2 and 3 of the proposed framework should be adjusted by applying a square root function to the Exposure Indicator, or some part thereof, in the formula used in each of those options.**

7. Standardized Approach: One Additional Risk Weight Needed

Currently, the Basel Accord contains four risk weights (0%, 20%, 50%, 100%), although the vast majority of obligors fall into the last risk-weighting bucket. The Basel Committee proposals for the Standardized Approach would increase the granularity of the capital framework by adding one risk weight (150%). However, since the majority of banks likely to use the Standardized Approach will likely operate in countries where the number of rated obligors is high, the reform proposals will result still in the majority of obligors being assigned to the 100% risk-weighting bucket because they are not rated. Last year, the WGCA recommended that the minimum number of risk weights in the Standardized Approach be at least eight for the corporate portfolio, with substantial increases (rather than step-wise increases) as credit quality deteriorates.[15]

Emerging market banks, where the Standardized Approach is most likely to be applied broadly, are particularly worried that the Standardized Approach's five risk weights do little to help local banks prepare to implement an IRB approach. They note that the move from a system that relies on five buckets for assessing credit risk to a system with a minimum of six to nine performing and two nonperforming grades is significant and costly, especially in areas where relationship banking remains the market norm. Therefore, the Standardized Approach creates a structure in which the incentives to improve internal risk management are small and the cost to borrowers is likely to be large.

The Steering Committee understands and supports the policy that the regulatory capital framework should create incentives for banks to move into the IRB Approach and that therefore the Standardized Approach should not become too comfortable. However, increasing the number of risk weights in the Standardized Approach would not likely make the Standardized Approach more attractive than the IRB Approach for banks looking to improve their internal risk management structures. Instead, it would ensure that banks were encouraged to apply more detailed analysis to obligors and develop a credit culture emphasizing credit quality. **Thus, the Steering Committee recommends that a 75% risk weight be added to the framework.**

8. Standardized Approach: Expanded Use of Local Currency Ratings

The Steering Committee notes that the proposed framework fails to differentiate between foreign and local currency obligations to the private sector. However, beneficial risk weights are applied to lending extended to local sovereigns using local currency and local funding. The logic underpinning this treatment also holds for similar obligations to private sector entities: transfer and currency risks are not present. In addition, default probabilities associated with lending to an obligor can be affected by whether or not an instrument is funded using foreign or local currency, a fact reflected by the growing use of differential rating structures for such instruments by independent rating agencies. Lending to local borrowers in local currency by definition is less risky than lending to such borrowers using foreign currency. **Consequently, the Steering Committee recommends that the new capital framework recognize local currency ratings in both the Standardized and IRB Approaches for purposes of setting regulatory capital risk weights for obligations in local currency**.

In addition, the Steering Committee believes that local currency ratings should be used for trade finance. Although such obligations are funded in foreign currencies, the transfer risk (i.e., the risk of default due to the imposition of foreign exchange controls by the local authority) is quite small. In particular, it is worthwhile to note that:

- few historical losses are associated with trade finance obligations
- cash flows from trade are countercyclical

15 WGCA 2000, p. 4.

- the risk spread charged to these loans, even during periods of stress in emerging markets, is lower than that charged for different credit or debt instruments of the same maturity.

Thus, trade finance credits are seen by global banks to present substantially less risk than even government instruments of the same maturity. **Consequently, the Steering Committee recommends that local currency ratings be used for trade finance obligations even though these obligations are nominally funded in foreign currency.**

C. Pillar One: Other Portfolios

The Basel Committee reform proposals demonstrate a serious desire by banking regulators to craft a capital framework that generates cushions tailored to the risk characteristics of different exposures. This development is welcomed by banks around the world, because it provides the foundation upon which risk-sensitive and individualized capital requirements can reflect the real risks undertaken by the bank. In addition to the corporate, retail, bank, and sovereign portfolios, the Basel proposals indicate an interest in tailoring capital requirements to cover two different additional types of exposures: equities and project finance.

The banks participating in the Steering Committee and the WGCA support this effort. The Institute's response to the difficult questions raised within the consultative papers focuses on one guiding and overarching goal: comparability. Specifically, banks active in the IIF processes believe that the capital framework should treat similar risks in a similar manner. **Thus**, **all assets that expose the bank to loss due to default or bankruptcy should be assessed in a conceptually consistent manner. All assets that expose the bank to loss due to trading, where the assets in question are valued on a mark-to-market basis, should be assessed in a conceptually consistent manner**.

This analytical approach is driven by recognition within banks that regulatory capital rules based on product types may soon become obsolete. The number and types of credit assets that will soon be traded is growing. Similarly, some traded assets with little or low liquidity (e.g., private equity) may require risk rather analysis closer to that which accompanies assessment of bankruptcy or default risk rather than a market risk paradigm. Rather than craft a capital framework based on notions that may soon become obsolete, the Steering Committee believes that instead the appropriate approach is to consider whether the assets will be held by the bank for their full life or may be traded prior to maturity.

1. Project Finance

The Basel Committee proposes to segregate for special treatment assets characterized by a structure in which the risk of the obligor is closely correlated to that of the project or guarantor, where repayment is linked to the cash flows generated by the project, which serves as security of the loan. The asset itself is often a highly idiosyncratic item with little or no secondary market (e.g., a dam).

Both the Steering Committee and the WGCA accept the general definition of project finance contained in the Consultative Proposal, with one clarification. A distinction must be made between cash flow finance (i.e., "infrastructure projects") and the financing of both the construction and leasing of movables such as airplanes and ships (i.e., "asset-based finance") and some commercial real estate finance of similar risk profile.

The appropriate method for calculating regulatory capital for all project finance exposures should be a modified PD/LGD/EAD structure. The necessary modifications are:

- **Specialized LGD values should be crafted to reflect loss experience in each portfolio segment. Thus, LGDs associated with infrastructure projects would be different from those assigned to asset-backed projects.**

- **Validation procedures for PD and LGD values must be amplified to take into account the special structures of the projects in question and the role that cash flows play in assessing risk. It is also possible that procedures specific to project finance lending affiliated with multilateral development banks may be necessary to reflect the relative lack of experience with defaults in these instruments.**

- **It is possible that terminology may change to reflect better a focus on the probability of failure of the project rather than just the obligor.**

In summary, it may not be reasonable to require statistically validated estimates of PD, LGD, and EAD for project finance exposures. This does not mean that quantifying the risk associated with those projects and allocating an appropriate amount of capital for them is an impossible task. **Instead, assessing internal ratings for project finance is substantially similar to the process used to assign country ratings in banks, where both qualitative and quantitative processes are used to assign risk ratings.**

The WGCA will work during the next four months to develop a set of recommended best practices and oversight standards for validation of banks' project finance rating and risk management systems. At the same time, the WGCA will investigate whether standard LGD factors can be established for use in the Standardized and IRB Approaches based on observable market information and/or internal data. For example, some portions of project finance (e.g., asset-based finance) could be treated as a collateralized corporate loan if sufficient quantitative evidence of LGD values could be established. This work should be completed by August 2001.

The Steering Committee strongly supports this work, viewing it as essential to building a relevant and meaningful capital framework that is tailored to the risks in the banking business. It strongly recommends that the Basel Committee remain open to making necessary changes in the fall based on the outcome of this market research.

2. Equity Exposures

The Basel Committee's proposals to assess a regulatory capital charge for equity holdings are based on two concerns, one backward looking and the other forward looking. First, looking at market experiences in the past few years, policymakers at the Basel Committee observed that bank losses associated with venture capital investments (especially in high-tech and dot-com companies) had spiked with the recent general market downturn. Second, the Basel Committee observed that banks' underwriting activities are likely to increase over time as the financial services industry continues to evolve, especially with the elimination of the Glass-Steagall restrictions on bank underwriting activities in the United States.

The Steering Committee endorses the recommendations developed by the WGCA for assessing regulatory capital against equity exposures. The recommendations are based on making a fundamental distinction between equities held in the banking book that are not traded and equities held for trading purposes. **Those equity holdings held by banks indefinitely or for sufficiently long periods that expose the bank to loss due to the issuer's bankruptcy rather than exposing the bank to loss due to market downturns should be subject to a regulatory capital charge using a modified default-type of analysis. Those equities held for shorter periods that expose the bank to risk of loss associated with market downturns should attract a regulatory capital charge based on a market risk/stress-testing framework.**

To avoid cherry-picking in the designation of where equity holdings are placed in a bank's portfolio, the Steering Committee additionally recommends that each bank articulate a policy for placing equity holdings in the banking book based on (a) its underwriting role, (b) its intention to promote a long-term relationship with the company or to acquire bargaining leverage or control over the company's affairs such that the bank's investment would be recovered, (c) the lack of a traded market for private equity, or (d) establishment of strategic alliances through cross-shareholdings.

Within the Standardized Approach, the current treatment should continue to apply to these holdings (i.e., they should be subject to an 100% risk-weighted capital requirement). This recommendation is driven mostly by the need to ensure simplicity of approach and implementation. Within the IRB Approach, these holdings should be treated in a manner comparable to that used for other banking book exposures that are not traded (i.e., a PD/LGD/EAD framework) with some modifications.

The modifications proposed by the WGCA are endorsed by the Steering Committee since they seek to capture the actual risk associated with holding equity instruments for long periods, using methodologies that are accepted as robust indicators of risk. The adjustments identified below seek to avoid confusion with the credit risk framework since such holdings are not properly subject to default risk. These recommendations may expand, as the WGCA and the Steering Committee consider additional elements such as EAD in more detail this summer.

- The term *PD* should be replaced by the term *probability of loss (PL)* and should be determined as the probability that the company in which the bank has the strategic investment will experience a default event in any senior debt instrument held by the bank. Thus, the PL value for a strategic investment would be identical to the PD estimate made by the bank for any senior debt.

- The term *LGD* should be replaced by the term *loss (L)* and should be set at 100%. Thus, the bank would be assumed to suffer a complete loss of its strategic investment at the time of the credit default event.

This structure would establish comparability and consistency with the credit risk framework without creating conceptual confusion or the implication that equity investments expose a bank to default risk. In addition, supervisors using their Pillar Two authority should be permitted to determine whether a bank had chosen its calculation method appropriately given the particular structure of the markets in question.

All other equity investments would be treated as if they were trading assets, relying on a stress-testing approach to set the regulatory capital requirement. Alternatively, venture capital could be treated as a loan collateralized by the entity's equity if consistency with the banking book is deemed a higher policy priority.

Chapter 3: Pillar Two Issues

The length and breadth of the capital proposals suggest that more effort may be needed to ensure adequate international implementation. The concerns of the Steering Committee in this area relate mostly to the dynamics associated with implementing the consolidation requirements and the interplay of supervisory jurisdictions between Home and Host banking supervisors. Even with the improvements and clarifications concerning use of Pillar Two provided by the Basel Committee, bankers in the Steering Committee remain concerned that differences in implementation across borders could seriously compromise their ability to meet the capital standard on a globally consolidated basis and that the regulatory burden associated with differential implementation could undermine their ability to operate on level playing fields. Also, it is to be expected that individual national regulators will pursue domestic objectives, possibly to the detriment of foreign banks.

At the same time, banks and their supervisors share an interest in building a global supervisory framework that is internationally consistent, fair, relevant to the risks, and as simple as possible. If the regulatory capital framework is to contain detailed validation standards (as is currently proposed by the Basel Committee to promote consistent application across jurisdictions), there is a shared global interest in creating a process by which level-playing-field issues can be discussed and possibly resolved.

The Steering Committee therefore recommends that the Basel Committee either create or provide an "ombudsman" function for the implementation of the regulatory capital framework. This would permit individual banks to meet with groups of supervisors responsible for overseeing their activities to discuss a plan of implementation that would be consistent with the bank's activities and the relevant national priorities. This structure would not imply cession of sovereignty by any one regulator beyond that which is already contemplated through the Home/Host state division of responsibilities established through the Basel Concordat. Instead, it would simply provide a mechanism by which the level-playing-field issues associated with implementation of the regulatory capital rules could be discussed and pragmatic solutions consistent with existing regulatory and juridical structures could be found.

The Steering Committee also recommends that national supervisors for internationally active banks increase their cooperation. This could take the form of standardized regulatory reporting templates or joint meetings with supervised banks, as was recommended in 1998 by the Institute's Task Force on Conglomerate Supervision. [16]

The Steering Committee consequently believes it is essential for the Basel Committee to promote increased cooperation and coordination in the application of the regulatory capital framework internationally. Without such coordination, the resulting mix of varied implementation standards and possibly conflicting requirements could render impossible the determination of a reasonable capital charge for large, complex banking organizations. **The Steering Committee thus reiterates its previous recommendation that the Basel Committee could expand its role to serve as a clearinghouse for guidelines, interpretations, and implementation processes related to the new regulatory capital guidelines.**[17] This would

[16] *Report of the Task Force on Conglomerate Supervision*, "Response to the Consultative Papers released by The Joint Forum on Financial Conglomerates" The Institute of International Finance (July 1998).

[17] SCRC 2000, p. 26.

serve the dual function of increasing transparency in the regulatory process while also facilitating cross-border supervision of banks' regulatory capital allocation processes and increasing supervisory comfort levels with applying the new standards.

It is important to note that the Steering Committee strongly supports the goal of creating comprehensive and consistent risk management structures across globally active banks. The concern is not with the necessity or even the regulatory incentive to establish such systems. Instead, the concern is with the timing of implementation and the possibly severe and adverse consequences associated with failing to achieve statistical validity in default or recovery rate statistics for a large operation in a major country. The legitimacy of this concern already has been recognized by some regulators.[18]

This situation requires a "rule of reason" to be applied when implementing the new capital framework. For example, one type of "rule of reason" could seek to encourage banks to implement risk management systems commensurate with the bank's activity levels rather than require all banks globally to implement immediately best risk management practices regardless of their appropriateness to the bank's business. The Steering Committee supports the Basel Committee's efforts to avoid "cherry picking" behavior by banks seeking to minimize capital requirements by determining which approach would generate the lowest charge. The Basel Committee also rightly seeks to establish a defined and limited path to move banks quickly along the path toward implementation of improved risk management systems that can qualify for the IRB Approach. However, the use of a blanket consolidation requirement in the face of strong evidence that it is neither practical nor possible for banks to comply serves no supervisory purpose.

The Steering Committee therefore also recommends that Pillar Two supervisory review should be used to evaluate the speed with which implementation of the IRB Approach is proceeding. This would enable supervisors to urge banks along with implementation plans without creating arbitrary deadlines.

[18] "Although both supervisors and financial institutions support the concept of consolidated risk management, few if any financial firms have fully developed systems in place today. The absence thus far of fully implemented consolidated risk management systems suggests that there are significant costs or obstacles that have historically led firms to manage risk in a more segmented fashion. We argue that both information costs and regulatory costs play an important role here by affecting the trade-off between the value derived from consolidated risk management and the expense of constructing these complex risk management systems." Christine M. Cumming and Beverly J. Hirtle, "The Challenges of Risk Management in Diversified Financial Companies," *Federal Reserve Bank of New York Economic Policy Review*, vol. 7, no. 1 (March 2001), p. 2.

Chapter 4: Pillar Three/Transparency

The Steering Committee reiterates its support for increased transparency in the banking business. Increased disclosure can enhance competition as well as risk management by facilitating counterparty risk assessment. Banks in the Steering Committee as well as in the working groups agree that more relevant and reasonable disclosure under Pillar Three of the regulatory capital framework is both desirable and necessary to building a capital adequacy regime that is both robust and effective.

In its report last year, the Steering Committee identified the following elements of a good credit risk disclosure framework:

- The level of detail for disclosure should be clearly defined, and any additional requirements should not place an undue compliance burden on banks relative to other financial services providers. At a minimum, comprehensive information on capital structure and types of risk exposures should be provided.

- Disclosure should balance the importance of forward-looking information with historical information. Indeed, information on the way a bank has acted or is prepared to act when faced with important risk management challenges is possibly more important to investors than past results and other quantitative information. Therefore, improved disclosures should provide markets with a perspective on a bank's ability to respond successfully to stress scenarios, including liquidity-related stresses.

- More active use of the Internet by both banks and supervisors to disseminate information should be explored.

- The Basel Committee's "supervisory information framework" should be updated to reflect credit-risk-related issues.[19]

The Steering Committee notes that Basel Committee's current Pillar Three proposals do not demonstrate recognition of the importance of these guiding principles for purposes of building an effective and efficient transparency regime.

Deep concern exists within the banking community that the Pillar Three proposals present an overly broad attempt to provide information into the market without considering first whether the information is helpful to the assessment of the adequacy of a bank's capital cushion. This issue should be the focus of any disclosure requirements attached to a capital framework. Consistency with existing accounting standards also is important. In particular, it is critically important that regulatory capital standards on transparency do not conflict with existing accounting requirements.

Increased transparency can increase market efficiency and enhance market discipline, but only if the information provided to the markets is relevant, timely, meaningful, and capable of being understood. Excessive amounts of irrelevant data can be as bad as having too little data. More information can actually increase opacity in markets if the information is not relevant to risk analysis. It is far from clear whether the portfolio breakdowns suggested in the Pillar Three

[19] SCRC 2000, p. 28.

proposals meet these standards. Portfolio breakdowns would provide more insight into a bank's portfolio *strategy*, but not necessarily its risk. A variety of models exist to evaluate credit risk in banks' portfolios. These models are "highly sensitive to subtle changes in assumptions about correlations and valuations, as well as default probabilities. This means that a range of responses could be correct estimates of credit risk, if the underlying assumptions were consistent with market realities."[20] Consequently, market analysts could draw starkly different conclusions about the risk of a portfolio using as inputs the information requested in the Pillar Three proposals. These estimates could all be correct, but they would not provide any insight into the adequacy of a bank's capital cushion or the adequacy of the bank's management processes.

Consequently, the Steering Committee believes that the data points requested by the Basel Committee under the Pillar Three proposals are excessively broad and costly. They are also not likely to enhance transparency even if they do increase the amount of information disclosed by banks. A competition issue exists as well: Nonbank providers of credit intermediation services would not be required to fulfill the same disclosure standards. This could expose banks to unfair competition in certain markets where their portfolio breakdowns were exposed. It is also important to note that credit rating agencies, whose assessments will be used to set risk weights within the Standardized Approach, will not be subject to comparable disclosure standards to qualify for use within the regulatory capital framework. Finally, questions about the feasibility of implementing the Pillar Three proposals in emerging markets need to be addressed carefully, especially those markets where existing disclosure practices are not consistent with global standards.

The Steering Committee believes that a more appropriate approach would be to require a targeted set of disclosures by banks under Pillar Three. Steering Committee members therefore endorse the following data points recommended by the WGCA:

A. Quantitative Disclosures: All of the following from IRB banks, by PD band:

i. Funded amount
ii. Unfunded amount
iii. Weighted average EAD
iv. Weighted average LGD
v. Weighted average maturity
vi. Expected loss
vii. Regulatory capital

B. Qualitative Disclosures: Descriptions of the following:

viii. PD validation process
ix. LGD methodology
x. EAD methodology

C. Additional Disclosures: Top five geographic and industry segments as a percentage of total exposures.

[20] *Modeling Credit Risk: Joint IIF/ISDA Testing Program*, The Institute of International Finance and the International Swaps and Derivatives Association (February 2000), p. 55.

The Steering Committee hopes that disclosing these items will increase market efficiency and transparency by assisting users of financial statements in assessing both the bank's capital adequacy and the systems used by the bank to assess and validate its risk measurement processes.

Chapter 5: Level Playing Field

A. Among Banks Internationally

From its inception, the Basel Accord has identified the establishment of level playing fields among commercial banks to be a key goal of internationally harmonized regulatory capital standards. One major motivating factor behind the original Basel capital framework was in fact to facilitate bank competition on the basis of price rather than on the basis of artificial advantages created by national regulatory capital requirements while simultaneously creating a common minimum standard below which no bank should fall and possibly endanger the system.

Banks share with their supervisors an interest in creating common minimum standards that facilitate competition within the banking industry. Encouraging banks to develop increasingly advanced risk management systems that measure risk more accurately should enhance level playing fields over time by emphasizing equality of competitive opportunity. As the WGCA noted in 1998, "An emphasis on minimum risk management standards would also benefit the financial system by encouraging banks to upgrade the rigor of their internal systems. The playing field would be level in that all banks would have an equal opportunity to compete for recognition of their internal models for capital adequacy purposes."[21]

Achieving that level playing field within the banking sector will be a challenge in a world where it is far from clear that all regulators have either the ability or desire to implement the IRB Approach and/or the Pillar Three disclosure guidelines. Significant discretion will also exist in interpreting and implementing the Pillar Two supervisory review guidelines. It will be essential that all G-10 governments and at least the leading emerging market countries implement the IRB Approach if a level playing field in fact is to be developed. Some examples can demonstrate graphically concerns in this area.

Example 1: A leading emerging market bank is required to use the Standardized Approach to calculate regulatory capital. This means that all loans by the bank to the best quality unrated corporate in that country must attract a 100% risk weight. Costs are passed along to the borrower who, being a strong company, decides to seek financing from another bank. The local regulator has authorized sophisticated foreign banks to use the IRB Approach. This would permit the foreign bank qualifying to use the IRB Approach locally to offer a loan at a lower price than the local bank *if* the borrower in fact is of high quality. This scenario could occur if a local regulator determines that it did not have sufficient resources to offer the IRB Approach to all banks in its jurisdiction or if it determined that no local banks were sophisticated enough (or did not have sufficient historical data) to qualify to use the IRB Approach. As a Host country authority, it could rely principally on the external Home country authority to validate the foreign bank's internal rating system and, thus, pass along the regulatory authorization cost to the Home country.

Example 2: A large (but not necessarily cutting-edge) bank is required by its Home country regulator to implement the Foundation IRB Approach. The implementation plan calls for the bank to devote resources to creating information technology and management information systems to link its entire global banking operation to a new internal rating system that assesses all

[21] *Recommendations for Revising the Regulatory Capital Rules for Credit Risk*, Report of the Working Group on Capital Adequacy (1998), p. 32.

borrowers from Africa to Canada using the same system. More complex global banks in other countries are permitted a period of five to seven years to establish such systems. This bank must implement the system in three years, regardless of the impact that implementing such a system would have in terms of diverting resources away from lending activities. More important, the bank must implement the Foundation IRB despite the fact that the risk-weighting function will inappropriately require excessive amounts of capital for the same lending activities.

Example 3: A large bank is required to use IRB and a small bank allowed to use the Standardized Approach. The large bank will avoid business with badly rated corporates that attract a 625% risk weight. This business is likely to migrate to the small bank where the same corporate would attract a 100% risk weight. On the other hand, the large bank will offer attractive conditions for highly rated corporates. The small bank will not be able to offer similar conditions, as it is required to attribute this corporate higher risk weights. Over time, the "bad" corporates are likely accumulated with the small bank, while good quality corporates migrate to the large bank.

Example 4: Two banks with identical risk profiles located in different countries (A and B) go under Pillar Two review. The supervisor in country A lacks resources and interprets the guidelines in a lax fashion, while the supervisor in country B has highly qualified staff and has a highly conservative interpretation of capital requirements. The review outcome ends with the bank in country A not requiring additional capital under Pillar Two while the bank in country B is asked to prop up its regulatory capital.

These examples demonstrate that inappropriate implementation of the new framework could generate profound inequalities of competitive opportunity without regard to the underlying quality of a bank's capital base and risk management capabilities for the market in which it operates. Some of these problems would disappear with gradual elimination of the Standardized Approach and/or gradual predominance of banks using the IRB Approach. However, neither of these outcomes can occur if the IRB Approach is not calibrated to set appropriate incentives for banks to devote resources to qualify to use it. In addition, it is possible that the prevalence of unrated entities in the Standardized Approach might create a disincentive for banks in emerging market countries to create complex internal rating systems because the cost of implementing such internal systems could outweigh the capital benefit of such implementation.[22] This is because lower-quality obligors would receive risk weights much greater than 100% in the IRB Approach.

Steering Committee banks note that reliance on an incentive-based structure implies freedom of choice. An incentive rewards the right choice and penalizes a bad choice. It does not require a specific choice. The key element to establishing level playing fields among banks therefore is not to mandate that individual banks must use the Foundation IRB Approach. Instead, the key element is to make the IRB Approach more attractive than the Standardized Approach so as to encourage banks to improve their systems and data to be eligible to use the IRB Approach. This requires that regulators have sufficient resources to implement the IRB Approach to make it a viable alternative for a critical mass of banks worldwide. It also requires that appropriate calibration be established as between the different methods for calculating regulatory capital for credit risk.

[22] Giovanni Ferri, Li-Gang Liu, Giovanni Majnoni, "The role of rating agency assessments in less developed countries: Impact of the proposed Basel guidelines," 25 *Journal of Banking & Finance* 115-146 (2001).

The Steering Committee notes that effective implementation of the Pillar Three transparency proposals could enhance level playing fields significantly by providing a basis for comparison across banks. However, the data points chosen for such disclosures would need to be crafted in a manner that provided sound information on a bank's risk profile. The proposed data points for Pillar Three disclosure seem to fail this test because they are more appropriate to the analysis of a stock price than targeted to facilitate analysis of a bank's capital adequacy. The WGCA has proposed an alternative set of disclosures that we believe will enhance transparency concerning regulatory capital while providing timely and relevant data to the markets so that competition can occur based on an analysis of the bank's capital cushion.

B. Among Financial Firms

Level-playing-field issues are not limited to the banking sector. In fact, many members of the Steering Committee believe that the most urgent level-playing-field issues exist with respect to intermediation activities offered by financial firms that are not subject to comparable regulatory capital requirements. The existence of electronic delivery mechanisms will only accelerate disintermediation trends, especially if commercial banks are not permitted to recognize portfolio asset correlations within the regulatory capital framework. This creates a situation where nonbanks operating in different regulatory environments will reap a dual benefit. First, they are not required to comply with the vast validation and disclosure standards associated with the IRB Approach. Second, they are free to assess and price credits based on an assessment of asset correlation and diversification effects. Third, they are not subject to Pillar Two supervisory reviews. Fourth, they are not subject to capital requirements to cover operational risk.

The role of nonbank financial institutions relative to banks in international lending has tripled in the past 10 years[23] and the level-playing-field issues with respect to these institutions are growing more acute each year. **The Steering Committee therefore urges the Basel Committee to seek comparable capital treatment of credit, market, and operational risks in other regulated sectors to ensure that risks are appropriately priced, regardless of the corporate form providing the financial service.** This recommendation is consistent with suggestions made by other IIF groups in recent years, favoring the creation of globally standardized regulatory reporting forms for specific risk silos that could decrease compliance costs without decreasing the amount of information available to regulators for supervisory purposes.[24] Appropriate fora for pursuing comparable standards include the Joint Forum on Financial Conglomerates and the Financial Stability Forum.

---

[23] In 1988 (the year the Basel Accord was originally promulgated), commercial banks extended 45.3% of all external debt for emerging market economies and "other private creditors" accounted for only 12.5%. The balance had shifted significantly by 1997: lending by commercial banks had dropped to 34.3% while lending by other private creditors had almost tripled to 31.9% of total lending. Some academics have additionally observed that "the fact that deposit insurance is commonplace among industrialized countries, yet financial crises still occur, suggests that models of bank runs are insufficient for understanding modern financial crises." *Report of the Working Group on Financial Crises in Emerging Markets,* The Institute of International Finance (January 1999), Table 1, at p. 16.

[24] "The Task Force also strongly recommends that the regulatory reporting framework for globally active financial institutions should be revised to incorporate a portfolio-level, risk-based approach that could replace some outdated and duplicative reporting requirements currently in place." *Report of the Task Force on Conglomerate Supervision*, Response to the Consultative Papers released by the Joint Forum on Financial Conglomerates, The Institute of International Finance (July 1998), pp. 3-4; pp. 18-22.

Chapter 6: Compliance and Cost Issues

As noted, the compliance costs associated with implementing the new capital framework are expected to be extremely large. Here banks refer specifically and only to the personnel and information technology costs associated with building global internal rating systems within a defined period of time (two to three years). For purposes of illustration only, it might be helpful to suggest a variety of implementation costs that could be incurred by the global banking industry (at least 30,000 banks worldwide) if the Basel Accord were implemented as designed. A variety of hypothetical cost estimates appear below, using both a one-year and five-year horizon:

30,000 Banks Hypothetical Compliance Cost

Assumed additional average cost per bank USD m			Number of Banks	Cost for 1 Year	Over 5 years
USD	500'	x	30,000	= USD 15 bn	USD 75 bn
USD	1 Mn.	x	30,000	= USD 30 bn	USD 150 bn
USD	5 Mn.	x	30,000	= USD 150 bn	USD 750 bn
USD	10 Mn.	x	30,000	= USD 300 bn	USD 1,500 bn
USD	15 Mn.	x	30,000	= USD 450 bn	USD 2,250 bn

For scaling purposes, it is important to note that the total Tier 1 capital of all banks in the world is estimated at USD 2000 billion. The losses associated with the Asian and Russian crises together ranged from USD 140 billion (official support) to USD 250 billion (investor losses). These numbers make it clear that even a modest implementation cost associated with the new capital proposals will have a large impact on the profitability of the banking industry.

In addition to these costs, one must consider the hidden costs associated with failure to meet the consolidation provisions of the new capital framework. The Basel reform proposal indicates that a bank using the IRB Approach for one portfolio (e.g., corporate exposures) must implement the IRB Approach for all portfolios on a globally consolidated basis. Capital may be assessed using the Standardized Approach only for "non-significant business units that are immaterial in terms of size and perceived risk profile subject to national discretion ... No capital relief would be granted for intra-group transactions between the IRB bank and a business unit on the Standardized Approach. This includes asset sales or cross guarantees."[25] It is unclear also how insurance activities conducted within a bank (as opposed to insurance subsidiaries, which are not subject to the consolidation requirements) would be treated.

The compliance costs associated with implementing this provision, especially in low-information environments where obligor histories are not available presently, is staggering. It is also highly unclear how the consolidation provisions could be implemented if a regulator in one country chose not to make the IRB approach available within its jurisdiction. Would application of the IRB Approach to the foreign banks active in that country be exempted from the general consolidation standard? Would a bank be required to cease operating in that country if continued operation were to invalidate the bank's ability to qualify for the IRB Approach? Legal compliance costs associated with obtaining all necessary approvals would likely soar.

---

[25] *The New Basel Accord* (January 2001), para. 159-160.

Appendix A

THE INSTITUTE OF INTERNATIONAL FINANCE, INC.
BOARD OF DIRECTORS
May 2001

Chairman
Sir John Bond*
Chairman
HSBC Holdings plc

Vice Chairmen

Josef Ackermann*
Member of the Board of Managing Directors
Deutsche Bank AG

William R. Rhodes*
Vice Chairman
Citigroup/Citibank

Tasuku Takagaki*
Senior Advisor to the President
The Bank of Tokyo-Mitsubishi, Ltd.

Mohammed Abalkhail
Chairman of the Board of Directors
Riyad Bank

Daniel Bouton*
Chairman and Chief Executive Officer
Société Générale

Edward J. Brown III
President, Global Corporate and Investment Banking
Bank of America Corporation

Yavuz Canevi*
Chairman
Türk Ekonomi Bankasi, A.S.

Charles H. Dallara *(ex officio)**
Managing Director
The Institute of International Finance, Inc.

David Eldon
Chairman
Hongkong and Shanghai Banking Corporation Limited

Bernd Fahrholz
Chairman
Dresdner Bank AG

Jacob Frenkel
President
Merrill Lynch International

Yoshiyuki Fujisawa
Chairman
The Industrial Bank of Japan, Ltd.

Peter C. Godsoe*
Chairman of the Board and Chief Executive Officer
Bank of Nova Scotia

Hirokazu Ishikawa
Deputy President
Sumitomo Mitsui Banking Corporation

Sir Andrew Large
Deputy Chairman
Barclays Bank PLC

Cees Maas*
Executive Board Member and Chief Financial Officer
ING Group, N.V.

Rainer S. Masera
Chief Executive Officer
Sanpaolo IMI S.p.A.

Manuel Medina Mora
President and Chief Executive Officer
Grupo Financiero Banamex-Accival

Liu Mingkang*
Chairman and President
Bank of China

Gerhard Randa
Chairman and Chief Executive Officer
Bank Austria CA Gruppe

Frank Savage
Chairman
Alliance Capital Management International

Roberto Egydio Setúbal
President
Banco Itaú S.A.

Chartsiri Sophonpanich
President
Bangkok Bank Public Company, Ltd.

Remi Vermeiren
President
KBC Bank NV

Marko Voljc
President and Chief Executive Officer
Nova Ljubljanska Banka d.d.

Sir David Walker*
Senior Advisor
Morgan Stanley International

Jacob Wallenberg
Chairman
Skandinaviska Enskilda Banken AB

Peter Wuffli
Chief Executive Officer and Member of UBS Group Executive Board
UBS Asset Management

Secretary of the Board
Michael Bradfield, Esq.

* Member of the Executive Committee

Appendix B

Institute of International Finance, Inc.

Working Group on Capital Adequacy

Abbey National
ABN AMRO Bank, N.V.
Australia and New Zealand Banking Corporation
Banca Intesa
Banca Monte dei Paschi di Siena, S.p.A.
Banca Nazionale del Lavoro
Banco de Galicia
Banco Itaú
Bank of China
Bank of Nova Scotia
The Bank of Tokyo-Mitsubishi
BBVA
Byblos Bank
Ceskoslovenska obchodni banka
CIBC
Citigroup
Credit Agricole Indosuez
Credit Suisse First Boston
DBS Bank
Deutsche Bank
Dresdner Bank
Fuji Bank, Ltd.
Grupo Financiero Banacci
Gulf International Bank
HSBC Holdings plc
ING
J.P. MorganChase
Komercni Banka, a.s.
Lloyds TSB
Mediocredito Centrale
National Bank of Greece
Qatar National Bank
Rabobank Nederland
Riyad Bank
Royal Bank of Canada
Royal Bank of Scotland
Sanpaolo IMI S.p.A.
The Sanwa Bank Limited (UFJ Holdings, Inc.)

Skandinaviska Enskilda Banken
Société Générale
Standard Chartered Bank
Sumitomo Mitsui Banking Corporation
TD Bank
UBS AG
Vseobecna Uverova Banka, A.S.

Appendix C

Institute of International Finance, Inc.

Working Group on Operational Risk

Abbey National plc
ABN AMRO Bank NV
Australia and New Zealand Banking Corporation
Bank of New York
Bank of Nova Scotia
The Bank of Tokyo-Mitsubishi, Ltd.
Barclays Bank plc
BNP/Paribas Group
CIBC
Citigroup
Commerzbank AG
Commonwealth Bank of Australia
Credit Lyonnais
Credit Suisse Group
Deutsche Bank AG
Dresdner Bank AG
FleetBoston Financial
Fortis Bank
Fuji Bank, Ltd.
HSBC Holdings plc
HypoVereinsbank AG
J.P. MorganChase
Lloyds TSB Group plc
Merrill Lynch & Co., Inc.
Mizuho Holdings, Inc.
Nordea
Rabobank Nederland
Royal Bank Financial Group
Sanpaolo IMI S.p.A.
Skandinaviska Enskilda Banken
Société Générale
Standard Chartered Bank Plc
Sumitomo Mitsui Banking Corporation
Tokai Bank Europe plc
UBS AG
UFJ Holdings, Inc.
Unibanco-União de Bancos Brasileiros S/A

Appendix D

Institute of
International
Finance, Inc.

Working Group on Country Risk

Abbey National plc
ABN AMRO Bank N.V.
Arab Banking Corporation
Australia and New Zealand Banking Group Limited
Banca Nazionale del Lavoro
Banco BBA-Creditanstalt S.A.
Banco Itaú
Banco Mercantil (Venezuela)
Banco Santander Central Hispano, S.A.
Bank of America
Bank One NA
Barclays Bank plc
BNP/Paribas Group
Chase Manhattan Corporation
Citigroup
Commerzbank AG
Crédit Lyonnais
Credit Suisse Group
Dai-Ichi Kangyo Bank, Ltd.
Den Danske Bank A/S
Deutsche Bank AG
Dresdner Bank AG
FleetBoston Financial Corporation
HSBC Holdings plc
ING Group
Lloyds TSB Group plc
Merrill Lynch & Co., Inc.
Royal Bank Financial Group
Sakura Bank, Ltd.
Sanpaolo IMI S.p.A.
Skandinaviska Enskilda Banken AB
Société Générale
Standard Chartered Bank
Tokai Bank, Ltd.
UBS AG
Zivnostenska banka a.s.