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Basel Committee on Banking Supervision
Bank of International Settlements
CH- 4002 Basel
Switzerland

25 May 2001

Dear Sirs,

SCB comments on the Basel Committee consultative document: The New Basel Capital Accord January 2001

Standard Chartered Bank is pleased that the revision of the regulatory framework for capital adequacy is progressing. We welcome the move towards a more risk sensitive approach in assessing capital requirements, which mirrors the way in which banks themselves assess their own risks.

We appreciate the efforts that have been made by the national supervisors and other contributors to the revision of the Accord. We recognise that a number of the concerns raised by the industry following the first consultative paper have been taken into account in this version of the document. There remain, however, certain key areas where we feel that the draft Accord still needs further amendment. This is essential if the Accord is not to have unintended adverse consequences.

Standard Chartered has been involved in the work undertaken by several industry bodies, specifically the British Bankers Association and the Institute of International Finance, to review the Basel Accord draft. We endorse the comments made by these institutions but, nonetheless, would like to draw attention to some of our own main concerns. Detailed comments are attached as an Appendix but in particular, we would highlight the following key areas:

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- **Calibration of IRB approaches for credit risk**

Our calculations indicate that SME and middle market business, which is typically below investment grade quality, will require much more capital backing under an IRB approach than under the Standardised Approach. We believe that, when calibrating the IRB Approaches, insufficient cognisance has been given to the way that banks manage their SME business, for example by lending on shorter tenors or enforcing stricter covenants. This results in a prohibitive capital requirement, with internationally active banks covered by the Accord being at a marked competitive disadvantage. We fear that there could be systemic impacts on the supply of finance to the SME and middle market segments if the calibrations remain as in the current draft. Specific suggestions to mitigate these adverse effects are contained in the Appendix.

Furthermore, the inclusion of Expected Losses within the capital charge, without recognition of any loss absorbing capacity from margin income, presents a highly unrealistic view of the economics of banking businesses, especially in the retail sector. In our view, capital requirements should be limited to cover for Unexpected Losses only.

- **Narrow Recognition of Collateral**

Standard Chartered Bank has been extensively involved in managing exposures arising from trade finance products, and in our experience the nature of these products influences exposure at default (EAD) and loss given default (LGD) significantly. In cross-border trade finance, the lender takes into account specific physical transactions that require finance, often taking some control over the movement of goods. This gives the lender more control than would be the case with, say, general working capital finance. In addition, trade finance facilities are usually excluded from country risk reschedulings. Whilst the Advanced IRB methodology allows the use of an institution's own EAD and LGD estimates, we believe that recognition of the specific features associated with trade finance is a key issue which needs to be taken into account in all approaches for the credit risk capital charge. Without this, there is the danger of the Accord producing damaging, and unintended, side-effects on the provision of international trade finance.

- **Consistency of Application**

Whilst a combination of home and host country regulation is not new for us, the draft Accord introduces the possibility that capital adequacy measurements will be significantly different between jurisdictions, depending on the approaches that are approved by the different national supervisors. Without close co-operation between supervisors, the new framework may lead to unjustified inequalities between market participants, with the potential to cause serious damage to the efficient and safe functioning of the global financial markets. For example, the need for international banks to meet the higher of home and host country requirements throughout their group may result in excessive overall capital levels. Furthermore, and as noted above, competition between local banks using the Standardised Approach and international banks using IRB approaches may be distorted in some important market segments.

- **Need for "Common Sense" Implementation**

The Accord lists many minimum requirements that must be met on a common basis across all products and businesses. Strict interpretation of these requirements could preclude even the best banks from proceeding to the advanced approaches allowed under the Accord. Standard Chartered has a physical presence in a variety of countries that are in vastly different stages of economic development and where the financial markets operate in a large variety of ways. Implementing the same risk methodologies across all business units is not practical, and in many instances would not enhance risk management. We urge the regulators to apply pragmatism in their implementation of the Accord and to recognise the need to balance the benefits of achieving the highest standards against the costs of doing so across the whole of a diverse international group. At the very least, we believe that a common sense interpretation of "de minimis" exceptions is essential.

Concluding remarks

The above highlights, and the more detailed comments contained in the attached Appendix, constitute our response to the draft Accord. In summary, we believe that there is much to be welcomed. An undertaking of this scale is, though, bound to require several iterations in order to surface and resolve areas of theoretical difference and potential practical difficulties. Whilst recognising the existence of time pressures, we support the requests from industry bodies for further consultation before the Accord is finalised. It will have far reaching impacts on the financial markets and it is in no one's interests for a flawed approach to be rushed through. We welcome this opportunity to comment and will gladly continue to work with our various national supervisors to reach a mutually satisfactory outcome.

Yours faithfully,

Christopher A. Keljik
Group Executive Director

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Standard Chartered

APPENDIX

SCB comments on the Basel Committee consultative document: The New Basel Capital Accord January 2001

1 PILLAR 1

1.1 Scope and Consistency of Application

The Accord states that its requirements will apply at all levels of an internationally active banking group. The allocation of capital to activities where risks are taken is appropriate. To ensure a fair outcome of the Accord, it is important to ensure that this requirement does not lead to conflicting capital adequacy rules for a banking group. The Accord leaves a good degree of discretion to national supervisors. This introduces the possibility that capital adequacy measurements will be significantly different between jurisdictions, depending on the approaches that are approved by the different national supervisors.

Most internationally active banking groups, including Standard Chartered, operate through a combination of branches and subsidiaries in many different countries. Reporting on a consolidated and solo basis is already a requirement in the UK, and we additionally report to host country regulators under the local regime. The Accord's requirement to report individually at every level of a group is, therefore, not totally new for us. Under the New Accord, though, the varied approaches that can be adopted, together with Pillar 3 disclosure requirements and various technical aspects of the IRB approaches (such as the granularity adjustment) could result in an onerous compliance burden on groups operating through networks of subsidiaries. In addition, the need to meet the higher of home and host capital requirements throughout a group such as ours could lead to the aggregate capital charge being much higher than either set of regulators intended.

As a UK regulated bank focusing on emerging markets we are particularly concerned about the implications of being subjected to capital adequacy, reporting and disclosure requirements which can be justified in well developed markets but which may not be applied to local banks with corresponding activities. These issues can be managed within a consolidated capital adequacy framework, but application within each country could have adverse impacts on competition, ultimately to the detriment of the customer.

Whilst we agree that internal risk management processes and methodologies should be subjected to rigorous supervisory review, the requirements should be realistically achievable. We are particularly concerned about the suggestion in the consultative document that the same approach has to be applied to all products and businesses. The Accord recognises the difficulty of moving to the same approach completely simultaneously and proposes that there should be a plan to capture all activities in a short period of time. In our opinion this is too aggressive a requirement. It is potentially a threat to the implementation of the Accord.

It is standard practice in the financial industry to adjust risk measurement methodologies according to the level of sophistication in the operating environment and the size of exposures. Standard Chartered has a physical presence in a variety of countries that are in vastly different stages of economic development and where the financial markets operate in a large variety of ways. Implementing the same risk methodologies across all business units is not practical, and in many instances would not enhance risk management.

Our concern in terms of the 'all or nothing' approach also relates to the data required for an institution to qualify for the Advanced Approach. There will be cases where there is sufficient data for use on a consolidated basis, but individual unit or country specific evidence may be inadequate. We understand the supervisors' concern about the possibility of 'cherry picking' but believe that this must be balanced against the practical difficulties and cost of attempting to enforce the same standards in every operation throughout a group. Strict interpretation of this requirement could preclude even the best banks from proceeding to the advanced approaches allowed under the Accord. This cannot be the aim of the Basel Committee. We urge the regulators to be pragmatic in their application of the 'de minimis' exception included in the draft Accord.

We suggest that the practical implementation of the Accord would be greatly eased if the Committee gave guidance on the relative importance of the various qualifying criteria. For example some of the criteria could be designated as essential before recognition could be granted, whereas others would be regarded as recommended. Whilst a bank should have a plan in place to move towards meeting these latter requirements, they would not all need to be in place before initial recognition was given. A Pillar 2 adjustment could be made if thought appropriate. We believe that such an incremental approach would enhance the ability of banks to move towards the advanced levels.

1.2 Credit Risk

1.2.1 Calibration

The Committee has expressed an aim to maintain the overall capital within the financial industry at its present level. We do not share the Committee's view in this respect. We believe that it leads to a distortion in the calibration of the capital charge, as the individual institutions and separate risk categories are forced to add up to a preconceived outcome. This does not add to the soundness of the financial system, but instead it reduces the beneficial impact of the introduction of increased risk sensitivity, which is the cornerstone of the new Accord. The regulatory capital charge should reflect the extent to which the institutions have succeeded in making advances in their risk management processes and methodologies. We would expect to see the aggregate level of capital required reducing as financial institutions are improving their risk management.

We share the regulators' view that financial institutions should be encouraged to move towards using more sophisticated risk measurement and management techniques. It is logical that the different approaches should be aligned so that the most advanced techniques are associated with a lower capital requirement than the most basic techniques for a given set of risks. If this is not the case, the industry will find it very difficult to quickly adopt practices which are sound, but will involve high implementation costs.

The Standardised Approach will result in by and large similar capital charges as under the existing rules, although there are significant changes relating to individual counterparties. To the extent this reflects increased risk sensitivity, we agree with the Committee's proposals. There are, though, significant differences when the IRB approaches are analysed.

The IRB approaches require assumptions for a large number of parameters in reaching the capital requirements. The empirical work undertaken by the Basel Committee is impressive in its detail and we applaud the efforts that have been made to reach suitable parameter values. It is clear, though, that the Committee has sought to be conservative in its assumptions in every case. Making conservative assumptions throughout means that the overall calculation is, in our view, very conservative indeed. This is not obviously consistent with the Committee's wish to leave overall capital requirements broadly unchanged.

We specifically note that the calibration of the IRB approaches includes a 20% additional charge for model error and a 30% increase reflecting concerns over the value of Tier 2 capital at all stages of the cycle. We believe this to be excessive, and to a large extent, counterproductive. The prerequisites for internal model based approval include rigorous risk management processes, a substantial amount of historical evidence, and frequent validation. Introduction of a standard charge for model error undermines the rationale for these requirements and results in a limited incentive to strive for more accurate credit risk models. Furthermore, raising the capital charge as a buffer for problems in capital raisings will likely exacerbate, rather than resolve the issue. Demonstrably sound capital management and risk modelling are enough to ensure that adequate levels of capital are being maintained.

We have a particular concern over the impact of the new Accord on SME and middle market business. Our perception of the calibration of the IRB approaches for credit capital is that banks operating under an IRB regime will face much higher capital charges in the SME and middle market segments than banks on the Standardised Approach. Not only is it perverse for those banks which meet the higher risk management standards to be disadvantaged but we fear that there could be systemic impacts on the supply of finance to the SME and middle market segments if the calibrations remain as in the current draft. This would be especially relevant in emerging markets, with internationally active banks covered by the Accord being at a marked competitive disadvantage.

We also note that the Committee has placed most emphasis on the determination of risk based on the probability of default (PD) of the counterparty, with limited reference to the product range. Standard Chartered Bank has been extensively involved in managing products related to trade finance, and in our experience losses can be significantly influenced by variations in both exposure at default (EAD) and loss given default (LGD) that are dependent on the product type rather than the counterparty quality.

In cross-border trade finance, the lender takes into account specific physical transactions that require finance, often taking some control over the movement of goods. This gives the lender more control over EAD and LGD than would be the case with, say, general working capital finance. Whilst the Advanced IRB methodology allows the use of an institution's own EAD and LGD estimates, we believe that recognition of the specific features associated with trade finance is a key issue which needs to be taken into account in all approaches for the credit risk capital charge. Without this, there is the danger of the Accord producing damaging, and unintended, side effects on the provision of international trade finance.

The worst impact of the IRB calibration can be mitigated by the use of collateral. Under the Standardised and Foundation Approaches, the recognition given to collateral is, properly, conservative. Full value for the whole range of possible collateral is potentially available under the Advanced IRB Approach but it is unclear how much evidence will be required, and at what level of disaggregation, in order to qualify for approval. If supervisors adopt a strict interpretation of the New Accord's requirements, it could be many years before banks are able to provide the evidence required to obtain appropriate recognition for the risk mitigation provided by the use of collateral. We believe that some flexibility of interpretation will be essential and that consideration should be given to shortening the requirement for seven years of data, perhaps including some form of provisional approval whilst full data sets are built up. This would be especially helpful where banks are seeking to establish new businesses or introducing an existing business to a new geographic area.

1.2.2 Inclusion of Expected Loss within the capital charge

We are aware that there has been substantial discussion with the industry over the calibration of the capital charge to include both expected and unexpected loss. We believe this is contrary to industry best practice and that capital should be required to cover unexpected loss only. We are also aware of the supervisors' view that general provisions act as a buffer against expected loss. This view is difficult to reconcile with UK Accounting Standards, which discourage any form of forward looking provisioning. We would encourage further consideration of this point, especially in respect of retail exposures where expected losses can be high but pricing is deliberately set to ensure that margin income (rather than capital) will be sufficient to absorb them. It is also important to ensure that any adjustment factors employed in calibrating the risk weights are applied only to the unexpected loss portion of the credit risk charge. It appears that the current calibrations do not make proper distinction in this regard.

1.2.3 The Standardised Approach for Sovereigns

We appreciate the difficulty in finding a balance between simplicity and ease of application and the aim to correctly capture the risks in a capital charge. Basing the risk weights for claims on sovereigns and their central banks on private sector external credit assessments is a step to increase the risk sensitivity of the regulatory capital charge, although the moral hazard issues for the rating agencies themselves are clear. There is, though, an issue that is of particular importance for banks operating in emerging markets. Emerging market sovereigns are often unrated, or have a low rating assigned by the rating agencies. However, for banks operating in these countries, many of the local regulators impose high statutory liquidity portfolio requirements, which the banks are required to hold in order to operate at all. These portfolios tend to consist of government securities and support the liquidity of the local financial markets. Clearly, it would not be desirable for the new capital regulations to compromise these holdings. Increasing the cost of holding the liquidity portfolios is likely to have a detrimental effect on the liquidity of the securities, which in turn could damage confidence in the financial system.

The current regulations allow a risk weight of 0% on claims on governments and central banks, if the exposure is in local currency and funded by liabilities in the same currency. As a proxy for market risk, 10-20% weight is applied to government securities. The new proposal also allows national discretion for the regulators to assign a lower risk weight to be applied to banks' exposures to the sovereign or central bank of incorporation denominated in domestic currency and funded in that currency. We believe that it is very important for this option to be put into effect and, for the same reasons, that a similar treatment should be available under the IRB approaches.

We believe that government securities denominated in local currency and funded in the same currency should attract a 0% risk weight. As interest rate in the banking book will now be covered by Pillar 2 measures, there is no need for a proxy market risk charge here.

1.2.4 The Standardised Approach for Banks

The Standardised Approach allows two options for the treatment of claims on banks. We do not favour the methodology in Option 1, which links the risk weight to the rating of the sovereign of incorporation. This option does not allow differentiation between strong and weak banks and penalises strong banks in weak countries (and vice versa). To avoid unnecessary dilution of the increased risk sensitivity, Option 1 should not be adopted.

1.2.5 Definition of default

The Accord discusses the definition of default and suggests four events, any one of which would constitute default. Our internal processes are more or less consistent with the proposed alternatives. We would, though, suggest that there are circumstances where the criterion that the obligor is more than 90 days past due on any credit obligation may not be a sufficient condition in itself to constitute default. We have in mind specific product categories, for example seasoned residential mortgages, where accounts that become delinquent may often return to performing status and often do not result in actual loss. Similarly, companies undergoing restructuring may become more than 90 days overdue but still remain in such a position that no eventual loss or forgiveness is expected. We would suggest that the definition for this event of default exclude obligors where there is no serious expectation of economic loss.

There is also a requirement for discretion to allow for discrepancies in local regulatory requirements. It would be very onerous to redefine defaults for regulatory reporting purposes across an internationally active financial institution.

1.2.6 Independent rating assignment or review

The Accord requires that "each individual rating assignment must be subject to an independent review or approval by a person or unit that does not stand to benefit from the specific grade associated with an exposure. This requirement can be fulfilled if the rating is assigned by an independent credit risk management unit, or of the rating is assigned by other and subsequently reviewed/approved by an independent credit unit".

It is easy to see how such independence could be achieved in banks dealing primarily with publicly listed or externally rated counterparties, where readily available, fully audited financial data can form the basis of risk rating. It is less clear how this can be achieved with small and middle market customers, where qualitative information about, for example, management skills may play an important part. This information is most easily accessed by the relationship manager. Relationship managers are obviously originators of the transactions, and therefore not independent. It is unclear to us whether the relationship manager's contribution to the process would fail the requirement of independence. Whilst we see the benefit of an element of independent oversight, it would not enhance the quality of the risk assessment to exclude the relationship manager from the process. This is another area where a pragmatic approach needs to be adopted instead of following the strict letter of the Accord.

We would like to see further clarification of what is meant by "independent" in this context, and we would also urge the Committee to avoid creation of unnecessary, and potentially counterproductive, separation of activities in different parts of an organisation.

1.2.7 Maturity

We recognise the difficulty of defining an average maturity for calibrating the credit risk approaches. Whilst three years may represent a broad average, it is clearly at odds with the way that banks conduct business in some segments: too short for mortgages; too long for trade finance; etc. We believe that the availability of a maturity adjustment is an important factor in making the Accord workable. Whilst again acknowledging supervisors' needs to be convinced that banks are not indulging in regulatory arbitrage, we would hope that recognition could be given to the fact that banks will manage exposures to some of their weaker credits by engaging solely in short-term business with them. We note in particular that there is discretion for an exception on short term interbank lending and would suggest that some corporate business, particularly in the field of trade finance, could be treated similarly.

1.2.8 The Granularity Adjustment

Given the Accord's rejection of portfolio modelling approaches, the inclusion of a granularity adjustment is a little odd. This introduces one element of diversification (borrower concentration) whilst ignoring all others (geography, industry, etc). This is inconsistent and, in our view, unnecessary. Borrower concentration is already addressed through the Large Exposures Directive and similar single borrower limits under other jurisdictions.

There is also a practical implication in that portfolios that are well diversified when looked at from a group perspective may not be so granular when the calculation is applied at legal entity level. There is some ambiguity over the level at which the granularity adjustment will be applied but there is a danger that banks will be incentivised to an artificial manipulation of their booking policy in order to manage the application of the granularity adjustment.

Should it be deemed appropriate to retain the adjustment, we agree with the statement in the supporting document on the Internal Ratings-Based Approach that the granularity adjustment should be applied at the most aggregate portfolio level possible. We believe this should mean the consolidated group level, not individual legal entities.

We also note that a similar argument applies to the requirement to have no more than 30% of a portfolio in any one risk grade. In our opinion this requirement does not realistically reduce risk arising from portfolio concentration. The Committee has rejected the use of portfolio models, which would provide a much more meaningful insight into portfolio concentrations and correlations. To substitute it with a very crude and inflexible rule does not enhance management of concentration risk.

We draw your attention to the fact that the greater the diversification of a portfolio, the more costly it will be for a bank to gather and process the information needed to calculate the granularity adjustment. The observation that the less relevant the adjustment is, the more cost the bank concerned will need to incur, suggests that there is a need to reconsider whether the granularity adjustment is really justified.

1.2.9 90% Floor

We are disappointed by the suggestion that banks that qualify for the Advanced Approach will be subject to a limitation such that their capital requirement cannot be less than 90% of that calculated under the Foundation Approach. As indicated above, we believe that the calibration of the Foundation Approach is itself flawed. Given this, and the need to satisfy supervisory scrutiny before approval to use the Advanced Approach can be obtained, we believe the 90% floor to be without justification.

1.2.10 Retail exposures

We have referred elsewhere to the importance of recognising margin income as a means of absorbing expected losses in retail banking. There are several additional issues arising specifically in the retail context.

Firstly, there will inevitably remain some ambiguity in defining what qualifies as a retail exposure. It is highly likely that banks will have some lines of business that appear to straddle whatever regulatory demarcation line is finally agreed. This may be for entirely sound practical reasons that have nothing to do with regulatory arbitrage. It is not clear what, if any, discretion national supervisors will have for approving the portfolios that fall within the retail category. We would hope that such discretion as exists would be exercised in a way that recognises the business realities that banks face.

Secondly, whilst the required segmentation of customers is not dissimilar from what we currently use, there is a danger that too rigid a set of requirements could inhibit advances in risk management structures in the future. We recommend that scope should be maintained for a more general definition of customer segments.

1.2.11 Credit risk mitigation

Standard Chartered welcomes the expansion in credit risk mitigants eligible for regulatory capital purposes. However, the administratively burdensome requirements for collateral management significantly reduce the potential benefit arising from the expansion.

The minimum risk weight of 15% to cover 'other risks' (with the exception of government repo-style transactions) is excessive, particularly given the introduction of operational risk capital charges. The standardisation of documentation used in transactions relating to credit risk mitigation has expanded greatly in recent times, which reduces the risk of documentary failure. We do not believe that the minimum weight of 15% is justifiable, particularly on cash collateralised transactions, where the risks are negligible.

Whilst banks have the opportunity, under the Advanced IRB Approach, to provide their own estimates of collateral value, the standards of evidence that must be met seem difficult to meet. It is unclear from the Accord whether banks will need to supply evidence at legal entity level and/or for each geographic area separately. The ability to utilise generic estimates across an international group would help to provide statistically significant supporting data.

As we have mentioned above, this is of great importance for SME business. The economics of banking in this segment rely heavily on the use of collateral. If banks are unable to meet the Accord's requirements for recognition of collateral, they may find that the capital requirements make this type of business unattractive.

1.3 Operational Risk

It is important to recognise the implications of the current lack of a clear definition for operational risk, particularly in terms of the boundaries between credit and market risk. The minimum weight introduced to the collateralised transactions in the credit capital charge, and the multiplier in the market charge in the trading book are both intended to cover for operational shortcomings. The potential for double counting arising from this should be eliminated, and the boundaries should be defined to encourage appropriate risk management.

We are not convinced that 20% of total capital is the correct starting point for an operational risk capital charge. We believe this was based on a fairly small sample of banks and that it could best be classified as an "other risks" charge rather than relating to operational risk specifically. Reliable quantification of operational risk across the majority of the industry is not currently feasible, although considerable efforts are being spent to enhance the loss data.

Whilst the Basic Indicator Approach seems too simplified to add much value, the Standardised Approach is a step in the right direction. We note that the business categories in the Standardised Approach are very broad, which will result in potentially arbitrary allocation of activities to the proposed business lines. We would like more categories to be included in the Standardised Approach but acknowledge the trade-off between prudent systems and implementation issues.

Our Group-wide operational risk procedures already include regular risk tracking, which form a part of our internal approach to managing, controlling and mitigating operational risk. However, in common with the rest of the industry, where data is sparse, we would not be in a position to follow an Internal Measurement Approach for a considerable time.

We are disappointed by the lack of recognition for the adoption of best practice approaches to mitigating operational risk in the Standardised and Internal Measurement Approaches. It appears that banks that have undertaken, for example, extensive business continuity planning will still face the same capital charge as if they had done no such planning at all. The qualitative factors, such as the structure and management process for controlling operational risk should influence the capital charge under the Standardised Approach. Standard Chartered has undertaken substantial investment in mitigating operational risk. Under the current conditions outlined in the consultative document, there is no recognition for these investments in technology and controls, nor is there a facility to offset these expenditures against the suggested operational risk charge.

The various actions taken by institutions to mitigate operational risk are directly correlated to the vulnerability of the organisation, and we encourage the regulators to respond positively to the industry's requests for recognition of this in the Pillar 1 capital charge. It is particularly important, as the transition to the Internal Measurement Approach will be evolutionary for the majority of institutions.

The assumption of a linear relationship between operational risk exposure and size of activities inherent in the Standardised Approach is flawed, and it is not supported by empirical evidence. The industry has proposed alternatives based on a square root approach similar to that applied in Market Risk, which we believe to be a reasonable and practical solution to the problem within the existing proposal. Again we believe they should only be available for the Standardised and the Internal Measurement Approaches, and should be excluded from any initial calculation for the institutions under the Basic Indicator Approach.

We appreciate the Committee's survey to collect loss data, as further clarification is required on the extent of loss data required to qualify for the Standardised Approach. The actual definition of operational risk itself is not yet confirmed, which may lead to inconsistent approaches by institutions and national supervisors alike. The investment associated with the collection of the data will be substantial for most banks, and we believe that the current uncertainties around the definition and the required supportive loss data must be clarified before any firm decisions about Pillar 1 charge are made.

2 Pillar 2 – Supervisory Review Process

2.1 Supervisory review

Standard Chartered Bank supports the principles for supervisory review process detailed in the Basel Accord and the relevant supporting documents. We believe that adequate supervisory oversight is a good complement for the requirements set out in Pillar 1. We welcome the flexibility in approach to regulatory capital that this Pillar enables. However, the challenges faced by the supervisors in the implementation of the requirements are significant. Some regulators are in a good position to meet these challenges, but there will be countries where the regulators lack the resources to undertake the required tasks.

We are concerned about the potential implications for the maintenance of a level playing field internationally if there is inconsistency in the implementation of the requirements by national regulators. To avoid distortion in the competitive capabilities of banks due to disparate regulatory requirements, we would like to see the quantitative impact of Pillar 2 kept to a minimum, with the bulk of the quantitative elements maintained in Pillar 1.

2.2 Interest Rate Risk in the Banking Book

There is one area where we do recognise the difficulty of applying a specific Pillar 1 charge and this is in the treatment of interest rate in the banking book. We agree that there is such a diversity of situations to encompass that it is appropriate to treat this under Pillar 2. That being so, we find the inclusion of a standardised interest rate shock (as detailed in the Annex of the Supporting Document on Interest Rate in the Banking Book) in the regulations unnecessary and contrary to the rationale for including it in Pillar 2. We do not see that this would add any value to the interest rate risk management of an internationally active bank, particularly as the scenarios are broad-brush and do not necessarily reflect the circumstances in different operating environments. We find a holding period of one year to be unrealistic. In developed markets there is deep liquidity and access to a variety of hedging instruments so that positions can be neutralised quickly. In less developed markets, the majority of banking book interest rate exposures will be kept to a short tenor to reflect the limited hedging opportunities. In both cases, a holding period of 1 month would, in our view, be more appropriate.

We would also suggest that consideration be given to the recognition of banks' own estimates of banking book interest rate risk. We ourselves use a VAR equivalent, based on recent historical experience. If complemented with a selection of stress tests, designed to be reflective of the markets and conditions faced by the bank concerned, these estimates should be sufficient to satisfy supervisors as to the adequacy of capital cover.

3 Pillar 3 – Market Discipline

As a means of facilitating adequate peer review and therefore complementing enforcement of the stability of the financial services sector, we are in favour of increased transparency. We are concerned, however, that the current proposals relating to disclosure lead to excessive and costly reporting requirements without adding significant value in terms of market discipline.

Our belief is that greater disclosure of off-balance sheet activities would provide a valuable enhancement to the data available for use in assessing an institution's creditworthiness but that there is little additional value to be obtained from the detailed disclosure of asset quality required by the Accord. On the contrary, disclosure of deterioration in the quality of the loan portfolio could lead to premature conclusions by external groups, which in turn would result in unwarranted adverse impact on the institution's financial position. Moreover, disclosing impaired loans by industry sector as proposed, could potentially cause concerns about a particular industry, and therefore become self-fulfilling prophesy.

We are concerned that the lack of clear definition of the items to be disclosed will result in a need to provide extensive descriptions, and consequently lead to excessively lengthy and cumbersome financial statements. This would not promote the interests of the investors, shareholders or depositors, but would create confusion as well as a substantial increase in the time and costs related to producing the statements.

The additional burden arising in terms of time and cost would be particularly significant if the data disclosed were required to form part of the audited accounts. It is not clear to us whether this would be expected. However, if the disclosures were part of the supplementary information, the resultant quality is likely to be variable, and therefore would add little value.

We believe that the proposal to disclose operational risk losses, while laudable, may not produce the results for which the Committee is hoping. In the event that boundaries with credit and market losses are not clearly defined, different interpretations may mean that the numbers could become meaningless when used for comparison across institutions.

The level of detail disclosed should not be the same for each individual entity in a group, being greater at the Group level. Excessive detail could compromise customer confidentiality; prejudice a bank's position in negotiating the work out of a defaulted debt; or lead to the disclosure of information of competitive value.

We have difficulty in understanding what is the target group for the disclosures suggested. We do not believe that the providers of funds to the banking sector would benefit from this type of information. We are in continuous communication with our investors and do not believe that detailed regulatory driven disclosure is an efficient complement to it. We believe that there would be a far greater risk in the disclosures being misused by competitors, or left unutilised, neither case justifying the burden and cost of providing the data.

We support the comments and suggestions made by the British Bankers Association relating to Pillar 3. We particularly endorse the proposal that there be very close alignment between the Accord and the International Accounting Standards Board revision of the Disclosures in the Financial Statements of Banks and Similar Financial Institutions (IAS 30). The co-ordination between the Basel Committee and the IASB would help to make the disclosure requirements consistent and relevant for the purposes of Pillar 3.