ABI
ASSOCIAZIONE BANCARIA ITALIANA

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BASLE COMMITTEE ON
BANKING SUPERVISION
Basle

Ms. D. Nouy
Secretary General

The New Basel Capital Accord - Consultative Document from the Basel Committee on Banking Supervision (April 2003)

Dear Ms. Nouy,

in order to draft the position paper of the Italian banking system, on the proposed amendments to the capital adequacy accord, ABI conducted a formal, co-ordinated survey of the various views and proposals on the Consultative Document issued by the Basel Committee.

Based on the comments received and the outcome of several interbank working group, ABI has drafted the enclosed position paper for the consideration of national and international supervisor authorities.

A copy of the position paper will be sent to European Commission DG Internal Market, involved in the Capital Adequacy Directive review.

Yours sincerely,

THE GENERAL MANAGER
(Giuseppe Zadra)

Enclosures

RA1200/RA1205/RA1210

Position paper of the Italian banking system on the Consultative Document: New Basel Capital Accord

July 2003

This paper is based on contributions from individual member banks and on meetings on selected issues with a series of interbank working groups:
- on Credit Risk
credit risk rating and general features of the Accord
mitigation
securitization
- on Operational Risk
- on Pillar3

Contents

Acronyms

ABI (Associazione Bancaria Italiana, Italian Banking Association)
ABS (Asset Backed Securities)
AIRB (Advanced Internal Rating Based approach)
AMA (Advanced Measurement Approach)
ASA (Alternative Standard Approach)
BIA (Basic Indicator Approach)
BL (Business Lines)
CP3 (Consultative Package 3)
CAD (Capital Adequacy Directive)
EAD (Exposure At Default)
EL (Expected Loss)
FCC (Credit Conversion Factor)
FIRB (Foundation Internal Rating Based approach)
GI (Gross Income)
IRB (Internal Rating Based approach)
LGD (Loss Given Default)
LTV (Loan To Value)
OR (Operational Risk)
OTC (Over the Counter)
PF (Project Finance)
PSE (Public Sector Entity)
QIS3 (Quantitative Impact Study 3)
RBA (Rating Based Approach)
SA (Standard Approach- credit risk)
SF (Supervisory Formula)
SL (Specialized Lending)
SME (Small and Medium Enterprises)
STA (Standardized Approach- operational risk)
UL (Unexpected Loss)

Premise

The Italian Banking Association, in developing the position of the Italian banking system on the proposed modification of the Capital Accord, has systematically gathered the views and proposals of its member banks on the questions left open by the consultation paper prepared by the Basel Committee in April 2003.

Based on the observations received and the activity of several ad hoc interbank working groups, ABI has drafted the attached position paper. Following its approval by the Association's Executive Committee, this paper has been transmitted to the Italian supervisory authorities, to the Basel Committee and, for information, to the European Commission.

Under particular agreements with the relevant professional associations, this position paper also includes comments on the factoring and leasing sector and also on the private equity and venture capital market.

The Italian Banking Association thanks the Basel Committee for making its Third Consultation Paper available in translation in a number of languages, including Italian. This helped to create the conditions for a real "level playing field" in terms of the circulation, discussion and analysis of CP3.

General questions

As our previous papers have made clear, the Italian banking systems sees the new Capital Accord as in line with developments in banking risk management and appreciates that the Committee's work has been shaped by international best practices.

To be sure, one cannot expect that these best practices will spread quickly throughout the entire banking system, especially to the smaller banks. In any case the European Capital Adequacy Directive (CAD) will propose them among the recommended methods for calculating capital requirements.

In this regard, the Italian banking system highlights the need for special attention to the possible effects, in terms of level playing field, of failure to subscribe the New Capital Accords overall. This is relevant, in particular, to competition in third-country markets between banks subject to Basel 1 and to Basel 2 respectively.

We believe that the discussion that has arisen on the issue of installing internal rating systems has brought benefits and will continue to do so in the future, and not just to the financial community but to the economy as a whole. In fact, the entire range of economic operators need to better understand the determinants of credit risk that are factored in by the banks and by regulators.

In this regard, the New Capital Accord has already provided an important moment of discussion, for Italy, between the banking system and the business community. ABI has arranged some 70 meetings around the country for a detailed examination of the New Accord and the opportunities it offers in particular for SMEs inclined to pay greater attention to the financial side of their operations and to transparency vis-à-vis banks. These meetings created an opportunity for direct contact between single ABI member banks and the business community.

In Italy, the increased awareness of the factors of risk and hence of the related pricing has convinced all economic agents of the urgent need for reforms, including bankruptcy law reform and revision of the operation of joint borrowing, on which ABI has been working for some time now.

Turning to the consultative package on the new capital accord (CP3), the Italian banks welcome the changes made in response to the requests set out in earlier position papers. In particular:

1. The confirmation, in the April package, of the provision of the Technical Guidance for QIS3 for application to SMEs, under certain conditions, of the rules for the retail portfolio or else of application to them, within the corporate segment, of a special capital requirement reduction.

2. **The reduction of the risk weight to 35% for claims secured by residential property under the Standard Approach.**
3. **The recognition of some counter-guarantees as risk mitigation.**
4. **The broadening of the possibilities for combined use of different methods for calculating the charge against Operational Risk and the greater flexibility allowed banks in classifying their business activities, hence their operating losses, in the eight business lines indicated by the Committee.**
5. **The introduction of roll-out mechanisms in the implementation of the New Accord.**
6. **The introduction of the Simplified Standard Approach.**

In any case, we must express concern over a number of matters, which in the view of the Italian banking system still need further improvement.

1. **Implementation of the Accord and problems for the treatment of home/host control.**
2. **Penalization of interbank portfolios under the IRBF.**
3. **Calibration of the corporate curve for SMEs.**
4. **Fiscal treatment of provisions and the level playing field.**
5. **Revision of the treatment of personal guarantees under the Foundation Approach.**
6. **Penalization of securitizations.**
7. **System of incentives, overall an especially for specific portfolios and business lines.**
8. **Lack of incentive to move from BIA to STA in gauging OR.**
9. **Penalization of purchased receivables.**
10. **Methods for determining any capital add-ons under Pillar 2.**

We shall return to each of these points further on.

The results of QIS 3

Considering the importance of correct calibration of the parameters, we feel that the results of QIS3 are not entirely adequate, insofar as they show substantial variability. This variability cannot always be definitely attributed solely to the risk sensitivity of the new rules but also depends on factors connected with:

1. the short time covered by the impact study;
2. the lack of perfect definition of the set of rules, recognized by the Committee itself in its remark that “results have been adjusted by national supervisors to tale into account the latest changes”;
3. the possibility of using estimates and criteria not entirely compliant with Basel 2.

On this latter point, let us recall that:

1. Probabilities of default have been estimated using time series constructed by the banks under national or company definitions of default, which are not always consistent with the reference definition set out in the New Accord.
2. The IT systems available, in most cases, lack the necessary data detail, so that margins for error have certainly crept in (with positive and negative effects on the overall capital requirement whose sum is not necessarily zero);
3. The lack of point estimates of some portfolios (e.g. the PD of Public Sector Entities and the interbank portfolio) and their replacement with portfolio-wide averages and/or estimates by third parties may cause distortions;
4. The overall impact assessment refers to the lower of the requirements resulting from the Standardized and the Alternative Standard approaches, assuming that all intermediaries may not use the Basic approach, which other things being equal results in higher requirements.

For these reasons the results of QIS3, though undeniably “on a best effort basis” by the banks, cannot be taken to be the basis for the Committee in definitively calibrating the New Accord.[1]

As we know, in the year preceding the entry into effect of Basel 2, the banks using foundation and advanced approaches will have to calculate their capital adequacy applying both the approach chosen and the current Accord. Accordingly, we would request that the Committee explicitly indicate, in the final document, its willingness to undertake a revision of the parameters if it should

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1 Let us also note the lack of indications on the impact of the Advanced IRB approach on Group 2 banks. The Committee itself considered that there were too few respondents.

find that the present calibration entails, for single national banking systems, a significant average increase in capital requirements over those now in place.

Finally, let us emphasize that based on the QIS3 results the Committee's aim of ensuring that the more complex methodological options produce lower capital charges does not appear to have been attained.

In the light of the studies, the objective is achieved in terms of overall approaches (SA vs. IRB; FIRB vs. AIRB) but not always for single portfolios. For comparable data for the SA and FIRB approaches, in fact, the latter imposes, on average, a heavier capital charge on the Sovereign, Specialized Lending and Equity portfolios.

In these cases, Italian banks call for correctives on the weights under FIRB in order to eliminate these implicit inconsistencies, not least because, as was noted in point 7 under general questions, this lack of consistency could penalize specialized-portfolio units within universal banking groups relative to specialized intermediaries.

Among other things, we would like to call the Committee's attention to the lack of facilitations for universal banking groups, which are intrinsically characterized by differentiation of risk.

Implementation

Italian banks welcome the Committee's proposals allowing for phasing in the more sophisticated methods (roll-out).

The EU Commission's proposal has, in special cases, provisions allowing permanent adoption of combinations of SA and IRB. The Italian banking system considers such provisions absolutely appropriate and advisable and calls on the Basel Committee to introduce some such possibility.

To ensure sufficient flexibility, we also suggest the provision, in special cases that will be detailed below, for the application of IRB Foundation to some sub-portfolios, including material ones, together with IRB Advanced to others. This should be allowed only if the bank can demonstrate to the supervisory authorities that the data needed to estimate LGD and EAD are objectively unavailable. Regardless of the bank's capacities or any data pooling, such a lack sometimes depends on the very structure of the transactions making up a sub-portfolio, so the partial application of IRB Advanced should be allowed to remain until time series are robust enough.

Finally, important questions stemming from the application of the New Accord to international groups operating in different jurisdictions remain to be cleared up (the home/host control issue).

Given the importance and delicacy of the issue, we believe that at least some of the basic criteria should be mentioned explicitly in the New Accord, although we are well aware that for most existing situations the Accord Implementation Group will have to study the problem and devise consistent specific solutions.

Scope of Application

Under the current rules equity interests in insurance companies are treated as 100% risk-weighted assets, whereas under the new rules they would be directly subtracted from supervisory capital, which amounts to a capital charge 12.5 times as great as at present.

Either of two alternative solutions would be much preferable: a) an easing of the new rules; or b) at least retention of the present weighting system, until the rules on insurance supervision have been completed (the retention of the present rules appears to be the solution intended in a number of G10 countries).

We should also like to highlight the asymmetrical treatment between banks' holdings in insurance companies and insurance companies' holdings in banks. In the former case, there is a total deduction but not in the latter. While the Directive on Financial Conglomerates and the application of the new IAS should limit deductions and ensure a real level playing field for banks and insurance companies, we hope that the final version of the New Capital Accord

Finally, as for non-insurance capital deductions as well, we consider it excessively burdensome and unwarranted to deduct 50% from Tier 1 and 50% from Tier 2, as proposed in § 18.

Pillar 1

- **Credit risk - Standard approach**

Claims on banks

Under the first of the two options envisaged for interbank assets, no provision is made for especially favourable treatment of short-term items, as under the second option. We request that this possibility be introduced, and also that the time limit for "short-term" be extended to original maturity of up to 6 months.

Claims on securities firms and non-bank intermediaries

Current Italian supervisory rules provide that non-bank financial intermediaries included in the special register under Article 107 of the 1993 Banking Law are subject to prudential supervision based on the bank supervision model. As these intermediaries must comply with specific capital and risk control requirements, and with regard to specific risks comparable to those envisaged in the New Accord, we propose that assets with such intermediaries (similarly to those with investment firms) should be treated in the same fashion as assets with banks.

Claims included in the regulatory retail portfolios

There is an inconsistency between the provisions for IRB (§ 199) and for the Standard approach (§ 44): in the latter case reference is not to the exposure to the banking group as a whole, much less to the "consolidated" exposure to the borrower.

Preferential risk weight for claim secured by commercial real estate

In the case of loans secured by mortgages on non-residential property, as the practice in European markets generally and the Italian market in particular is to lend a maximum of 80% of the market value of the residential or commercial property being acquired, it seems harsh to have preferential risk weight (50% instead of 100%) only up to 50% of the value of the property.

Accordingly, we suggest raising the portion of the loan eligible for the lower risk weight to near the 80% level.

Past-due loans

Consistent with the IRB approach, under which the 90-day limit for reclassing a loan as "past due" is lengthened to 180 for a transitional period of five years, we ask that this treatment be extended to the Standardized Approach as well.

If this disparity is not eliminated, the same borrower could be classed as performing by a bank using IRB and as non-performing by one using the SA.

Treatment of provisions

Italian banks appreciate the changes to the Standard and to the IRB approaches, which on average will reduce the capital charge, but some aspects, such as the possible recourse to allocations to provisions and write-downs to lower risk weights of past due loans or, under IRB, for the deduction or offsetting of the EL portion of the risk weights, need to be evaluated in the light of the international level playing field in terms of tax treatment.

As to the treatment of past-due residential mortgage loans (§51), we ask that national discretion be applied not to the entire measure but only to the setting of the threshold percentage of the provision that allows lowering the weight from 100% to 50%.

- **Credit risk - the IRB Approach**

Before dealing with more detailed issues, we should like to ask the Committee to ensure some elasticity in its interpretation of the need to satisfy all the qualitative and quantitative requirements for the IRB approach, especially over the transitional period.

For the transitional period, we emphasize that the lack of any such assurance as regards estimating LGD and non-retail EAD is excessively burdensome.

We accordingly request that in §§233 and 234 there be inserted express reference to the possibility, with the approval of the national supervisory authorities, of shortening the time series of LGD and non-retail EAD from 7 to 4 years during the three-year transitional period, increasing the length by one year for each of the three years.

Definition of retail exposures

To fit the definition of "retail exposure", assets must be a part of a large pool of exposures which are managed by the bank on a pooled basis. Although it has been clarified that this prevents individual treatment in some phases, thus making the provision more similar to prevailing Italian practice (present supervisory rules, for instance, require that the periodic review of loans be made exposure-by-exposure and not pooled), we would prefer a single, objective definition of the retail segment (such as the €1 million ceiling) rather

than deriving the definition from internal management practices (i.e. whether the loans are managed in pool or portfolio).

Calibration of the corporate function for SMEs

Although most of the improvement, by comparison with January 2001, in the risk weights for the PD classes generally attaching to SMEs was introduced in November 2001, we also greatly appreciate the introduction of a further adjustment for SMEs via a specific function for calculating the capital requirement which, already present in the Technical Guidance to QIS3 in October 2002, is confirmed in the current consultation paper.

Nevertheless, in our view the asset correlation is still to high compared with the large corporate segment. A recent study by M. Dietsch and Joël Petey[2] shows that the correlation of this segment with the business cycle averages around 1%. SMEs with sales of between €7 million and €40 million, i.e. with treatment in line with the corporate segment, would suffer particularly, as their correlation rate is even lower (0.49%).

In order not to retain these excessively burdensome requirements, we would like to request a revision of the asset correlation calibration towards values that are less prudential and more closely in line with banks' operational practices.

Among other things, it should be noted that despite the introduction of the adjustment factor for calculation the correlation for SMEs, there is still a strong cliff effect by comparison with the treatment of other retail assets; this jump does not appear justified by the size differences in firms.

Project Finance

A study of four international banks in 2002 has shown that the PF segment has probability of default quite comparable to the corporate segment but a lower LGD.[3]

This suggests the advisability, in cases where the bank is in a position to estimate the PD independently, of applying a significantly lower risk weight than would be assigned to a corporate loan, ratings being equal.

Otherwise, the banks unable to apply the Advanced approach from the outset will continue to penalize project financing business by applying highly onerous pricing to projects.

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2 "Should SME exposure be treated as retail or corporate exposure? A comparative analysis of probability of default and asset correlation in France and Germany" March 2003.

3 "Credit Attributes of Project Finance", The Journal of Structured and Project Finance, International Investor, Fall 2002, Vol. 8, N. 3 (www.iijspf.com)

As to §246, Italian banks call for the elimination of national discretion in the assignment of preferential weighting of exposures classed as "strong" and "good".

In keeping with the foregoing, i.e. that LGD for project finance is appreciably lower than for regular corporate loans, Italian banks ask for a lowering of ratios also for lower regulatory categories, which are especially severe for default positions (625%), at least aligning them with corporate loans.

Maturity

The banks using the IRB Foundation approach and with a substantial portion of their portfolio in interbank assets would be penalized by the setting of a 2,5-year maturity, given that for that maturity the actual duration of a loan is much shorter.

For the Trading Book of IRB Foundation banks, one problem is that the curves used to calculate counterparty risk are centred on the maturity value of 2,5 years, in blatant contrast with the typical duration of such transactions.

For receivables, too, the 2,5-year maturity set in the Foundation approach is punitive. In Italy, trade credits have an average maturity of 90 days.

Accordingly, Italian banks request that the Foundation approach always allow for calculating effective maturity according to the provisions of the Advanced approach (§§ 290 and 291) for these three portfolios.

For repo-style transactions, finally, we feel that the maturity provided under the Foundation approach should be further shortened from 6 to 3 months.

LGD

Although empirical evidence is scanty, we believe that in the interbank segment LGD is much lower than the 45% set in the Foundation approach. We accordingly request a substantial reduction of that charge for the interbank segment (§256). Similarly, we ask a reduction in LGD on subordinated claims on banks (§257).

As to the treatment of LGD under the Advanced approach, Italian banks would like to make explicit, for all portfolios, the possibility (subject to the approval of the national supervisory authority) of using a "hybrid" method where there is collateral (in particular, financial collateral); that is, allowing the use of internal estimates for the unsecured portion of the exposure and the haircut approach for the secured part.

This method would be useful to many banks, many of which have rather low level of detail on LGD, often limited to the presence or absence of collateral on a defaulted position.

The use of this approach should be contemplated for at least the three years of the transitional period, when banks will work to produce totally internal estimates of LGD, including the secured portion.

- **Mitigation**

Guarantees

In general, the method of replacing the PD of the principal borrower with that of the guarantor is punitive, because it takes no account whatsoever of the "double default/double recovery" effect.

Under the *Standardized Approach* the requirements for recognition of the mitigation due to personal guarantees include:

(i) "By making a payment under the guarantee the guarantor the guarantor must acquire the right to pursue the obligor for monies outstanding under the documentation governing the transaction" (§. 161[a])
(ii) "The guarantor covers all types of payments the underlying obligor is expected to make under the documentation governing the transaction, for example notional amount, margin payment etc. (§. 161[c])".

In this regard, it should be noted that the principle of "substitution" does not appear to be significant in ensure mitigation of credit risk. The important element, in fact, is the "prompt" execution upon the guarantor when the principal borrower defaults. Our request, therefore, is that the requirement of substitution be eliminated, or at least defined less stringently.

On point (ii), we request that in setting this requirement any default interest accrued not be taken into account, in view of the relative insignificance of these costs given the small amount of time required between the default land the execution of the guarantee.

Turning to the Internal Rating Approach, to increase the possibilities of mitigating risk by personal guarantees, we suggest broadening the class of eligible corporate guarantors, currently limited to those rated at least A- or equivalent, to all corporate entities with risk weight lower than the prime borrower. This makes the approach more consistent, because for equal PD between banks, governments, and corporate borrowers there is not difference in the risk weight curve, hence in the implicit risk of guarantors.

Incidentally, in Italy this extension would involve non-bank financial intermediaries subject to prudential supervision in line with that laid down for banks in the New Accord. This would permit equal treatment of these borrowers with governments, PSEs, banks and investment firms.

We further hope that the IRB Foundation approach will contemplate mitigation from personal guarantees (and credit derivatives, as below) on the LGD. At present this option is envisaged only under IRB Advanced and is generally applied for loans secured by collateral.

Finally, the Italian banking system appreciates the recognition accorded to guarantees of guarantees (§171) in the range of mitigation instruments. However, we would like to see an extension of the list of possible issuers of such second-level guarantees, going beyond sovereigns to banks, public sector entities and private guarantors.

Credit derivatives

As in the discussion of personal guarantees, again the substitution of the guarantor's PD for that of the prime borrower is punitive, failing to take account of the "double default/double recovery" effect.

Italian banks appreciate the possibility of not considering the restructuring of the underlying obligation as a "credit event" when the lending bank has "complete" control over the renegotiation decision. However, it would nevertheless be useful to set a specific threshold of "materiality" for the restructuring above which it must be considered as a credit event.

As to the risk mitigation effect envisaged for "first to default" derivatives, our view is that limiting the coverage to the least risky position in the basket is excessively prudential and fails to reflect the real potential of this instrument. Moreover, as to the capital charge for the protection provider, even though the cap of 1250% has been introduced it is still too high and could significantly increase the cost of protection.

Therefore, the mitigation effect of the "first to default" should be recognized not on the exposure with the lowest risk weight but, for example, on the riskiest exposure in the reference basket. Such treatment would counterbalance the worse treatment of the protection seller.

Collateral

As for financial collateral and the haircuts used to take account of the volatility of the mitigation effect, we feel that it is excessively onerous to apply to UCITS/mutual funds the haircut relative to the riskiest investment; instead, we suggest using the average haircut. We also think consideration should be given to including among the recognized types "collateral deposits in cash without a pledge", as this is the most common type of collateral used in correspondent banking.

We also think that in the future the rules be supplemented to clarify whether or not insurance policies ("life", "index", "unit", etc.) may be included in the list of eligible collateral if correctly pledged to cover lines of credit.

As to physical collateral, we should like to point out that by comparison with the stringent requirements for eligibility (costly to satisfy because of the modified of IT systems that is required), they provide negligible reduction of LGD (at the most 10 percentage points), and this despite a very high overcollateralization threshold of 140%.

Financial receivables

Under the present formulation of CP3, financial receivables provide risk mitigation only under the IRB Approach. And under IRB Foundation, given the requirement that banks make an "efficient" assessment of the risk of trade credit, the overcollateralization threshold of 125% for eligibility is quite high. The Italian banking system accordingly requests (i) that the mitigation effect of financial receivables be recognized under the Standardized Approach as well and (ii) that the overcollateralization threshold under IRB be significantly lowered.

Mortgage credit

IRB Approach: The LGD floor on residential mortgages

The 10% floor on assets classed in the retail residential mortgage loan portfolio is excessively onerous. It is quite realistic to imagine cases in which mortgage default entails no loss at all for the bank. Consider, for instance, the case of a 15-year mortgage at the standard loan-to-value ratio of 80%. After 3 or 4 years the ratio of residual exposure to building value is such that the LGD is practically zero.

Prudential treatment of mortgage loans classified as specialized lending

Under the proposals of CP3 (and earlier in the European Commission's consultation document), loans whose repayment depends on the cash flow from the mortgaged property (already existing or under construction) must be classed as Specialized Lending (SL), which means a significantly more onerous treatment than the regular corporate/retail lending segment.

This could result in an unfair disadvantage both for real estate credit (in the case, for instance, of "buy to let") and for real estate development lending. For the latter in particular, let us note that:

> **(i) in Italy building credit is often granted to limited liability partnerships or to cooperatives, characterized by low capitalization but engaged in projects that may be of very substantial value. In such circumstances, obviously, much real estate development lending would be classed as SL, with a significant impact on SMEs in the construction industry;**

(ii) for decades it has been the established practice in Italy to convert the loan to a builder into a large number of small loans to the individual purchasers (once construction is completed), by splitting and reassigning the original loan. This means that the initial extra cost for the corporate loan, which in most cases would have to be classed as SL, can also have an impact on the terms of the mortgage loan to the purchasing households.

Even though IRB banks with adequate data have been allowed to apply the corporate curve to calculate capital requirements on IPRE and HVCRE lending, as the Italian banking system requested in its previous position paper, the ratios under the Supervisory Slotting Approach (which will not in any case be uncommon) are still to high.

Italian banks would therefore like to see: (i) a general lowering of the charges for the SL portfolio; (ii) elimination of the HVCRE category; (iii) the possibility, as in the recent EU Commission consultation document, for developed markets with defined loss rates in the segment, of treating loans whose repayment depends on the cash flow from the mortgaged property outside the specialized lending portfolio, under the ordinary corporate or retail portfolio as the case may be.

Other Collateral

We propose recognition of other collateral (such as liens on ships or aircraft) for purposes of capital requirement reduction also under the Standardized Approach.

- ## Securitization

Before analyzing the various individual features of the Basel proposal, the Italian banking community expresses its appreciation for the broadening of the range of assets eligible for securitization (including non-credit assets). However, there is a need for clearer and more specific definition of what is meant by securitization.[4] According to CP3 this definition should reflect the economic substance of the transaction rather than the legal form. Greater clarity in this sense would spare banks the trouble of having to ask their supervisors, time and again, whether any given operation does or does not qualify as a securitization.[5]

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[4] See §. 501: "Since securitisation may be structured in many different ways, the capital treatment of a securitisation exposure must be determined on the basis of its economic substance rather than its legal form". Similarly, supervisors will look to the economic substance of a transaction to determine whether it should be subject to the securitisation framework for purposes of determining regulatory capital".

[5] Ibidem: "banks are encouraged to consult with their national supervision when there is uncertainty about whether a given transaction should be considered a securitisation".

Below we offer a series of considerations on the new regulatory proposal, in the light among other things of the recent results of QIS3, which highlight the significant adverse effect for securitizations.

"Clean up" and "time call" clauses

Italian banks welcome the Committee's acceptance of the request made in our earlier position paper concerning securitization, namely to avoid the unfair treatment of the originator (a ratio equal to that on the underlying portfolio, as if the securitization had not taken place) when a clean up call clause is exercised if:

(i) the securitization is non-performing or

(ii) the cost of servicing the outstanding securities is less than the benefits of servicing the underlying credit exposures.

However, this disadvantageous treatment remains when the clauses are exercised for residual portfolios larger than 10% of the original one.

It is not clear, first of all, by what criterion the 10% threshold was decided on. This limit would appear to be the result of market practice more than the outcome of specific tests demonstrating that below that floor the exercise of the call is not a credit enhancement but a means of reducing the costs of the transaction in the closure phase.

Moreover, application of the proposed rules could also lead to significant distortions in the amount of capital required by the system as a whole. The existence of clear-up calls could cause application of the requirement at a 1:1 ratio both on the originator and on any investors in the junior tranche, unless the regulations provide expressly that if the 1:1 requirement is applied to the originator it is not also applied to investors in the tranche.

For time call clauses, while we agree with treating them under Pillar 2 we should like to stress the risk of inconsistency with the treatment, under Pillar 1, of transactions allowing for early extinction (as in clean up call clauses).

Finally, we think further clarification is needed on the possible cases that can be considered as "implicit support".

Eligible liquidity facility

The treatment of suppliers of liquidity facilities is still too severe. Moreover, we should like to emphasize that the FCCs envisaged in the IRB approach (also with reference to liquidity facilities available in the case of "market disruption") are more burdensome than under the Standardized approach.

Standardized Approach

The Italian banking community is still concerned, as regards risk management, at the disparity of treatment – for equal ratings below BBB- – of ABS held by investing banks as compared with corporate securities. Furthermore, the prudential ratios envisaged for this category of ABS in the Second Working Paper are even heavier than in the previous consultation document of January 2001 (350% instead of 150%). Table 1 summarizes the disparities of treatment.

Table 1

	AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to BB-	< B+ or unrated
Investor	20%	50%	100%	350%	Deduction
Originator	20%	50%	A-<x<BBB- = 100% < BBB-= Deduction	Deduction	Deduction
Corporate bond					
	20%	50%	100%	100%	150%
Basel 2001					
Investor	20%	50%	100%	150%	Deduction
Originator	Deduction for *first loss*. The *second loss* with higher rating is treated like the underlying asset.				

As for the utilization of the look through approach to super senior unrated tranches, we consider that the application of the average risk weight of the underlying exposures is unnecessarily severe, because ordinarily such a tranche carries greater seniority than AAA-rated tranches. In this case there is a disincentive to the purchase of super senior tranches for banks using the Standardized approach. Moreover, Italian banks would like to stress that the super senior tranche is located within the AAA tranche, and that the tranching is performed merely for the marketing needs of the originator. Formally, then, this risk is one falling into the AAA tranche. This tranche is subjected to a re-tranching, creating two tranches, one at a higher level of subordination (the super senior).

Finally, we think that the Standardized Approach too should have a cap on the capital requirement, as under the IRB (Supervisory Formula Approach).

Internal Rating Approach

Rating Based Approach

Italian banks appreciate the approach proposed, which permits the calculation of capital charges on ABS for IRB investing banks lacking the data needed for internal assessment of the credit quality of the underlying assets.

However, the introduction of the coefficients of granularity (N) and density of high-rated classes (Q) for calculating the risk weights under the Rating Based Approach (RBA) is questionable. Those values should already have been factored into the rating given by the ECAIs. Introducing them into the calculation of the risk weights as well would mean double counting of the same valuation elements.

Further, we must note that the risk weights for tranches with ratings below investment grade are significantly more onerous than for corporate bonds with the same creditworthiness.

As for the recognition of risk mitigation techniques under the IRB approach (RBA and SF), Italian banks do not agree with the idea of restricting eligibility only to those guarantees (personal guarantees, collateral and credit derivatives) that meet the requirements of the Standardized Approach.

Finally, considering that exposures must be weighted gross of specific provisions (unlike the Standardized Approach), we think that value adjustments and provisions should be recognized as forms of credit enhancement.

- **Operational risk**

Flexible mapping of BLs in the Standard Approach (STA)

We appreciate the greater flexibility allowed to banks in mapping business lines (BL), with the setting of general principles of classification, in view of the objective difficulty of reducing the complex realities of banking to the 8 BL envisaged. In particular, we welcome the possibility of using internal pricing methods to allocate gross income (GI) among the various BL (principle *d*, Annex 6).

So, given that for the single bank such flexibility permits initiating a process of data collection and operational risk management reflecting a more “authentic” classification of activities, in the case of participation in external data pooling, which is one of the prerequisites for validation of internal estimates of operational risk exposure, there must be uniform classification of banking activities, not so much for purposes of allocating GI as for uniform allocation of operational losses among the various BL.

Accordingly, the Italian Database on Operational Losses (DIPO)[6] is now working to develop a common reference definition.

As to principle [e] in Annex 6, we agree with classifying activities retaining a certain degree of consistency with what is done to discriminate between retail and corporate borrowers in calculating capital requirements vis-à-vis credit risk. However, applying the use test could be problematical, in that the definitions of retail and corporate customer in the Standard Approach and the Internal Rating Based approaches are not consistent with one another.

Italian banks accordingly call on the Committee to resolve this inconsistency between the definitions envisaged under the different approaches to credit risk.

Finally, with reference to the eighth BL, we would opt for the term "brokerage" in place of "retail brokerage", in that the term "retail" does not refer to a specific type of customer but should be understood to be the opposite of "wholesale".

Gross income by Business Line

Our hope is that national regulators develop a method for calculating open gross income for individual business lines (consolidated and solo) through appropriate reference to standard data forms for the domestic banking industry. In Italy, these would consist in the items of the PUMA2 reporting form.

Such a method would not only help smaller banks that lack a detailed enough management control system but would also improve the uniformity, at least at national level, of ratio calculations under the standard method.

Incentives to advance from the Basic Indicator to the Standard Approach

The Basel Capital Accord provides for different methods of calculating the capital requirement against operational risk, permitting adaptation to specific characteristics and types of bank.

If on the one hand the successive approaches are increasingly complex and costly, on the other it should be the Committee's intention to provide adequate incentives for banks to move on to more advanced methods. This is not always the case. In particular, the incentives to switch from the Basic Indicator Approach (BIA) to the Standard Approach (STA) need review. Organizationally, to be eligible for STA a bank must meet severe qualifying criteria not called for by BIA, and in some case the saving on capital requirements under STA could be nil or even, paradoxically, negative.

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[6] This is a consortium, created under ABI in 2002, for the collection of data on operational losses caused by individual events experienced by the members (currently 32 banks and banking groups). For further information, see the DIPO link on the home page of www.abi.it.

In order to lead banks to move on to the more advanced methods of operational risk management, therefore, the Italian banking system would like to see the Committee introduce a series of incentives, such as:

1. extending the recognition of insurance mitigation to BIA and STA (consistent with the standardized approach to credit risk, which does recognition such risk mitigation), but with a greater mitigation effect under STA;
2. introducing a cap, so that the total capital charge under STA is at most equal to what would result from BIA.

Qualifying criteria for STA

As noted, the requirements to qualify for STA are quite strict, considering the substantial organizational costs of instituting a system of operational risk management.

Since non-international banks will also certainly apply the method, we appreciate the power left to international regulators of not requiring banks that do not do international business to meet the criteria (and we hope the regulators will exercise that discretion).

With a view to creating incentives for banks to adopt more risk-sensitive OR management systems, there might well be, for a transitional period, a discount on the minimum capital requirement for those banks, for example, that while meeting all the quality standards for AMA are partially defective in the quantity standards (for instance, lacking a robust internal data time series) and thus must continue to use STA.

Criteria for risk mitigation via insurance

As to the possibility of a lower capital charge by virtue of insurance policies of more than a year's duration, the Italian banking system would like to point out that the normal operating practice is to renew operational risk insurance annually, and their expiration dates may coincide with a variety of different renewal dates.

Thus on any given observation date for the capital requirement, the residual life of a policy may be less than a year. It therefore seems illogical to pro rate the mitigation effect simply because the policy is subject to renewal. We request, consequently, that for policies that are not one-off but stipulated on a continuing basis, the provision in the second point of §638 on policies with less than a year of residual life should not apply.

Italian banks further consider that the 20% floor for recognition of insurance cover be transitory.

Finally, Italian banks believe that the treatment of "captive" insurance companies under the New Accord is highly severe and could produce

competitive disadvantages for banks. Holdings in insurance companies are deducted 100% from supervisory capital, while policies with "captive" insurance companies are not recognized as reducing the capital requirement, except for the portion that is reinsured.

Finally, the Italian banking system hopes the Committee will not limit the concept of risk transfer to insurance but will also consider other, alternative risk transfer instruments.

Specific criteria for AMA

CP3 allows for calculating the capital charge solely on unexpected losses when the expected losses have been regularly measured and "accounted for". One presumes that accounting for expected losses means not only expressly entering them in the budget but also making specific risk provision.

If this is correct, then in the long run (and in any case once IAS rules are applied) it would seem more appropriate, in order to avoid duplicate provisions (capital + funds), to include any funds allocated specifically to operational risk as part of supervisory capital and thus to calculate the capital charge as the sum of expected and unexpected losses (EL + UL). In the short to medium term some form of reduction of the capital requirement against operational risk should be allowed.

The term "*accounted for*" (§ 629[b]) needs clarification.

Note that in *§*627 of previous versions of the Accord reference is made to 99.9% as an example (e.g.) rather than a requirement (i.e.). At present it is impossible to determine what level of confidence may be considered adequate. As a consequence the Accord should make no reference to any specific value. Further, requiring such a high level of confidence could result in imposing a capital requirement that is too high or not credible (great instability of estimates).

Finally, with reference to §636, we hope that in the process of implementation macro categories of "Business environment and internal control factors" can be identified, as well as the criteria for gathering information on these factors and the procedures for integrating them with the other elements of AMA methods.

Greater flexibility in calculation of risk weights

The new version of the Accord broadens the range of methods of calculation, providing for two forms of Standard Approach, the familiar one plus an Alternative Standard Approach and increasing the possibilities of using hybrid forms, i.e. different methodologies for different business lines.

As for the ASA method, it is our view that replacing "gross income" with volume data such as "loans and advances" for the commercial and retail banking lines, though it improves risk sensitivity, applies to business lines where the correlation between gross income, volume of business and level of operational risk was already not entirely unjustified. At the same time, however, the new approach does not improve the model in business lines where gross income is objectively less well correlated with risk (e.g. trading and sales or corporate finance).

Finally, broadening the range of calculation methods is a benefit during the launch phase, when banks will presumably still be grappling with organizational problems and can benefit from the added flexibility and elasticity.

The need for quality as well as quantity requirements for approval of STA and AMA

The standards reaffirm the rule that the bank must have an operational risk management unit, separate from the audit function, responsible for detecting, measuring, monitoring and controlling operational risk, setting OR policy for the bank, devising and maintaining reporting methods and systems.

These requirements are practically identical for STA and AMA methods. The only difference is that under the latter the quantification of risk is still described as "measurement" rather than "assessment". While we are convinced that this difference is nothing but an oversight but we think that it would be better to use the broader term "assessment" in both cases.

Clarifications

a) §619 of CP3 requires "banks adopting the AMA will be required to calculate their capital requirement using this approach as well as the existing Accord for a year prior to implementation of the New Accord at year-end 2006". As the present Accord does not provide for a capital requirement against operational risk, must one presume that the "joint" calculation means the capital charge on operational risk, together with that against credit risk, is subject to the single floor for the first two years of application of the New Accord?

b) §629(c) says that "a bank's risk measurement system must be sufficiently "granular" to capture the major risk drivers": how is sufficient granularity to be determined?

c) §629(d) - "The bank may be permitted to use internally determined correlations in op risk losses across individual op risk estimates, provided it can demonstrate to a high degree of confidence and to the satisfaction of the national supervisor that its systems for determining correlations are sound, implemented with integrity and take into account the uncertainty surrounding any such correlation estimates": what parameters will be used to assess and hence to validate analyses on correlation between operational losses?

d) Finally §640 allows for partial implementation of AMAs: "On the date of implementation of an AMA, a significant part of the bank's operational risks are captured by the AMA": what is meant by "significant part" of a banks operational risks?

- **Simplified Standard Approach**

The Italian banking system appreciates the introduction of the simplified approach (Annex 9), designed principally for the less complex banks and thus such as to facilitate broader participation in the New Accord. However, we request that banks using the Simplified Standard Approach also be allowed to act as originator and servicer of securitizations.

Pillar 2

As for Pillar 2, the Italian banking community would like supervisors' action to be based on criteria that are harmonized and made known to the industry.

We ask the Committee to consider introducing a netting system to determine total regulatory capital charges when by the Pillar 2 rules different business lines show capital in excess of requirements and capital shortfalls.

Considering that some of the areas of analysis defining the domain of Pillar 2 are listed, and that they include large exposure risk, Italian banks are highly satisfied to note that the differentiation and granularity of portfolios are held to be a major factor in the assessment.

The major international banks certainly already operate with capital ratios significantly above 8%, and the Italian supervisory authorities even today have set Tier 1 target ratios for these banks at above 4%. Nevertheless, Italian banks are concerned at the third principle laid down under Pillar 2, namely that "Supervisors should expect banks to operate above the minimum regulatory capital ratios and should have the ability to require banks to hold capital in excess of the minimum" (§ 715).

In our view it is inappropriate to institutionalize this practice and apply it to all the banks subject to the new regulations, in that the purpose of Pillar 2 should be to create an environment in which (*a*) supervisors can assess the situation of individual banks and (*b*) they can take adequate measures specific to the bank.

The fact is that the objective of keeping the present 8% capital ratio constant is inconsistent with a rule requiring banks to operate above that level. Furthermore, the principle would affect rating agencies, which would be likely to raise their expectations concerning capital ratios.

Finally, we recommend deleting all reference to strategic risk and reputational risk from §700. These types of risk (non-*event risk*) would not appear to fall within the scope of the Accord. Obviously, this affirmation is not intended to downplay the importance of guarding against those risks in banks' operations. The point, instead, is that the bank's capital is not the right instrument for protecting against them.

Pillar 3

The intent has been to produce the most effective possible combination of reflections on the usefulness or necessity of disclosing certain data considered relevant to an effective market discipline, which is the rationale underlying the system outlined in Pillar 3, with the need to take proper account of the implications for the banks of the possibility/necessity of divulgation, notably to the investment community, of the information called for under Pillar 3.

On this general basis, we developed a set of criteria guiding our analysis of the contents implied by Pillar 3 and the resulting observations.

First of all, we have taken account of the major role that will be played by international accounting standards in ensuring adequate market discipline. Specifically, their application will mean a requirement, not just a recommendation, for listed banks (and eventually, one imagines, for non-listed banks as well) to disclose information that in itself will work to the benefit of greater transparency concerning banks' business and results, but that will also entail a cost for the banks. Italian banks accordingly think it would be reasonable, as far as possible, to realise some degree of consistency between the level of detail required by these accounting standards and that envisaged in Pillar 3; this, mainly in order to avoid overlapping and/or redundancy between the two types of disclosure, which would be excessively burdensome to banks in the provision of the information required. It is worth noting, in this regard, that international accounting standards are in constant evolution, and that the Basel Committee's recommendations should therefore adapt to these changing standards.

Second, proper account has been taken of the position held by the prospective recipient of the information envisaged under Pillar 3, and specifically the different nature, but above all the differing informational objectives and different reactions, of investors from those of supervisory authorities. To this end a preliminary analysis was conducted on the level of detail required for various types of information, which in some cases was found to be excessive by comparison with what the banks consider the informational needs of investors to be. Specifically, it was felt that over-detailed information could be too costly for the banks and at the same time misleading for investors, and thus not translate into effective market discipline.

Third, close attention was paid to all those kinds of information that could have significant effects on the market, with impact on banks' competitiveness.

Thus, in keeping with our preliminary considerations and the criteria guiding our comments, the enclosure 1 sets out our comments, drawing on a set of observations made together with a working group of the European Banking Federation. In particular, as was requested in the December 2002 letter of the Transparency Group, for almost each set of data presented in Pillar 3 the paper

gives a judgement on the practicability of providing the data, the burden involved, and any questions of interpretation of the recommendation. These parameters of judgement are followed by a general comment on whether the requirement to provide the given type of information is acceptable or not, with the grounds for any dissent.

Appendices

- **Factoring**

The following appendix summarize the point of view of the Italian Factoring industry (ASSIFACT, Factoring Italian Association), particular with respect to the "Treatment of pool of purchased receivables".

Definition

The New Accord proposes top-down rather than bottom-up treatment of purchased receivables. The provision for pooled treatment that the New Accord introduces is a function of the homogeneousness of the individual exposures within the pool, which is what justifies equal treatment.

With regard to the minimum requirements envisaged in §211, let us set out our observations:

- **The fact of receivables' being purchased from related third parties has no effect on the homogeneousness of the pool of receivables. Our view is that as long as they can be treated as a single risk asset what matters is not the origin but the characteristics of the portfolio. In addition, intragroup transactions consisting of purchases of receivables from other group companies are effected by financial intermediaries under management criteria such as to guarantee the complete independence of this business. We therefore propose to eliminate this requirement (point 1 of §211).**
- **The ineligibility of receivables subject to contra-accounts between firms that buy and sell to each other is reasonable only for those where the seller is involved in the management and collection of trade credits. In Italian practice, the management of trade credits is one of the defining characteristics of receivables purchases, so that no invervention by the seller in the management or collection of the claim is allowed. We therefore suggest that the scope of this requirement be specified (point 2 of §211).**
- **The maximum maturity of receivables for eligibility for this approach is one year. This is adequate, but we consider that it needs to be specified whether it is measured from the purchase or from the time of observation (point 4 of §211).**
- **For purposes of concentration limits, assessing the adequacy of the three measures proposed (the size of one individual exposure rfelative to the total pool; the size of the pool of receivables as a percentage of regulatory capital; the maximum size of an individual exposure in the pool) requires specification of the difference between the notions of pool and of total pool and further study of the operational requirements for the formation of the pool. In any case, we think that measuring concentration via a value ceiling on individual exposures within a pool is not appropriate.**

Weighting default risk

As to note 71, § 334, on discounts refundable to the seller, as an example the text mentions the risk of dilution as the reason why the obligor constitutes the guarantee, which results in an LGD of 0 for the guaranteed portion of the exposure. As the note is in the section on capital requirements against default risk, we consider that a clarification on the source of risk entailing the LGD of 0 (default or dilution) would be helpful.

IRB Foundation treatment

In Italy the business of purchasing corporate receivables is a continuing relationship in which a firm transfers, under Law 52/1991 or under the provisions of the Civil Code, a significant portion of its present or future portfolio of receivables to the assignee, who performs a personalized service characterized by three elements: credit management, guarantee against debtor's insolvency, and lending in the form of advances of the credit. In addition the purchaser of receivables usually also provides services of assessment of debtors, credit recovery and legal consulting (separately or in addition to the characteristic services)

Through the financial component of receivables purchasing, the intermediary advances to the obligor the value of the portfolio of receivables sold. However, the advance does not coincide with the nominal value of the credits, because the intermediary generally applies a discount. In practice, this discount is applied prudentially against the risk of loss in connection with the underlying receivable. Only in some types of transaction, such as the invoice discounting practiced mainly in Britain and the United States, is the advance equal to the nominal amount of the claims assigned.

Accordingly, it should be pointed out that in operations in which the purchaser does not guarantee payment by the debtor (i.e., purchases with recourse) the exposure at default (EAD) is not the value of the portfolio of receivables assigned but the advance to the obligor (§335).

As to the treatment of unutilized margins on "purchasing revolving facilities" granted by intermediaries, we think clarification is needed on the following:

a) ***the reference counterparty of the undertaking to purchase receivables*****: in operating practice, the purchaser may grant the obligor a line for the purpose of credit purchases, the amount of which is often only partially specified in contract, or the assignee may simply acquire the claims on individual debtors without recourse. The difference is fundamental, because as a rule the sum of the limits on acquisition of individual claims differs from the amount of the line of credit granted to the obligor;**

b) ***whether the undertaking is revocable or irrevocable*****, and if irrevocable, its *duration*.**

It is our view, therefore, that the elements set out in points (a) and (b) are relevant in determining EAD when there is an undertaking to purchased receivables and must be treated differently, as there is a different degree of risk for the intermediary. Finally, let us note the inconsistency between the treatment of CCFs between this methodology (a risk weight of 75%) and those under the standard and bottom-up IRB methods (20% and 50% respectively for maturities up to a year and longer; see 56 and 286).

As to the procedure for determining the capital requirement, note that considering the proportionality of the charge *k* with respect to LGD, taking EL equal to PD and LGD equal to 100% may be too prudent, even though it is a formal solution for calculating the capital requirement when the intermediary is unable to decompose EL into PD and LGD. To this end, given the impossibility of estimating the specific contribution of PD and LGD to EL, we feel that as the weighting for corporates is to be applied, the maximum LGD should be equal to that envisaged in the bottom-up approach for firms, i.e. 45% for unsecured non-subordinated and 75% for unsecured subordinated exposures.

Advanced IRB

In the framework of continuing purchases of receivables, in our view the impossibility of using the intermediary's internal estimates of EAD in the advanced approach is not justified by comparison with the rules provided under the bottom-up treatment of other forms of finance. Moreover, we consider that at least this ban must be differentiated according to the features of the undertaking to purchase receivables, as in point (b) of the paragraph on IRB foundation, above.

As for irrevocable undertakings to purchase receivables not covered by "covenants" protecting the financial intermediary in the event of the deterioration in the quality of the claims assigned, CP3 provides that the maturity (M) of the unutilized margins is equal to the sum of the longest-maturity receivable purchasable and the residual maturity of the line of credit granted. Yet in the case of sale of a receivable with maturity longer than that of the credit line, in the period before the expiry of the line it is necessary to subtract from said sum of maturities the days when the line has not yet expired and the longest-maturity claim has already been purchased; otherwise there will be double-counting in determining M.

Weighting the risk of dilution

The capital requirement against the risk of dilution obliges the intermediary to hold additional capital over and above that for default risk. The source of this risk is the possibility that events in connection with the underlying receivable (e.g., compensation or allowances stemming from returns of goods sold, disputes over product quality, and debts of the obligor with the debtor liable for the receivable sold, or any promotions or discounts offered by obligor) can result in losses for the intermediary other than those due to default. In factoring in Italy, in reality, even when a dilution occurs, the loss is actually due to the

risk of default by the obligor's counterparty. For even in assignments without recourse, the master contracts used for the purchase of receivables in Italy provide that the obligor guarantees the existence of the receivable and provides a guarantee against any event relating to it that could result in a decrease in the value of the portfolio of rfeceivables assigned for reasons other than debtor default. Let us note that the prudent discount that the purchaser of the receivable applies when he pays the advance to the obligor is designed precisely to cover this risk, so that exposure to the risk is actually non-existent or in any case negligible. Even in assignments without recourse, if such risk were to arise the purchaser would not be obliged to pay to the obligor the value of the receivables when they fall due. Further, under this method there is a disparity between the treatment of dilution risk and that of lending secured by financial receivables eligible for a 35% risk weight (§481). In that case the risk of dilution does not entail a capital charge but represents a qualitative operational requirement as part of risk management.

From the theoretical standpoint, moreover, default and dilution are treated as two independent risks that can arise simultaneously, since the capital charge obtained is the sum of the two separate items. In reality, however, under Italian contract forms the emergence of dilution risk only results in the risk of default vis-à-vis the obligor.

Furthermore, applying the definition of default given in §414, we find that non-payment due to dilution risk is one of the possible manifestations of default risk (overdue by more than 90 days). This can result in average estimates of PD for the pool of credits that already incorporate dilution risk. Even assuming subjective assessment of the cause of risk (default/dilution), there will be severe problems, both theoretically and operationally, in actually making the distinction.

Italian intermediaries also have doubts concerning the treatment of dilution risk according to the weighting function for the corporate portfolio.

In consideration of the foregoing, we suggest abrogating the capital charge against the risk of dilution both in pooled treatment and in the IRB approach (foundation and advanced alike), following bottom-up treatment of purchased corporate receivables.

Specific requirements for estimating PD and LGD (or EL) on eligible receivables

Financial intermediaries generally purchase receivables through a series of purchase agreements with various obligors.

The operational requisites for estimating the risk parameters lay down that the pool of receivables must be sufficiently homogeneous, reflecting the credit practice of the obligor and the diversity of its customers. As the standard practice is to acquire receivables from a number of different obligors, in our view it is sufficient to specify the number of persons from which receivables may be purchased (one obligor, more than one obligor); see §455. This is relevant both for application of this type of treatment of purchased receivables and to how the pool of receivables is formed. On the formation of the pool, the procedures possible include the following (and combinations thereof):

a) *n* pools for 1 obligor, so that all told for *m* obligors a total of *n x m* pools could be formed. By this procedure receivables that are homogeneous in type but purchased from different obligors could not form part of the same pool;
b) *n* pools of receivables, grouped by obligor's business (segmentation by obligor);
c) *n* pools of receivables, grouped by type of contract under which the receivables are purchased (segmentation by product);
d) *n* pools of receivables, grouped by the obligor's debtor (segmentation by debtor); under this method, the purchaser could form the entire set of receivables purchased from several obligors into homogeneous groups of receivables, having a large enough number of observations to produce robust estimates of the risk parameters for each pool.

Considering the specificities of this business, procedure (d) would appear the best for the typical factoring business. It permits the purchaser to group homogeneous receivables into homogeneous pools even if they are purchased from different obligors. We think this way of pooling ensures large enough numbers – in any event larger than in case (a) – to build robust risk parameter estimates.

- **Leasing**

The following appendix is constituted by the position paper of the Italian Leasing industry (ASSILEA, Leasing Italian Association).

Issues relating to finance leases

Specific requirements expressly concerning leasing transactions have been introduced for the first time in Section H, "Minimum requirements for IRB approach", sub-section 10.

Paragraph 486

The relevant provision is that finance leases[7] *"will be accorded the same treatment as exposures collateralised by the same type of collateral... (CRE/RRE or other collateral)"* This requirement appears to be exceedingly penalising for leasing transactions, on the one hand, and unsure as to actual applicability on the other hand. For:

1. It appears penalising in that the legal ownership title to the leased asset allows the lessor to rely on far better recovery time and rates (i.e. lower LGDs) than in the case of similar asset finance transactions merely secured by mortgage or pledge, in connection wherewith the Bank of Italy has long

[7] The actual wording in the Basel document is, in fact: "Leases other than those that expose the bank to residual value risk", a phrase that appears to refer to the definition of a Finance Lease given by IAS 17.

collected ample statistical evidence showing that real estate leases have a far lower risk content than CRE lending transactions; and

2. **It appears unsure as to actual applicability in that the "risk mitigation" effect implied in leasing transactions is fully available not only in the case of "immovable" (real) property, but in the case of other medium-to-high fungibility leased assets as well (e.g. motor vehicles, aircraft or printing presses), whereas paragraphs 484 and 485 require that national supervisors may allow for recognition of "other physical collateral", provided that certain standards which most leases are likely to comply with are met.**

As for the first issue, having regard to the considerable size of the Italian real-estate leasing market (one on the leading edge in Europe) and to the firmly-established low risk content of this specific asset finance instrument, though in the awareness that the level of risk associated with leases may vary from a country to another even to a large extent, and because of the different contractual, commercial and operational terms applied in practice in any one country relative to another, it is hereby suggested that each national Supervisory Authority should be allowed:

- **under the Standardised IRB Approach, as similarly provided for in footnote 21 to paragraph 47 (CRE), to assign a separate, specific risk weight to real estate leases – equal to the risk weight accorded, for example, to RE (35%) or, at least, to the one currently in force (50%) for total exposure;**
- **under the Foundation IRB approach, as similarly provided for in footnote 64 to paragraph 258, to assign a separate, specific LGDs to real estate leases, at a lower rate than the average LGD applied to CRE (35%), and not to require over-collateralisation or, in the alternative, only to require over-collateralisation at a lower level than that required with respect to CRE (140%, see para. 264); and**
- **under the Advanced IRB Approach, as similarly provided for in paragraph 298 with respect to RRE, to apply a specific, more favourable formula to the calculation of risk weights in the case of real estate leases.**

As for the second issue, it is by no means clear at this time whether or how leases should be recognised depending on the type of leased assets for the purposes of risk mitigation. Should they not be so recognised, finance leases (possibly with the exception of real estate leases) would incorrectly be treated as plain unsecured loans at all times, even in case the relevant leased asset has a high or good fungibility. Therefore, it appears necessary to clarify the extent of, and any requirements applicable to, the recognition of the leasing of assets other than real estate. Thus:

- **in respect of the Standardised IRB Approach,**
    - **national supervisors should be allowed to introduce more favourable risk weights for leases of highly fungible assets with a secondary market meeting the requirements under paragraph 484 (e.g. motor cars, ships, aircraft, etc.); and**
    - **the possibility should be restated for leasing companies to rely on the effects provided for in paragraph 50 with respect to loans past**

due more than 90 days[8] wherever any such loan is covered in full by other forms of "eligible collateral";

- **in respect of the Foundation IRB Approach, the 40% LGD applicable to loans secured by other forms of "eligible collateral" (see paragraph 258) should be recognised, much as such 40% rate appears exceedingly penalising for many types of leased assets in any event, and so appears to be the required level of over-collateralisation (140%, see paragraph 264); and**
- **in respect of the Advanced IRB Approach, a specific, more favourable formula should be applied to the calculation of risk weights for leases relating to highly fungible assets.**

Paragraphs 191, 194 and 195

It is unclear whether the provisions set out in relation to "physical assets" intended for specific uses (e.g. ships, aircraft and others), as well as to IPRE and HVCRE, should only be applied – as one may construe in some respects – within the context of project financing transactions. In any event, the possible application of the treatment required with respect to these asset classes to leasing would be entirely inappropriate, artificially complex and unreliable, in addition to being highly penalising for the leasing business at large. More specifically, it should be pointed out that, in the case of HVCRE assets – which may be taken also to include leasing exposures to real estate under construction (for which a more careful treatment than that of real estate already constructed would otherwise appear to be unjustified) – the resulting adverse impact may be even worse, since (see §. 220) they are excluded from the estimates under the Advanced IRP approach or (if so allowed by the national supervisor, see §. 252) only admissible with an extremely penalising "correlation".

Paragraphs 277, and 436 through 439

The requirement is that, in calculating EAD (Exposure at default), *"for on-balance sheet items, banks must estimate EAD at no less than the current drawn amount"*. In fact, since PD is to be calculated on the basis of a 12-month time horizon, assuming an EAD equal to the exposure obtaining at the time of estimation would be penalising in the case of leases and of transactions with principal repayments at fixed dates in general vs., for example, exposures to revocable overdraft accounts. It is unclear whether, in these particular cases, the use of statistical models is permitted in estimation of EADs.

Paragraphs 373

Much as the principle that *"banks must take all relevant available information into account in assigning ratings to borrowers"* and that *"information must be current"* may well be shared in theory, it appears appropriate, in the case of leases and other finance transactions not revocable by the bank, to provide for a different depth of the analysis for rating assignment depending on the specific

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[8] In this connection, it is unclear whether, in light of the option granted to the Bank of Italy to use a 180-day definition of "default", as opposed to 90 days, in the case of retail and PSE credit obligations (see footnote 80 to §. 414), reliance can be made by Italian lessors on obligors past due more than 180 days in this case as well.

stage of such analysis, whether when granting a rating or when merely monitoring creditworthiness. Incurring exceedingly high costs to update all the data and information which was just reasonable to collect at the time of lending would otherwise be inconsistent with the different, comparatively minor, purposes of merely monitoring the performance of a loan outstanding.

Issues relating to operating leases

Paragraph 487

The requirement here is that a specific treatment should be applied to operating leases (as defined by IAS 17), i.e. leasing transactions in which "residual value risk" rests with the lessor.

One first comment is that this specific requirement as set out in the Basel Accord shows that, at least under some national supervisors' regulations (presumably in the US and in the United Kingdom), this type of risk is allowed to lie with the leasing companies subject to supervision in those jurisdictions. This is a business segment which is, however, still precluded to leasing companies subject to supervision in Italy. Thus, Italian supervised leasing companies are forced – if interested in operating leasing – to work through commercial subsidiaries outside the scope of consolidation of the banking group concerned. Therefore, the specific requirement set out in the New Basel Capital Accord leads up to thoughts about the expediency of revising Italy's entire regulatory framework with a view to allowing Italian supervised leasing companies – as is the case in other countries – to do business in the operating leasing segment as well and, accordingly, to take residual values risks on themselves. Obviously enough, there are questions still open to scrutiny with respect to the predictable impact on the competitive balance, since non-supervised commercial companies – which are relieved, as such, of the burden of supervisory regulations and regulatory capital requirements in "operational" terms – are most likely to continue to work in the operating leasing segment. The resulting asymmetry may be offset at least in part through the recognition – as oftentimes recommended – of the same treatment of loans issued to supervised leasing companies as the treatment accorded to loans issued to banks.

As for the treatment of *"residual value risk"* recommended by the Basel Committee, it should be pointed out that, in order for capital charges to be correctly measured against the risk actually assumed, it appears more appropriate to apply a 200% risk weight to the portion of residual value in excess of 50% of the presumable fair value of the asset at the time of expiry of the lease term. In this way – the measure of the average capital requirement set out by the Basel Committee being kept unchanged – the lessors that are the more "prudent" in predicting final residual values will be "rewarded", whereas those that assume residual values which are close to, or the same as, presumable fair values at lease expiry will be "punished".

Issues relating to supervised leasing companies

Paragraph 39 (SA) – 198 (IRB)

In Italy as well as in France – though to a slightly different extent – most leasing companies are supervised direct by the national supervisor, whether out of their status as banks or because they are entered in the Special List provided for by Article 107 of the Italian Consolidating Banking Act (TUB).

In the same way as provided for with respect to claims on supervised securities firms, it now appears anachronistic and penalising not to treat claims on supervised leasing companies in the same manners as claims on banks – at least with respect to leasing companies that are members of banking groups, thus already subject to compliance with "consolidated" capital requirements and supervisory regulations.

- **Private Equity and Venture Capital**

This appendix represents a general assessment on possible impacts of the New Basel Capital Accord on the Italian Private Equity and Venture Capital market, and it includes the A.I.F.I. position paper with reference to the above mentioned Accord.

Impact assessment

In order to assess the impact of "Basel 2" provisions, in the following section we try to simulate some hypothesis that a bank should evaluate when it carries out an investment decision, considering that, within the Accord, the acquisition of equity securities is considered a high-risk activity, therefore "costly" in terms of capital requirements.

Consider the following examples.

Example 1 – Comparison between a bank loan and an equity acquisition in a company with an external rating
Comparison between:

- **bank loan granted to a corporate rated B by S&P (annual default rate equal to 9,29%)**
- **equity acquisition of a corporate rated AAA (default rate equal to 0%).**

In the first hypothesis (bank loan) the risk weight required is equal to 241%, in the second one (given that the corporation is quoted) it is equal to 200%, if the bank has already provided finance to the company and owns detailed information in the corporation, or equal to 300% if at least one of those two conditions is missing.

Example 2 – Comparison between bank loan and an equity acquisition in a SME with a turnover equal to 13 mln. Euro
Comparison between:

- **bank loan granted to a corporate-SME in the lowest rating range class (annual default rate equal to 11,84%)**
- **equity acquisition of a corporate-SME in the best internal rating range class (default rate equal to 0%).**

In the first hypothesis (bank loan) the risk weight required is equal to 221%, in the second one (given that the corporate in unquoted) is equal to 300%.

These two examples show how the equity acquisition activity in company with virtual zero risk (in one year horizon time) obliges the bank to set aside more capital than in case of debt granting activities in favour of companies with higher expected losses.
This mechanism, inter alia, brings about a market distortion, considering that it is not rationally explainable why the provision should penalize an equity investment in a company with a low PB (probability of default), in favour of debt investments in a riskier company (in terms of PB)

Example 3 – Comparison between bank loan and equity acquisition in a corporate

- **equity acquisition in an unquoted corporate rated B+ (PD=3,24%)**
- **bank loan granted to a quoted corporate rated BB (PD=1,07%)**

The weight calculated with the QIS3 provisions, following the PD/LGD approach, is equal to 299% (up to 300% by the regulatory threshold) in the first hypothesis (bank loan) and equal to 200% in the second hypothesis.
This example highlights how an approach based on PD and LGD (with a given high LGD equal to 90%, a value twice as much as the LGD value for an unsecured credit) determines a capital requirement lower than the one set by the regulatory threshold equal to 300% when the company (unquoted) is rated (referred to the S&P scale) above B+. If the company is quoted, the threshold is BB (i.e. the PD is equal to 1,07%).
All this means that in the first case (unquoted company), companies rated above B+ seem to be penalized. In the second one, on the other hand, the penalization deriving form the regulatory ratio in applied only to companies with a rating above BB.

Moreover, in order to assess the real impact of the Accord on equity investment activities carried out by banks, it is possible to use performance average industry data shown in the research undertaken by A.I.F.I., in collaboration with KPMG, on a sample of 55 primary players in the Italian market, and a total of 202 realized[9] investments, on a time period ranging from 1990 to 1999.
Results show that the Italian market is characterized by a positive trend and a significant 40.3% IRR[10].
Observing the IRR distribution by class of returns, it is to notice that the percentage incidence of the amount of deals with a negative return is equal to

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9 As far as the EVCA (European Venture Capital Association) methodology is concerned, investments are realized when at least 30% of the initial equity investment is divested.

10 The Pooled IRR is a performance index resulting form the aggregation of cash flows, as if they were generated by a single fund.

6,9%. If we take this value as a good proxy of the average industry loss (counterbalanced by high capital gain obtained in all the deals with IRR>0) and considering the case of an investment in a private equity fund, that guarantees a good diversification, a LGD value equal to 90% (as indicated in the new Basel Capital Accord) is definitely penalizing.
Finally, considering a capital ratio equal to 8% (unchanged with reference to the 1988 Accord), amounts invested in the private equity (and venture capital) asset class will call for a capital requirement equal to 32% of the total investment (if we consider a weight equal to 400%) or to 24% of the total investment (if we consider a weight equal to 300%). By the analysis of this methodology indicated by the Accord, a bank willing to invest 100 in the private equity asset class, will have to set aside into reserves 32 (or 24) compared to a requirement equal to 8 in case of an investment in an activity rated between B- and BB+ (with a weight equal to 100%). Therefore, an equity investment, independently from the target company "quality", is always considered worst than an investments with a B- rating.

	Hyp. A	Hyp. B	Hyp. C
Invested amount	100	100	100
Weight	100%	300%	400%
Capital ratio (Cooke)	8%	8%	8%
Capital requirement	8,00	24,00	32,00
Cost of equity	10,00%	10,00%	10,00%
Funding	92,00	76,00	68,00

A.I.F.I. (Italian Private Equity and Venture Capital Association) Position Paper

By the analysis of the documentation produced by the Basel Committee which, in the final version, will replace the 1998 Accord, we have indicated some remarks with reference to the negative impact that those provisions may have on the private equity and venture capital players belonging to the banking industry.

A.I.F.I. is particularly committed to those potential impacts since, on the basis of the evidence shown by the A.I.F.I.-PricewaterhouseCoopers data on the Italian private equity and venture capital market, banks represent, in Italy, the primary source of capital raised for private equity.

On a quantitative basis, as a matter of fact, this kind of player represented, since 2000, a percentage equal to 35% of the total amount raised on the market yearly. This value is well above the European average that, in the last five years, fluctuated between 25% and 30% and it is in line with other European countries where the banking sector is the most important source for private equity and venture capital (such as France and the Netherlands)

To explain the relevance of the private equity industry in Italy, it is worthy noticing that Italian private equity and venture capital market more than tripled form 1999 and 2000, reaching almost 3.000 Euro million in 2000, in terms of amount invested. Furthermore, in 2001, the Italian market suffered from its first setback that, even tough, was lower than the average European decrease. Moreover, data about the Italian 2002 market show a relevant upward movement. Invested amount reached 2.626 Euro million, positioning the Italian market in the third position in Europe, just after the UK and France.

In general, with reference to benefits of the venture capital and private equity activity for the development of a country and for its economic growth, lots of studies evidenced the importance of the contribute provided by the risk capital activity. The injection of risk capital in selected high growing companies fosters R&D and investments programs and also enables acquisition projects.

In particular, those studies show, for a definite time range, that growing ratios for venture backed companies well above the top tier European and American companies, in terms of turnover, export, employment, gross returns.

As far as remarks and data above are concerned, we point out that A.I.F.I., even understanding the general goals that the Committee is looking for with the New Basel Capital Accord, expresses concerns that the new Accord provisions may discourage the banking sector from investing in the private equity and venture capital asset class.

As a matter of fact, as far as the technical guidance is concerned11, the application of new rules for equity exposure would call for weight ratios equal to 400% (in case of use of "market - based approach") and equal to 300% (in case of use of PD/LGD approach). This means that, in case of use of a 400% weight, the capital requirement for private equity and venture capital exposure will raise from 8% to 32%, potentially decreasing the direct contribution of banks either to closed-end private equity funds and to banks private equity specialized divisions.

We would like to underline that the cited rules, indicated by the New Accord, do not consider at all the specificities of private equity and venture capital investment activity, some of which are:

- **a double principle of risk diversification is valid. At the first level, banks invest in different private equity funds and, at the second level, funds, invested by banks, invest in different companies;**
- **a portfolio made of target companies is naturally affected by a certain number of bankruptcies (called write offs). This value is more than offset by extra-returns gained by the divestment of all the other participations. This reasoning is valid, more than in other countries, in the Italian**

11 Basel Committee on Banking Supervision, Quantitative Impact Study 3 Technical Guidance, October 2002.

market that registered a lower write off ratio and higher returns ratios than the European average;

- **risks and returns of the private equity and venture capital activity highly fluctuate depending on the investment stage, since early stage investments are characterized by higher returns and higher risks.**

In conclusion, the depicted situation would imply a dangerous threat for the Italian market. The danger is represented by the weakening not only of the main source of capital for private equity, but also of the only internal source of capital, since pension funds and funds of funds still play a marginal role in our industry.

We thereby firmly believe that it is necessary to suggest a revision of the above mentioned parameters mindfully considering: i) the impact on the Italian and other European private equity and venture capital market, and also ii) the specificity of the private equity and venture capital asset class.

Enclosure: ABI comment on Pillar 3

The Third Pillar – Market Discipline

QL = qualitative disclosures; QT = quantitative disclosures

1.1 Scope of application

CP 3 – BASEL II (Table 1 – p157)	Comment
QL : a. The name of the top corporate entity in the group to which the Basel Accord applies.	Agreed.
QL : b. An outline of differences in the basis of consolidation for accounting and regulatory purposes with a brief description of the entities within the group (a) that are fully consolidated ; (b) that are pro-rata consolidated ; (c) that are given a deduction treatment ; and (d) from which surplus capital is recognised plus (e) that are neither consolidated nor deducted (e.g. where the investment is risk weighted).	Agreed.
QL : c. Any restrictions, or other major impediments, on transfer of funds or regulatory capital within the group.	Unclear: examples are necessary. f it is not clarify the comparison could be difficult.
QT : d. The aggregate amount of surplus capital of insurance subsidiaries (whether deducted or subjected to an alternative method) included in the capital of the consolidated group.	We do not agree because, in our opinion, it is the responsibility of the supervisor to ascertain that these subsidiaries are well capitalised and it is not the bank's task to disclosure under-capitalisation of other financial institutions.
QT : e. The aggregate amount of capital deficiencies in all subsidiaries not included in the consolidation.	Same remark as in d).
QT : f. The aggregate amount (e.g. current book value) of the firm's total interest in insurance entities, which are risk weighted rather than deducted from capital or subjected to an alternative group-wide method, … . In addition, indicate the quantitative impact on regulatory capital of using this method versus deduction or alternate group-wide method.	Same remark as in d).

Enclosure: ABI comment on Pillar 3

1.2. Capital structure

CP 3 – BASEL II (Table 2 – p158)	Comment
QL : a. Summary information on the terms and conditions of the main features of all capital instruments, especially in the case of innovative, complex or hybrid capital instruments.	Agreed.
QT : b. The amount of tier 1 capital, with separate disclosure of: ? paid-up share capital/common stock ; ? reserves ; ? minority interests in the equity of subsidiaries ; ? innovative instruments ; ? other capital instruments ; ? surplus capital from insurance companies ; ? goodwill and other amounts deducted from tier 1.	Banks should not be required to publish their capital structure any more frequently than they are required to issue financial reports to the market. We do not agree that there should be mandatory quarterly disclosure of capital adequacy ratios and their components. In many parts of the world there is no requirement for quarterly financial reporting and we do not believe that it is appropriate to disclose regulatory capital details without the corresponding financial information. To do so would invite speculation on capital ratio movement figures, and encourage the analyst community to infer price-sensitive information from the capital data and thereby place banks in an impossible position to challenge erroneous extrapolation of the capital movement figures without selectively disclosing other price-sensitive data. For significant subsidiaries, it should only be disclosed if these subsidiaries are listed.
QT : c. The total amount of tier 2 and 3 capital.	Agreed.
QT : d. Deductions from tier 1 and tier 2 capital.	Agreed.
QT : e. Total eligible capital.	Agreed.

1.3. *Capital adequacy*

CP 3 – BASEL II (Table 3 – p159)	Comment
QL : a. A summary discussion of the bank's approach to assessing the adequacy of its capital to support current and future activities.	This information is highly price sensitive and if is not clarify the comparison could be difficult. So that, we strongly oppose disclosure of the group's capital management strategy and contingency planning.

QT : b. Capital requirements for credit risk :
- portfolios subject to STA or simplified standardised approaches ;
- portfolios subject to IRB approaches:
  - corporate, interbank, and sovereign ;
  - residential mortgages ;
  - qualifying revolving retail ;
  - other retail.
- securitisation exposures.
	Agreed.

QT : c. Capital requirements for equity risk in the IRB approach :
- Equity portfolio subject to the market-based approaches;
  - Equity portfolio subject to simple risk weight method; and
  - Equities in the banking book under the internal models approach (for banks using IMA for banking book equity exposures).
- Equity portfolios subject to PD/LGD approaches.
	Agreed.

QT : d. Capital requirements for market risk : - STA ; - Internal models approach: - Trading book.	Agreed.
QT : e. Capital requirements for operational risk: ? Basic indicator approach; ? Standardised approach; ? Advanced measurement approach.	Agreed.
QT : f. Total and Tier 1 capital ratio: ? For the top consolidated group; ? For significant bank subsidiaries (stand alone or sub-consolidated depending on how the Capital Accord is applied).	Disclosures for significant banking subsidiaries should be limited to those which are required to publish financial statements in their own right, and should be included into the subsidiary's accounts (because of timing difficulties).

1.4. General qualitative disclosures

CP 3 – BASEL II § 773 – p 160	Comment
QL : a. for each risk area banks must describe their risk management objectives and policies including : - strategies and processes ; - structure and organisation of the relevant risk management function ; - scope and nature of risk reporting and/or measurement systems ; - policies for hedging and/or mitigating risk and strategies and processes for monitoring the continuing effectiveness of hedges/mitigants.	Agreed.

1.5. Credit risk :general disclosures for all banks

CP 3 – BASEL II (Table 4 – p 160)	Comment
QL : a. The general qualitative disclosures requirement (cf 1.4) with respect to credit risk, including: - Definition of past due and impaired (for accounting purposes) ; - Definition of approaches followed for specific and general allowances and statistical methods ; - Discussion of the bank's credit risk management policy.	The definition of past due and impaired is now qualified by the words "for accounting purposes". We support consistency between regulatory and accounting definitions and measures in principle. However, this creates a dependency on accounting rules in a scenario where these have not yet been finalised, particularly in IAS30/32/39, some proposals in which the banks are still contesting. While there is no common understanding between regulators and accounting standard setters about provisioning, this may not be helpful.
QT : b. Total gross credit risk exposures, plus average gross exposure over the period broken down by major types of credit exposure.	We do not agree with the requirement to provide average balances. This information is not required under Pillar 1 and could lead to a difficult comparison as a consequence of different calculation methodology.
QT : c. Geographic distribution of exposures, broken down in significant areas by major types of credit exposure.	Agreed, assuming that the geographical areas are wide and in line with internal management reporting.
QT : d. Industry / counterparty type distribution of exposures, broken down by major types of credit exposure.	Agreed at one line disclosure, assuming 5 or 6 counterparty classes.
QT : e. Residual contractual maturity breakdown of the whole portfolio, broken down by major types of credit exposure.	Agreed at one line disclosure as required for accounting purposes by IAS 30/IAS 32. We agree that this is relatively straight forward to disclose, but do not consider that this disclosure reflects the way the risk is managed. For risk management purposes, the portfolio is managed based on its behavioural maturity characteristics and not its contractual maturity. Therefore this disclosure may be meaningless or positively misleading if taken to be a measure of risk exposure. Behavioural data is not amenable to the same kind of detailed quantitative analysis as contractual maturity and would be more appropriately dealt with in the qualitative disclosures.
QT : f. By major industry or counterparty type: - Amount of past due/impaired loans; - Specific and general allowances; and - Charges for specific allowances and charge-offs during the period.	We do not agree. This information could be very misleading for those country were the payment systems are characterised by strong delays.
QT : g. Amount of impaired loans and past due loans broken down by significant geographic areas including, if practical, the related amounts of specific and general allowances.	Same remark as in f).
QT : h. Reconciliation of changes in the allowances for loan impairment.	Agreed.

1.6. Credit risk : disclosures for portfolios subject to the standardised and supervisory risk weights in the IRB approaches

CP 3 – BASEL II (Table 5 – p 161)	Comment
QL : a. For portfolios under STA : - Names ECAI and ECA used, plus reasons for any changes ; - Types of exposures for which each agency is used ; - a description of the process used to transfer public issue ratings onto comparable assets in the banking book ; - the alignment of the alphanumerical scale of each agency used with risk buckets.	Agreed.
QT : b. - For exposures subject to the standardised approach, amount of a bank's outstandings (rated and unrated) in each risk bucket as well as those that are deducted; and - For exposures subject to the supervisory risk weights in IRB (HVCRE, any SL products subject to supervisory slotting criteria and equities under the simple risk weight method) amount of a bank's outstandings in each risk bucket.	Unnecessary and too costly. This potentially presents a misleading picture of the credit risk profile, particularly if numerous local rating agencies are used. There are significant variances in the performance of the individual ratings, the rated instrument and a bank credit facility. Transposing bank internal ratings into multiple external ratings in order to calculate regulatory capital could present a misleading view of the risk profile. We recommend that quantitative disclosures be based on a bank's internal rating risk profile, restricted to material portfolios, with the qualitative disclosures as proposed.

1.7. Credit risk : disclosures for portfolio's subject to IRB approaches

CP 3 – BASEL II (Table 6 – p 162)	Comment
QL : a. Supervisor's acceptance of approach / supervisory approved transition.	Agreed.
QL : b. explanation and review of the : - structure of internal rating system and relation between internal and external ratings ; - use of internal estimates other than for IRB capital purposes ; - process for managing and recognising Credit Risk Mitigation ; - Control mechanisms for the rating system including discussion of independence, accountability and rating systems review.	Agreed.
QL : c. Description of the internal ratings process, provided separately for five distinct portolios: - Corporate (including SMEs, specialised lending and purchased corporate receivables), sovereign and bank; - Equities; - Residential mortgage; - Qualifying revolving retail, and - Other retail. The description should include, for each portfolio: - The types of exposure included in the portfolio; - The definitions, methods and data for estimation and validation of PD, and for portfolios subject to the IRBA, the LGD and/or EAD, including assumptions employed in the derivation of these variables; and - Description of deviations as permitted under paragraph 418 and footnote 84 from the reference definition of default where determined to be material, including the broad segments of the portfolios affected by such deviations.	Agreed.
QT : d. Percentage of total credit exposures (drawn plus EAD on the undrawn) to which IRB approach disclosures relate.	Agreed.

QT : e. For each portfolio (as defined above) except retail: - Presentation of exposures (outstanding loans and EAD on undrawn commitments, outstanding equities) across a sufficient number of PD grades (including default) to allow for a meaningful differentiation of credit risk; - For banks on the IRB advanced approach, default-weighted average LGD (percentage) for each PD grade (as defined above); and - For banks on the IRB advanced approach, amount of undrawn commitments and default-weighted average EAD; For retail portfolios (as defined above), either: - Disclosures outlined above on a pool basis (i.e. same as for non-retail portfolios); or - Analysis of exposures on a pool basis (outstanding loans and EAD on commitments) against a sufficient number of EL grades to allow for a meaningful differentiation of credit risk.	As indicated in our general comment, in our view, the capacity of the market to understand these detailed prudential figure is overestimated by the Basel Committee. We are also concerned that detailed disclosures for PD, LGD, and EAD data might be sensitive, if thinly broken down, and might lead to erroneous judgements by non-informed market participants (against the background of rumour-driven market volatility).
QT : f. Actual losses (e.g. charge-offs and specific provisions) in the preceding period for each portfolio (as defined above) and how this differs from past experience. A discussion of the factors that impacted on the loss experience in the preceding period – for example, has the bank experienced higher than average default rates, or higher than average LGDs and EADs.	Agreed.
QT : g. Banks' estimates against actual outcomes over a longer period. At a minimum, this should include information on estimates of losses against actual losses in each portfolio (as defined above) over a period sufficient to allow for a meaningful assessment of the performance of the internal rating processes for each portfolio. Where appropriate, banks should further decompose this to provide analysis of PD and, for banks on the advanced IRB approach, LGD and EAD outcomes against estimates provided in the quantitative risk assessment disclosures above.	Agreed.

1.8 Equities : disclosures for banking book positions

CP 3 – BASEL II (Table 7 – p 165)	Comment
QL : a. The general qualitative disclosure requirement (above) with respect to equity risk including : - Differentiation between holdings on which capital gains are expected and those taken under other objectives including for relationship and strategic reasons ; - Discussion of important policies covering the valuation and accounting of equity holdings in the banking book. The includes the accounting techniques and valuation methodologies used, including key assumptions and practices affecting valuation as well as significant changes in these practices.	Agreed.
QT : b. Value disclosed in the balance sheet and fair value of investments and, for quoted securities, comparisons to publicly quoted share values (where the share price is materially different from fair value).	Unnecessary. If there are public quotations for stocks and shares, they represent – .given the liquidity of markets – the fair value. Apart from that, no other theoretically founded at and the same time realisable model for the calculation of fair values of illiquid positions exists. In the light of the crucial significance of a permanent or long-term equity financing of small and medium-sized businesses by financial institutions, information is irrelevant for these cases.
QT : c. The types and nature of investments, including the amount that can be classified as : - Publicly traded; - Privately held.	Agreed.
QT : d. The cumulative realised gains (losses) arising from sales and liquidations in the reporting period.	Agreed.
QT : e. Unrealised or latent revaluation gains (losses) included in Tier1 and/or Tier 2 capital.	Agreed.
QT : f. Capital requirements broken down by appropriate equity groupings consistent with the bank's methodology, as well as the aggregate amounts and the type of equity investments subject to any supervisory transition or grandfathering provisions regarding regulatory capital requirements.	Agreed.

1.9 Credit risk mitigation techniques: disclosures for standardised and IRB approaches

CP 3 – BASEL II (Table 8 – p 166)	Comment
QL : a. The general qualitative disclosure requirement (above) with respect to credit risk mitigation : - policies and processes for, and an indication of the extent to which the bank makes use of, on- and off-balance sheet netting; - policies and processes for collateral valuation and management; - a description of the main types of collateral taken by the bank; - the main types of guarantor/credit derivative counterparty and their creditworthiness; and - information about (market or credit) risk concentrations within the mitigation taken.	Agreed.
QT : b. For each separately disclosed credit risk portfolio under the standardised and/or foundation IRB approach, the total exposure (after netting) that is covered by: - eligible financial collateral; and - other eligible IRB collateral; before the application of haircuts.	Agreed.
QT : c. For each separately disclosed portfolio under the standardised and/or IRB approach, the total exposure (after netting) that is covered by guarantees/credit derivatives.	Agreed.

1.10 Securitisation : disclosure for standardised and IRB approaches

CP 3 – BASEL II (Table 9 – p 166)	Comment
QL : a. The general qualitative disclosure requirement (above) with respect to securitisation, (including synthetics), including a discussion of : - the institution's objective in relation to securitisation ; - The roles played by the bank in the securitisation process (e.g. originator, investor, servicer, provider of credit enhancement, sponsor of asset backed commercial paper facility, liquidity provider, swap provider, etc…) and an indication of the extent of the bank's involvement in each of them.	Assets are securitised for a variety of reasons including to manage portfolio risks, to reduce regulatory capital requirements and to fund new business. In practice, the rationale for securitising assets will be a combination of, to a lesser or greater extent, all of these factors. This rationale is confidential to the institution and should not form part of a disclosure requirement. However, we would be prepared to provide general, high level disclosures.
QL : b. Summarise the bank's accounting policies for securitisation activities, including : - Whether the transactions are treated as sales or as financings; - Recognition of gain on sale; - Key assumptions for valuing retained interests; - Treatment of synthetic securitisations if this is not covered by other accounting policies (e.g. on derivatives).	The requirement should be in accordance wit IAS. If derecognition is absolute, there should be no requirement for any further disclosures. Where risks or rewards are retained, then disclosures should be limited to the retained interests.
QL : c. Names of ECAIS used for securitisations and the types of securitisation exposure for which each agency is used.	Agreed.
QT : d. The total outstanding exposures securitised by the bank and subject to the securitisation framework (broken down into traditional/synthetic), by exposure type.	Agreed.
QT : e. For exposures securitised by the bank and subject to the securitisation framework: - Amount of impaired/past due assets securitised; and - Losses recognised by the bank during the current period. Broken down by exposure type.	Agreed.
QT : f. Aggregate amount of securitisation exposures retained or purchased broken down by exposure type.	Agreed.
QT : g. Aggregate amount of securitisation exposures retained or purchased broken down into a meaningful number of risk weight bands. Exposures that have been deducted should be disclosed separately.	Agreed.
QT : h. Aggregate outstanding amount of securitised revolving exposures segregated by originator's interest and investors' interest.	Agreed.
QT : i. Summary of current year's securitisation activity, including the amount of exposures securitised (by exposure type), and recognised gain or loss on sale by asset type.	Agreed.

1.11 Market risk
Disclosures for banks using the standardised approach

CP 3 – BASEL II (Table 10 – p 167)	Comment
QL : a. The general qualitative disclosure requirement (above) for market risk including the portfolios covered by the standardised approach.	Agreed.
QT : b. The capital requirements for: - interest rate risk; - equity position risk; - foreign exchange risk; - commodity risk.	Agreed.

1.12 Market risk
Disclosures for banks using the IMA for trading portfolios

CP 3 – BASEL II (Table 11 – p 168)	Comment
QL : a. The general qualitative disclosure requirement (above) for market risk including the portfolios covered by the IMA.	Agreed.
QL : b. For each portfolio covered by the IMA: - the characteristics of the models used; - a description of stress testing applied to the portfolio; - a description of the approach used for backtesting/validating the accuracy and consistency of the internal models and modelling processes.	Agreed.
QL : c. The scope of acceptance by the supervisor.	Agreed.
QT : d. For trading portfolios under the IMA: - The aggregate value-at-risk (VaR); - The high, median and low VaR values over the reporting period and period-end - A comparison of VaR estimates with actual outcomes, with analysis of important “outliers” in backtest results.	This information is more typically provided under Pillar 2.

Enclosure: ABI comment on Pillar 3

1.13 Operational risk

CP 3 – BASEL II (Table 12 – p 168)	Comment
QL : a. In addition to the general qualitative disclosure requirement (above), the approach(es) for operational risk capital assessment for which the bank qualifies.	Agreed.
QL : b. Description of the advanced measurement approach, if used by the bank, including a discussion of relevant internal and external factors considered in the bank's measurement approach. In the case of partial use, the scope and coverage of the different approaches used.	Agreed.
QT : c. For banks using the AMA, the operational risk capital charge before and after any reduction in capital resulting from the use of insurance.	Too prescriptive. We are strongly opposed to any quantitative disclosures with respect to operational risk other than in aggregate. Any disclosures should be restricted to operational risk management objectives and policies.

1.14 Interest rate risk in the Banking Book (IRRBB)

CP 3 – BASEL II (Table 13 – p 168)	Comment
QL : a. The general qualitative disclosure requirement (above), including the nature of IRRBB and key assumptions, including assumptions regarding loan prepayments and behaviour of non-maturity deposits, and frequency of IRRBB measurement.	Agreed.
QT : b. The increase (decline) in earnings or economic value (or relevant measure used by management) for upward and downward rate shocks according to management's method for measuring IRRBB, broken down by currency (as relevant).	Competitively sensitive. We object to this because there is a practical difficulty of determining what the economic value of the bank is for a complex banking group. This measure also suffers from subjectivity and lack of comparability between banks. The figures in the proposed disclosures will inevitably be subjective to a greater degree than other figures disclosed in accounts. Also, although the concept of a parallel shift in interest rate curves is a widely applied stress test, such parallel shifts are rare in practice and the reality is that market movements are more complex than this. The effects are not limited to the interest rate. Such a rate movement would affect the wider economy including levels of unemployment and more generally, levels of economic activity.