CONTENTS

1. INTRODUCTION AND GENERAL COMMENTS 1

2. SCOPE OF APPLICATION

2.1- Sub-consolidation 3
2.2- Minority interests 4
2.3- Insurance companies 5
2.4- Minority stakes in financial institutions 5
2.5- Commercial investments 6

3. THE FIRST PILLAR: MINIMUM CAPITAL REQUIREMENTS

3.A. CREDIT RISK. THE STANDARDISED APPROACH 7
3.A.1. Claims on banks and other financial institutions 7
3.A.2. Claims on corporates 8
3.A.3. Retail exposures 8
3.A.4. Off-balance sheet items 8
3.A.5. External Credit Assessment Institutions (ECAI) 9
3.A.6. Credit risk mitigation 9

3.B. CREDIT RISK. IRB APPROACHES 11
3.B.1. Calibration of the capital calculation formula 12
3.B.1.a High level of capital 12
3.B.1.b Excessively steep curve 13
3.B.2. Inclusion of expected loss 13
3.B.3. Treatment of maturity 14
3.B.4. Retail portfolio 15
3.B.5. Transition between approaches 15
3.B.6. Project finance 16

3.C. ASSET SECURITISATION 16
3.C.1. Securitisation in the standardised approach 17
3.C.2. Securitisation in the IRB approaches 17

3.D. OPERATIONAL RISK 18
3.D.2. Definition of operational risk 19
3.D.4. Linearity in options 1 and 2 19
3.D.5. Qualitative factors 20

4. THE THIRD PILLAR: MARKET DISCIPLINE

4.1- Consistency of information requirements 22
4.2- Requirements in qualitative and quantitative terms 22
4.3- Information requirement costs 23
1. INTRODUCTION AND GENERAL COMMENTS

The Spanish Banking Association (AEB) in the first place would like to express its satisfaction with the current proposal for a review of the Capital Accord prepared by the Basel Committee, as it understands that this is a step forward in the right direction, which is none other than putting the regulatory capital requirement into line with risk levels really assumed by each financial institution. In this respect, the New Basel Capital Accord stimulates and develops the use of internal ratings, incentives the banks to adopting more powerful risk management approaches, and in general provides a more flexible framework than the previous one for the progressive introduction of financial innovations; in other words, it motivates the improvement of integral risk management by the financial institutions and it thus contributes to the solvency and stability of the global financial system.

However, and other than the observations on specific aspects which are included in the following pages, the current proposal suffers from a defective calibration whose final result is not only a high capital level in absolute terms – which the incorporation of operational risk also contributes to – but also a steeper curve relating required capital to risk grading. Such a result can only be put down to the calculation bases and to the parameters introduced, which therefore does not question the system itself. But revision is required for otherwise this will affect the level playing field for institutions but above all, and even more importantly, because it could have negative effects on the access to funds for certain users such as SMEs, because it will introduce a disincentive for capital flows from developed countries to the financial systems of the emerging economies, and because it will reinforce the undesirable pro-cyclical character which to a certain extent is inherent in the system.
The following chapters do not try to offer an exhaustive response to all the questions put forward in the Basel Committee’s document (or in the European Commission’s parallel document, which this paper also answers) but rather they try to focus the observations on those aspects that most concern the Spanish banks. In the case of those aspects not specifically dealt with, or where even though they have been dealt with certain technical details have been omitted, the AEB refers to the observations made by the European Banking Federation (EBF), in the preparation of which the AEB has participated actively. Furthermore, unless there are positions different to those contained in this document, the AEB adheres to the conclusions transmitted by other fora (such as, most significantly, the Institute of International Finance) in whose papers its members have contributed.

Finally, mention should be made, that the AEB hopes that dialogue will remain open with the Basel Committee during the next few months over all the questions in general, but especially in relation with those for which, due to their lower degree of development, the most representative associations in the banking sector all over the world have requested of the Committee the preparation of additional documents which will allow a more profound debate on them.
2. SCOPE OF APPLICATION

Generally speaking, the intention expressed by the Basel Committee to extend the scope of the Capital Accord in order to achieve better harmonisation in terms of consolidation at an international level, is favourably received by the AEB. In fact, including holding companies that are the parent companies for banking groups, or bringing horizontal financial groups into line with the more traditional groups in terms of regulation and capital requirements, should be considered as steps forward in improving competition. In this regard, it could be suggested that the criteria for consolidation be brought into line with those already in force within the regulatory framework of the European Union.

With regard to specific aspects, the following comments are offered:

2.1.- Sub-consolidation

The proposal of the new Accord to require sub-consolidation for all internationally active banks at every tier may seem reasonable in principle, in that the counterparts of such intermediate banks should not base their relations on the theoretical protection of the group they belong to, unless there are formal guarantees. However its extension to all banks without exception may become excessive if we consider the possible existence of intermediate structures for fiscal, historical or other reasons which are not business or profit centres and in which case sub-consolidation would make no sense. In such cases, the preparation, reporting and review of the sub-consolidated statements would lead to administrative and supervisory costs that would not be compensated for by the benefits achieved.
In such units, approaches such as those currently applied by the Bank of Spain, are very effective: the setting of minimum requirements at an individual level, depending on the degree of control by the group, but without requiring equity deductions, as these are in turn subject to the same type of treatment. Furthermore requiring an adequate distribution of resources among the companies of the group, also supervised by the regulatory authorities, ensures the correct follow-up of the subsidiaries within the group.

2.2.- Minority interests

The Basel Committee has chosen to leave in the hands of the national supervisors the degree of recognition given to the capital corresponding to third party minority shareholders, in that this is an asset which in principle is not available to serve the needs of other companies in the group. However this discretion could distort the competitive position of the various institutions and so it would seem more reasonable to set a clear ruling to avoid such dangers.

Therefore, even though accepting the different consideration that the minority shareholders capital deserves over a group’s other resources that are directly assignable to the parent company, its automatic deduction does not seem appropriate for reasons such as the following:

- These are resources of a quality not lower to other accepted resources, such as subordinated debt.
- Depending on the degree of control of the subsidiary, the group may decide to use resource transfer strategies that will finally affect the minority interests.

Considering the above, it might be deemed reasonable not to adjust the stake of the minority shareholders in companies where the parent company’s stake is very high (say above 90%) whereas in those with a lower level of control the excess of the minority stake over their share in the risk could be considered a second category resources. In any case, the adequate capitalisation of the subsidiary to be taken into account to this effect, and therefore the degree of responsibility of the minority shareholders, should not be measured in terms of regulatory minimum requirements but rather in terms of the
degree of the global capitalisation and of the policy followed in this respect by the group which the subsidiary is a member of.

2.3.- Insurance companies

The principal alternative included in the proposal, i.e., the full deduction of the capital invested in insurance subsidiaries, does not seem at all adequate neither from the point of view of competition, as insurance companies do not have the reciprocal obligation to deduct their majority investments in banks, nor from the point of view of risk, as insurance activity is penalised excessively and unjustifiably – 12.5 times as much as bank risks. Furthermore, the precautions and limits set to assuming as own the capital invested in insurance companies do not make sense inasmuch as the transfer of resources from the latter does not have to be very much different from that between other types of companies within the group.

In this case also, the treatment given by the Bank of Spain is more convincing, by considering the risks assumed by both types of business and establishing the requirement for funds to cover them jointly, after eliminating the repetitions in both resources and consumptions.

In any case, and given the existence of initiatives under way concerning global supervision of financial conglomerates, it would seem advisable for the Basel Committee to postpone any proposals concerning the treatment of stakes in insurance companies until the former have been made concrete.

2.4.- Minority stakes in financial institutions

The current proposal leaves it to the national supervisor to determine the threshold above which the stake in financial institutions should be deducted – setting a range of between 20% and 50% of the stake.

Once again this lack of definition will only be a source of differences between banks in different countries, which will hinder comparability and competition so it would
seem preferable to set a fixed level, understanding that any value within the range would be reasonable.

2.5.- Commercial investments

The approach proposed for stakes in companies not involved in financial or insurance activities seems acceptable in principle although it would be convenient, for the same reasons of comparability and competition mentioned above, for the limits from which the excesses should be deducted from the capital to be uniform.

However, there is another possibility for the treatment of strategic investments in equities, parallel to the rest of the loan portfolio, which the Basle Committee should perhaps study in depth at least in the case of the IRB approaches; basically this would be to apply to the total a risk weighting obtained from a bankruptcy probability equivalent to the probability of default (PD) in the case of loan risk – while both to the exposure at default (EAD) and to the loss given default (LGD) values are assigned reflecting the permanent and subordinate condition of equity vis a vis other liabilities.
3. THE FIRST PILLAR: MINIMUM CAPITAL REQUIREMENTS

3.A. CREDIT RISK. THE STANDARDISED APPROACH

Considering that there will be a significant number of institutions that would prefer to continue, at least in principle, applying the standard model to determine minimum capital requirements for credit risk, or even to continue doing so for a period with part of their portfolios, generally speaking the AEB views the modifications introduced as positive, and welcomes its final objective of introducing a more adjusted appreciation and discrimination of the really assumed risks. However the following observations can be made about specific aspects of the new approach:

3.A.1.- Claims on banks and other financial institutions

The freedom given national supervisors to decide between the two options, as they are defined in the Basel Committee’s proposal, is not only counter-indicated in terms of competition but would also stimulate capital arbitrage within those banking groups present in different countries choosing one or the other. This then is a situation which requires that a single criterion be set by the Committee.

In any case, and whatever the option chosen, preferential treatment will have to be given to short-term operations, because of the evidently smaller risk entailed. However the limit should not be set at three months as this would only encourage short term lending, with the systemic risk involved, and could even hinder funding for some institutions. Given that it would additionally stimulate the practice of roll-over operations
that would be difficult to detect, we propose increasing the maximum limit of short-term to 12 months residual maturity and not original one.

3.A.2.- Claims on corporates

- There is some discontinuity in the switch from investment to speculative grade— in terms of rating. It would therefore be advisable to consider including an additional weighting of 75% in the treatment of claims on corporates.
- There is a clear inconsistency in the treatment of claims on corporates compared with those on sovereigns and banks for the same rating which does not seem to make much sense. In any case the minimum corresponding to sovereign risk should not be applied to exposures granted and funded in the corporate’s domestic currency, which could be of particular importance for residents in the euro area.
- The favourable treatment given to operations in domestic currency, accepted for certain counterparties, should be extended to corporate exposures.
- Short-term foreign trade operations (up to 12 months), whether with banks or corporates, should be given preferential treatment for objective reasons of lower risk and because of their economic impact on the regions concerned.

3.A.3.- Retail exposures

The stated intention to apply a specific treatment to retail loan portfolios in the standardised approach as well – as is done in the IRB approach – must be positively valued, with a weighting of less than 100% for those portfolios that are sufficiently diversified.

3.A.4.- Off-balance sheet items

There is a certain degree of inconsistency in the conversion factors for commitments, whether referring to the standardised approach – up to 50% depending on maturity and cancellability – or to the foundation IRB approach, which sets a single 75% factor.
In any case, the AEB understands that the proposed grading for the standardised model does not adequately reflect the real assumed risks and so it is proposed an alternative 0% conversion factor for all commitments cancellable by the bank without prior notice, independently of the maturity, and another one of 20% in all other cases. Emphasis is placed on the need for analogous parameters for the foundation IRB approach in order not to increase the disincentives against its adoption already present for other reasons.

**3.A.5.- External Credit Assessment Institutions (ECAIs)**

With regard to the eligibility criteria for external rating institutions, we have the following comments:

- They should not be excessively rigorous as to make it impossible for new ECAIs with a more limited scope of action to appear, as indirectly this would benefit banks in countries, such as the US, with a longer history in the use of external ratings.
- The rating systems used by the ECAIs should be subject to evaluation requirements no laxer than those applicable to the validation of the internal models by the supervisory authorities.
- Considering that it is foreseen that it will be the national supervisors who will determine the eligibility of the ECAIs, there should be a general application of the principle of mutual recognition, under which acceptance under one jurisdiction would automatically be extended to all other countries. The Basel Committee would be responsible for maintaining an up-dated list of recognised ECAIs.

**3.A.6.- Credit risk mitigation**

The current proposal by the Basel Committee increases the range of collateral instruments susceptible of being used to hedge credit risk and furthermore regulates with greater precision their treatment and effectivity in terms of reducing regulatory capital. Thus the AEB positively receives the latest introductions.
However it would be advisable, both in the standardised approach and in the foundation IRB approach – the advanced IRB approach includes this automatically - to improve the consideration given to physical assets other than residential property, as their acceptance as a guarantee is a practice as common in commercial banking – think of the case of SMEs, especially family businesses – as it is in specialised financing. Thus industrial premises, equipment, vehicles, inventories, and obviously ships and airplanes, should be accepted as collateral according to the protection actually provided. The same is proposed for bills of trade and receivables, which are normally accepted as guarantee for discount and/or factoring operations. This would bring the proposal closer to reality in financing productive activity, as it does in the case of purely financial operations by considering many of the more recent and sophisticated developments.

As well as the above general comment, we have the following comments to make on more specific aspects:

- In the treatment of maturity, an excessively conservative criterion has been adopted, because while in the case of exposure the latest possible date is considered, in the case of hedging the nearest one is used to provide against early cancellation options. This could be especially restrictive in the case of hedges that contain the same early cancellation options as the exposure covered, so that in order to achieve a symmetric treatment it would be more correct to consider in both cases the maturity date to be that of exercising the first option.

- With regard to haircuts, we would like to point out:
  - The adjusted value of the collateral should depend only on the factors depending on its nature, so it does not seem logical to introduce add-on correctors for exposure, which would specifically discriminate against guaranteed claims over non-guaranteed ones.
  - These adjustments would have to be estimated by the institutions themselves and without having to meet the restrictive conditions concerning internal models for market risk.
  - Adjustments for risks in contracts subject to repricing would not be required.
In the case of guarantees provided by third parties, it should be revised the too cautious treatment of double default, as well as the limitations in terms of guarantor's rating. The only objective criterion that should be used is the correlation between both parties' probabilities of default (PD).

The proposal includes a coefficient $W$ in the calculation of regulatory capital for guaranteed exposures. This coefficient, set between 0% and 20%, aims at including the uncertainty over the effective value of the hedge, after being executed, due to legal motives. Thus it would seem clear that such risks are included in the wide concept of operational risk and in the capital requirements which are for this reason included in the new rules. We are therefore faced with a case of double-counting of risk and so the AEB is in favour of eliminating this coefficient.

3.B. CREDIT RISK. IRB APPROACHES

The possibility that the Basel Committee's proposal includes of using approaches based on the institutions' internal ratings (IRB), both in the foundation and advanced versions, for the purpose of determining capital requirements, represents an undeniable advance which the AEB welcomes: it is in line with the developments already assumed by the banks in evaluating credit risk, and should stimulate continued improvements in its management, especially when more complete and sophisticated approaches in this area are accepted in the future.

However we should ensure the existence of enough incentives within the overall design – obviously in terms of reducing required regulatory capital – so that the largest number possible of institutions opt for the IRB approaches as their calculation basis. But this, with the factors contained in the current proposal, is not at all ensured as far as the foundation approach is concerned – the transition to the advanced approach will take some time – but rather the contrary. This, however, is not an intrinsic defect of design but rather one of calibration requiring later adjustments, which the AEB hopes the Committee will introduce in the light of the studies of its impact currently under preparation. Apart from this crucial problem, which is studied in detail below, there are other aspects to be considered and which are also later analysed.
3.B.1.- Calibration of the capital calculation formula

Although obviously the use of the IRB approaches implies using the institutions’ own data in calculating capital, there is a common formula for this calculation which in turn introduces certain implicit hypotheses which are not necessarily, although they should be, neutral for the different banks and their corresponding business structures.

The current calibration arising from these points leads to two clearly identified problems: a very high level of capital in all cases and an excessively steep curve for the relation of capital required and risk grading.

3.B.1.a. High level of capital

There are various factors that lead to an excessively conservative valuation of the minimum capital required: inadequate weighting of some of the risk components, introduction of factors and coefficients which in some cases have no justification whatsoever, and insufficient recognition of portfolio diversification. The final result is a much higher level than that deriving from currently used economic capital determination models, which does not jeopardizes the level playing field as it affects all institutions equally but which undoubtedly will discourage the transition to the foundation IRB approach.

Furthermore, there is an indirect introduction of elements that will affect diverse institutions in different ways and which may condition their business strategies. Examples are:

- The implicit level of statistical confidence in the hypotheses (around 99.9%), equivalent to the highest ratings, may not be assumed nor even pursued by institutions with specific geographical locations or specialization segments.
- A similar level of minimum capital is assigned to a bank that concentrates mainly in a specific geographical area or activity as is to a bank whose portfolio is widely diversified by sectors, regions and client strata.

This anomaly, which means that capital requirements grow very fast as the assigned rating worsens, is basically caused by the following three factors, none of which is supported by facts arising from usual activities of universal banks:

- Diversification among ratings of the borrowers which is usually present in portfolios is not adequately taken into account, as it is a unifactorial model.
- The use of some of the coefficients mentioned above penalises ratings in relative terms more as the latter get worse.
- The adopted hypothesis for the average correlation, which is excessively conservative, also affects the higher risk ratings more strongly.

Unlike the previous problem, concerning the absolute level of the curve, the problem of the excessively steep curve does no doubt introduce distortions among the different institutions, penalising those with very diversified portfolios but with higher risk levels and/or with a definitely strong commercial activity.

The consequences of all this could furthermore spread across the financial sector to affect groups such as the SMEs – with poor quality global ratings - which would see their access to credit curtailed due to the excessively greater capital requirements involved in such operations. And more generally speaking, an excessively steep curve would only worsen the negative procyclical effect which the current proposal inevitably includes, and so the migration towards worse ratings which would occur in the models during a recession would lead to an increase in capital requirements precisely in those moments when fund-raising would be more difficult.

3.B.2.- Inclusion of expected loss

The implicit capital calculation formula in the Basel Committee’s proposal includes expected loss (EL). This situation, which means that there is no distinction between expected loss (business cost charged directly to results) and capital (whose purpose is to absorb possible unexpected losses to ensure solvency) has hardly any
Effect on the better ratings but is undoubtedly an important factor in the medium and lower ratings and in non-mortgage retail activity.

Therefore, should this aspect of the proposal finally not be modified, it will be necessary to opt for an alternative solution, which in the Spanish case would suppose the inclusion in the capital base, for those institutions using the IRB approach, of both the general provision and the new provision for statistical coverage of insolvencies.

3.B.3.- Treatment of maturity

The AEB very positively sees the fact that maturity is explicitly recognised as a factor affecting credit risk. However, considering the way the Basel proposal treats this component, the following comments are required:

- Regarding corporate exposures, it does not seem appropriate or necessary to use a standard period of 3 years in the IRB foundation approach, since this is an information that banks habitually have in their information systems.

- It would be more adequate to use the default method than the mark-to-market method to evaluate the effect of maturity on capital requirements. First of all, most banks lend money to their clients through non-liquid instruments that do not have a market price. Secondly, the nucleus of the approach used by Basel to calculate weighted risk assets (the so-called Gordy model) is essentially a default model, i.e. it does not include value changes due to rating transitions, and so maturity adjustment through the default method is the most consistent with the approach.

- In the Basel proposal, the maturity weighting tables begin with year 1; the AEB feels that weighting factors for transactions with maturities of less than one year should also be established. In other words, a continuous function for maturities of less than twelve months should also be created.
3.B.4.- Retail portfolio

The current proposal uses a similar formula for retail and corporate portfolios (including in the latter bank and sovereign exposures) but with rather different hypotheses for asset correlation. This means that, from similar objective data, very different capital requirements can be obtained according to whether the operation is in one or the other portfolio; specifically in the case of corporate exposures, twice as much.

This situation, which displays an unadvisable discontinuity in the treatment of both segments, also highlights the already mentioned excessive calibration in the case of corporate exposure. And likewise, it underlines the importance of clearly differentiating between both portfolios, especially if this discontinuity is not completely corrected. In this respect, the AEB considers that the retail portfolio should include not only credit operations with individuals, but also all those other operations, including corporate, where the method of analysis and follow-up are analogous to the former.

3.B.5.- Transition between approaches

Considering that one of the final objectives apparently sought after in the current proposal, and which the AEB decidedly supports, relates to the evolution by the institutions towards more developed formulae of evaluation and management of the credit risks they assume, the restrictions and/or disincentives for the transition to more advanced approaches should be relaxed as much as possible.

Thus, apart from the problems of calibration analysed above, the required migration of all the portfolio once the institution had decided to take up the IRB approach, for example, would have to bear in mind the existence of outside factors which could cause difficulties: the entry into new markets where obviously the institution would have no historical data, setting up in geographical areas where initially the IRB approach would be inappropriate, and similar problems which would either hold back the transition towards the desired approaches or else affect the decisions made on strategic projects. Moreover, certain other requisites should be reconsidered, such as minimum periods of statistics required for some factors and/or other minimum
conditions of an operative character which could hinder moving out of the standardised model

Considering the above, it would be advisable to drop the idea of a more or less rigid and/or compulsory transition timetable, and substitute it with a criterion that emphasises the definition of a systematic plan of adoption of more developed approaches for all the portfolio, agreed on by the supervisor and each institution, but which takes fairly into account the limitations mentioned above.

On the other hand, and with regard to the transition from the foundation IRB approach to the advanced one, the national supervisors (in this case, the Bank of Spain) should use the instruments the proposal leaves to their discretion, such as the possibility of introducing the maturity variable in the foundation IRB approach, so that the 10% ceiling in improvement during the transition, set for a period of 2 years, does not become a disincentive.

3.B.6.- Project finance

The definition of the project finance portfolio included in the current proposal does not clearly limit its area, introducing certain doubts about the consideration that should be given, for example, to a type of financing that is so common and important in Spain as are loans to property developers. The AEB wishes to express its total belief that this should continue to be part of the corporate portfolio, without any specific segmentation, as it refers to finality operations (which normally give place to a subrogated mortgage) where the repayment is not therefore linked to future cash flows, and where there is commonly recourse to the promoter, which in turn gives additional guarantees further to the financed asset.

3.C. ASSET SECURITISATION

The AEB welcomes the Basel Committee’s intention to introduce consistency in the treatment given by the different national supervisors to securitisation techniques and in particular the proposal to use ratings prepared by external agencies (ECAIs).
However the proposal as it currently stands offers no incentive, but rather the opposite, to promote this risk management technique which would be of benefit for both individual institutions and the system as a whole, by adding efficiency and stability thanks to a more adequate distribution of risk. The reason for the above lies in the perspective adopted by the Basel Committee which sees securitisation more as a means for capital arbitrage rather than its true motivation: better capital management.

3.C.1.- Securitisation in the standardised approach

As a general comment, it should be pointed out that the approximation adopted for the subject does not seem much justified, differentiating between those cases where the bank originates the securitisation operation and those cases where the bank plays the role of investor; the treatment should focus more on the nature of the transferred and/or retained risk, and the corresponding capital charges which should be kept or could be released.

Furthermore, in the current approximation the complete transfer of risk and the subsequent severance from the same should be established more clearly and with fewer restrictions, thus clearly delimiting the concept of implicit recourse.

3.C.2.- Securitisation in the IRB approaches

Regarding required capital calculations under the IRB approaches, it does not seem to make much sense to require the deduction of the total amounts of the first loss stand-by lines from the capital required, being rather the IRB approach itself that quantifies the retained credit risk.

There are also another restrictions that unnecessarily and excessively make the treatment of securitisation harder, to such an extent that there may be situations when the total calculated risk is greater than the risk assigned to the underlying assets, which obviously should not be a desired outcome.
3.D. OPERATIONAL RISK

The introduction of a capital requirement for operational risk is one of the changes with the greatest potential to distort the competitive framework amongst financial institutions, depending on whether they are affected or not by the rules stemming from this new requirement. This reason, along with others such as the scarce development of the quantification models for this type of risk, led the Spanish banks to express, on occasion of the first document issued by the Basel Committee in June 1999, their opposition to the introduction of this new capital requirement and to ask for other ways of dealing with operational risk.

Having made this important and preliminary observation, the AEB considers that both the chosen definition of operational risk and the proposed calculation scheme – based on several options of growing complexity – are basically correct. However, the little experience gathered in this field by the institutions and regulators would advise a prudent approach to it; and in this respect it would be most desirable for the subject to be included in the final document with enough flexibility and leeway as to make possible the progressive incorporation of any future advances regarding operational risk, its measurement and its management.

Concerning the proposal’s current state, the following wide-ranging comments can be made:

3.D.1.- Global calibration

The level indicated by the Basel Committee for capital requirement for operational risk, around 20% of the total capital for other concepts, seems very high, and not at all justifiable in the light of the current experience of most banks: the most common opinion would place this level below 10%, which would require an in-depth review of this global calibration, which obviously affects many other aspects of the proposed scheme.
3.D.2.- Definition of operational risk

Although the definition of operational risk is, as we have already pointed out, satisfactory in principle, by expressly excluding the strategic and reputational components, it will require greater precision in certain cases, to avoid any areas of double-counting which might still exist. In this respect, the problem caused by coefficient \( W \) – see 3.A.6. on credit risk mitigation – is quite clear thus arguing once again for its elimination and that of any others that could lead to similar problems of overestimating required capital.

3.D.3.- Capital charge gradient

The significant requirements foreseen for the transition to the more advanced options should allow us to think that the advantages obtained from this transition, in terms of capital charges, would be in accordance with these requirements. However this is not the case of the calibrations suggested so far, thus reducing quite considerably the implicit incentives in the scheme.

Therefore the values initially assigned for \( \alpha \) in option 1 (Basic Indicator Approach) and the various \( \beta \) in option 2 (Standardised Approach) (logically conditioned by the overall calibration parameters) should be revised, as should the minimum established for option 3 (Internal Measurement Approach, IMA) whose inclusion is a much moot point for the reason given above.

3.D.4.- Linearity in options 1 and 2

Both option 1 and option 2 are based on linear functions of capital, proportional to size in the first case and to volume of activity of the different business units in the second. This linearity, which is not backed up by any available experience, penalises larger-size institutions without any justifiable cause, which would suggest the introduction of one or more upper limits which would impede continued growth above a specific level.
Furthermore, in order to avoid any negative effects for specific types of institutions in the transition from option 1 to option 2, the principle that the capital resulting from option 2 could never be greater than from option 1 should be included.

3.D.5.- Qualitative factors

The singular character of operational risk, linked to the general environment of organisation, management or even situation rather than to specific transactions, makes its modelling more difficult on the one hand and on the other hand requires taking certain qualitative factors into account, such as procedures, internal and external controls, training, etc., which no doubt will affect the evaluation of operational risk at least as much as the objective elements that are chosen. Therefore, the AEB recommends the study of formulae that propitiate their inclusion, which in the case of options 1 and 2 could take the form of reducing $\alpha$ and $\beta$ according to the investments aimed at reducing operational risk, and in the case of option 3 could be modifiers of the risk profile index (RPI) obtained from permanent self-evaluation mechanisms.

3.D.6.- Operational risk mitigation

Although the Basel Committee accepts in principle that operational risk mitigation will be reflected in the amount of capital required, the fact is that no specific reduction is established. Thus, and recognising that this is a question still to be developed, the AEB requests that specific guidelines for mitigation be established, at least in the case of insurance policies underwritten to cover certain risks, since the mitigation they provide is unquestionable and relatively easy to quantity; furthermore, such consideration would encourage gathering and elaborating, by insurance companies, statistical data on such components of operational risk, thus paving the way to a better understanding of them which would finally lead to their better management.

In any case we must insist on the importance and need to accept with the greatest tolerance the reducing effect of the various mitigating techniques for this risk, which in many cases will be of a qualitative nature, as this is precisely the way to incentivize the adoption by the banks of action plans aimed at minimising and better managing of operational risk.
Finally there are two general comments on the treatment of operational risk:

- On the one hand, the right application of options 2 and 3 (based on breakdown by business lines) will require a degree of flexibility to precisely differentiate the risk profiles of the different institutions. Perhaps for this reason this is an area where the principles of the Second Pillar are of particular relevance, both in terms of degrees of liberty among the different national supervisors and of these in relation to the individual institutions under their jurisdiction.

- On the other hand, it has been anticipated that the Basel Committee is considering an eventual option 4 for calculating operational risk (the so called Loss Distribution Approach, LDA) but for the moment it has decided to go no further than option 3 (IMA). Certainly either of the two, as well as being very expensive, is, using current technology, beyond the reach of the great majority of the institutions. But, if a vision of the future is to be adopted, it seems that the Loss Distribution Approach (LDA) would be in the end the one which best suits the objective sought, so it would be advisable to establish beforehand a timetable for its acceptance.
4. THE THIRD PILLAR: MARKET DISCIPLINE

The AEB accepts in principle the idea that the new system of capital requirements will be accompanied by a greater level of transparency in the information provided to market agents, both of that referring to its own fulfilment as of the assumed risk profile and risk management. However, there are several questions whose current treatment gives rise to certain observations and which should therefore be revised in the definitive document.

4.1.- Consistency of information requirements

Currently certain forums of accountancy experts are working on the redefinition of the information included in the statements issued by financial institutions. Independently of the fact that some of their proposals do not seem to be at all adequate for certain banking business areas (such as fair value for the banking portfolio), the need to coordinate with such initiatives is quite patent, as is that the Basel Committee should act well tuned with others responsible for such matters.

4.2.- Requirements in qualitative and quantitative terms

The information requirements contained in the new proposal seem out of proportion in relation to the real needs of the market participants: the information supplied by the most relevant institutions already incorporates very acceptable standards, excepting certain specific aspects whose improvement is advisable but which do not question the overall system. This could even lead to a negative effect, that of breaking the accepted free market rules that govern the behaviour of the institutions, by placing sensitive information on their competitor’s hands.
In this respect, particularly worrying are the requirements concerning fulfilment of capital requirements, which could give the market unclear if not confusing signals, and which in no case can be generalised for all banks without considering their respective risk profiles.

4.3.- Information requirement costs

The foreseen requirements for quarterly reporting, or even greater frequency by electronic means, for certain contents, seem difficult to meet in practice, probably incompatible with rules in certain jurisdictions, and in any case highly expensive for the institutions. It is therefore crucial to review the cost-benefit analysis of such proposals, as well as to reinforce the coordination with other competent authorities to set standards concerning transparency.

As a general comment, the required information (other than the already mentioned consistency regarding the requirements of other authorities) should on the one hand try to reflect the attitude of each institution towards risk, how it manages it in each phase and, to sum up, the quality of its portfolio, but at the same time should be in line with all the information internally generated for risk control, although without the need, as is obvious, to make it all public.

In any case, it is to be hoped that the next documents on the Third Pillar proposed for the next few months will review the mentioned questions about which the AEB reserves its definitive opinion until it has analysed them in depth.