COMMENTARY ON THE APRIL 2003 DRAFT OF THE NEW BASEL CAPITAL ACCORD

Australia & New Zealand Banking Group Limited

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1. Executive summary

ANZ welcomes the opportunity to provide constructive comments on the final consultative draft ("CP3") of the New Basel Capital Accord ("Basel II"). We are generally comfortable with the proposed framework as we target the Advanced Internal-Ratings Based ("IRB") approach to credit risk and the Advanced Measurement Approach ("AMA") for operational risk.

Our concerns now are mainly around implementation, particularly consistent implementation across national jurisdictions and early clarification of issues. There is considerable scope for different supervisory interpretations in Pillars 1 and 2, and we are concerned that overly conservative interpretations in one jurisdiction may lead to competitive disadvantage. Indeed, many of the detailed concerns covered in the following sections have an overlay of competitive equity, due to the potential for different supervisory interpretation.

As Basel II is aimed mainly at internationally operating banks, prompt resolution of home/host issues and consistent interpretation and implementation will be fundamental to the new Accord's success. We welcome the creation of the Accord Implementation Group ("AIG"), and recommend that the Australian Prudential Regulation Authority ("APRA") be allowed to join this body. The four largest banks in Australia (internationally operating banks with total assets of over €600 billion) are targeting the more advanced Basel II approaches, so we believe that APRA should be part of the AIG rather than the proposed non-G10 supervisory forum which will focus on the less sophisticated options within Basel II.

The widening of Pillar 2 to mandate regulatory capital for new areas such as concentration risk also needs further consideration. The calibration of Pillar 1 will need to be revisited, so that the sum of Pillar 1 and 2 capital will not lead to higher than current levels of global regulatory capital.

We believe that capital relief is an appropriate outcome for banks which invest in more sophisticated risk management techniques and have low risk operations, so we are concerned by the potential for layers of supervisory caution to produce capital levels about the same if not higher than the current levels. In shaping the new Accord, the intention of the Committee was that it should produce about the same level of capital globally, but the distribution of capital should change. Riskier banks should hold more, while less risky banks that invest in more sophisticated risk management techniques should hold less.

Our other major concerns are summarised as follows:

Credit issues:

- Loss data availability is a major issue, particularly for bank, sovereign and large corporates where defaults are rare. Validation standards must therefore deal with this pragmatically.
- Long run loss data for middle market corporates is also sparse. This issue will resolve itself going forward, but is likely to be a limiting factor in determining whether a bank can adopt the Advanced IRB early in the Basel II era.
- The requirement to store "sufficiently detailed" but unspecified data to allow retrospective reallocation under newly developed models is unduly onerous, as sample back testing would achieve much the same result.

- Several aspects of Specialised Lending need further work, including codifying the supervisory slotting of particularly strong exposures, and the creation of a supervisory working party to develop guidelines to validate credit risk tools (particularly simulation models) used in the rating of project finance exposures.
- The proposed 10% LGD floor on residential property should be removed, as this should reflect a bank's own loss experience which in turn will reflect its own portfolio and recovery experience.

Securitisation Issues

- There are several securitisation requirements that are likely to reduce the attractiveness of securitising assets of banks using the Standardised approach to credit risk, or introduce harsher treatment for features of securitised assets compared to the treatment of those features of non-securitised assets. These should be removed, so that the securitise/non-securitise decision is not influenced by regulatory capital rules.

Operational Risk:

- The results of QIS 3 indicated that some banks might have to hold more capital under the Advanced Measurement Approach (AMA) than under the Standardised and Basic approaches. This result is contrary to the tiered approaches in the credit risk framework, where investment in more sophisticated approaches is rewarded by lower regulatory capital. This suggests that the alpha and beta factors need to be reviewed to increase the attractiveness of the AMA.
- A purely statistical approach to the validation of Operational risk capital measures is not possible. Accordingly, ANZ strongly believes that the language in paragraph 628 referring to independent model validation should be modified in order to explicitly acknowledge the limitations of purely statistical approaches for this purpose.
- Similarly, the proposals suggest that a 99.9% confidence interval be established for any model seeking recognition within the AMA approaches. However, attaining this level of confidence is difficult at this stage since it is unclear how these models will function. Accordingly, ANZ recommends that guidelines should be developed for supervisory discretion around the AMA soundness standard.

Interest rate risk in the banking book

- Our main concern with regulatory capital for interest rate risk in the banking book is the element of supervisory discretion. For reasons of competitive equity, there needs to be consistency both domestically and internationally.

Pillar 2 issues

- We are disappointed to see that while there is to be extra regulatory capital for credit concentrations, it appears that there will be no recognition of the positive effects of diversification across industries or countries. Diversification is a recognised strategy to reduce the volatility of earnings, helping to reduce a bank's risk profile. It is strange that diversification benefits are not recognised in the Accord, when the Accord is aimed at large, internationally-operating banks – many of which operate internationally as a conscious diversification strategy.

Pillar 3 issues

- We welcome the reduced disclosure burden, but note that there are still some onerous requirements concerning IRB disclosures and some drafting oversights that should be corrected.
- ANZ recommends a more flexible approach be adopted for Pillar 3 requirements, in close collaboration with international accounting standard setters so that consistency and meaningfulness of bank disclosures is significantly improved.

2. Overall capital levels

ANZ is a strong supporter of the Basel II process, to make the rules for regulatory capital more risk sensitive. In light of the composition and quality of our portfolio, in the Basel Committee's third Quantitative Impact Study, we were not surprised to see that the results showed that our regulatory capital should fall considerably. We also understand that this was broadly consistent with our peer Australian banks.

While we recognise that there may be a strong arguments put forward by regulators to maintain an additional buffer, we are nevertheless disappointed that APRA has been taking the view that only a "moderate reduction"[1] in regulatory capital is the best we should expect. Firstly, the Basel Committee's intention in devising Basel II started from the premise that the overall level of capital in the global financial system was about right: their concern was around the distribution of this capital: riskier banks would need more, while less risky banks that invest in sophisticated risk management techniques would need less. The results for ANZ and our Australian peers are consistent with this outcome.

Secondly, we understand that when the new Accord comes into effect, some anxiety about the capital levels is to be expected, as would be the case with changes of this magnitude and scope. However, this is what the two year floor is designed to address, giving supervisors a chance to assess how the new rules work in practice and if necessary make appropriate adjustments. We do not believe that it is appropriate at this time to rule out capital reductions implied by Pillar 1 calculations.

Thirdly, we are concerned that some host supervisors may require our local subsidiaries to be treated at a less sophisticated level than the rest of the bank, resulting in higher regulatory capital required in that jurisdiction. This problem could be exacerbated if the home regulator would not allow this additional capital to be consolidated into the overall total regulatory capital for the group. This has the potential to erode the business justification for compliance at the more advanced levels, as theoretical capital savings at a group level may be frittered away by similar decisions at each jurisdiction, and also has competitive equity issues.

For example, the supervisor for one of our largest markets is considering only allowing the Standardised approach (which will apply to ANZ there as a subsidiary of a foreign bank), which means that we will have to carry considerably higher capital for this operation than would be required under our targeted Advanced IRB status. Further, it is not clear whether our home regulator will allow any consideration for capital "trapped" in the other jurisdiction.

[1] Letter from APRA dated 23 June 2003 to the CEOs of all ADIs, ABA, CUSCAL, CREDITLINK, AAPBS, IBSA, AFC (Australian Finance Conference)

3. Implementation priorities

3.1. The need for consistency between home and host supervisors

We are particularly concerned that potential inconsistencies in the application of the new Accord between home and host supervisors will lead to considerable practical difficulties. ANZ operates in 30 countries with a variety of structures including through wholly owned and partially owned subsidiaries, branches and representative offices. For large, internationally operating banks such as ANZ, consistent supervision is a high priority.

From a practical perspective, different supervisory requirements across jurisdictions have the potential to add considerable complexity and greater cost to IT systems, policies and processes. Many of our IT systems are used in several countries, so a requirement in only one country means that we have to consider the impact of making a global change to the systems to accommodate it, or adopt a local "work-around". Similarly, ANZ operates several of its major businesses on a global basis – compliance-related changes that are required in only one jurisdiction mean that uniform processes are unlikely, raising both the initial and ongoing costs of Basel compliance in areas such as training as well as the complexity and therefore risk of the differing processes.

The other major reason for our concern for international consistency is because we compete for capital on a global basis. Institutions (both global and domestic) have considerable discretion in where they can invest: ANZ is relatively attractive from a risk/reward perspective because of our "AA-" rating and consistently high returns on capital. We would naturally be very concerned if the latter was jeopardised by a harsher Australian regulatory environment compared to those of our international peers.

There is enormous potential for inconsistency - a recent estimate put the number of national discretion issues in Pillar 1 at over 40, [2] and Pillar 2 is virtually all national discretion. Firstly, as noted above, there is no guarantee that host regulators will even permit a subsidiary to use the Basel approach adopted by the parent. Secondly, the areas of national discretion in Pillar 1 may lead to significant differences. For example, the discretion to allow preferential risk weights for Specialised Lending for the two highest supervisory categories. Thirdly, Pillar 2 is essentially all about national discretion, as it based on supervisors' own judgement of the risks facing the banks they supervise. While Pillar 2 provides guidelines for supervisors to consider, judgement inevitably involves some subjectivity.

[2] Jeffrey, C & Thind, S (2003), "Basel II - A race to the finish", *Risk*, June, p65

Given our concerns about the need for consistent implementation (which we know are widely shared by other banks), we therefore recommend:

- The Accord include the principle of lead supervision, so that a bank has only one interpretation of Basel II to implement in any one jurisdiction. This would incorporate establishing frameworks for supervisory coordination that do not dilute the authority of the consolidated Home country supervisor[3].
- Differences in treatment of branches and subsidiaries operating in foreign jurisdictions be minimised, to maintain competitive equity.
- In the interests of encouraging greater supervisory transparency, ANZ recommends that national supervisors publish their "national discretion" rulings, the reasons for the rulings, and the effect of the rulings. The Basel Committee should then publish these on a consolidated basis.

3.2. The need for early clarification

As we prepare to implement the required changes to our systems, processes and policies to comply with the Basel II requirements, timely guidance from the Basel Committee, APRA and other supervisors will be vital if we are to be ready for the start of the year of parallel running. In this regard, we are already concerned by the tight timetable from the publication of the final Accord to the national prudential standards, and suggestions about further changes – such as para 628 concerning refinements of the AMA by the end of 2006 – raise the risk of our overall compliance effort.

Systems changes in particular have considerable lead times, requiring comprehensive design and testing (particular for changes that affect several systems) and have to fit into release windows. Even subtle changes to requirements can result in considerable re-work, and resources have to be diverted from other projects in order to meet the original deadlines. The potential for more re-work and more complex designs (which are more costly and higher risk) is heightened when national supervisors make inconsistent requirements.

We welcome the establishment of the Accord Implementation Group to sort out some major issues, but banks will need more timely guidance on a range of issues as we progress towards implementing the new Accord.

One way supervisors should assist with implementation is to establish better feedback and information sharing with banks, such as frequent meetings to discuss issues as they arise.

3.3. The Australian Prudential Regulation Authority's membership of the Accord Implementation Group

We are of the strong opinion that the Australian Prudential Regulation Authority (APRA) should be allowed to join the Accord Implementation Group.

Firstly, APRA has a strong commitment to implementing the more advanced approaches to credit and operational risk particularly to cover ANZ and the three other largest banks that account for the overwhelming majority of lending in

[3] In this regard, we support industry recommendations that the Basel Committee explore the establishment of a college of supervisors to serve as a forum for supervisors to share information concerning oversight plans and compliance concerns. For example, for each global banking group, a college consisting of the group's four to six largest supervisors could exist.

Australia. The combined assets of these banks – all of which have substantial international operations – is over €600 billion, so early and consistent advice about implementation issues is not a trivial concern.

Secondly, while the Basel Committee will establish a framework for assisting non-G10 supervisors and banks, para 59 of the Overview makes it is clear that this is aimed at implementing the Standardised and Foundation IRB approaches. As APRA has a strong interest in implementing the Advanced IRB in Australia (as indeed we do), we believe that having APRA as a member of the AIG is a far more natural fit from the perspective of supervisory coordination.

4. Credit Risk

4.1. Procyclicality and stress testing

We recognise that procyclicality is an inevitable consequence of making the Accord more risk sensitive, but feel that the strict application of the proposed stress testing in a stressed period may exacerbate pressure on banks in a downturn. It is our view that the capital required to support customers as they migrate through ratings in terms of economic stress will be adequate (recognising the sensitivity of the risk weight function) with the normal supervisory buffer – any requirement for extra capital in the light of stress testing on top of this may force a bank to try to recapitalise in a poor market. Replenishing capital in an economic downturn is likely to be expensive for individual banks, and may not be possible for the banking sector as a whole. Banks will come under pressure, either from the cost of recapitalising or if they cannot recapitalise, then from higher capital costs as their ratings fall in line with their falling capital levels.

While it may be argued that banks should therefore try to build up higher buffers to avoid having to replenish capital in stress periods, the discipline imposed by the markets means that there is constant pressure to use or return excess capital.

In our view, supervisors should allow some flexibility around requiring extra capital based on stress tests conducted in stress periods.

Further, the failure of the new capital framework to recognize the diversification benefits associated with operating multiple different global businesses, and the failure to recognize the credit risk models that can quantify that diversification benefit, demonstrates the likely areas where improvements could be made. Increasing the regulatory capital framework's risk sensitivity without also enhancing the recognition of banks methods for managing and mitigating risks is highly problematic and inappropriate. This may lead to creation of the perverse incentive for banks to focus on specific business areas and disincentives for banks to operate in a globally diversified manner. We therefore recommend that the levels of potential procyclicality be assessed throughout the implementation period and that recalibration be undertaken if subsequent research indicates this is needed.

4.2. Default and loss data availability and the implications for validation

It is most unlikely that an individual bank will ever have enough loss data relating to banks, sovereigns, project finance and highly rated corporates for it to be able to develop its own statistically robust PD, LGD and EAD estimates as default data is particularly sparse. This is also true for validating these estimates and models. Where a supervisor takes an overly statistically-based approach, the prospects of a bank being able to prove its models for these asset classes (and therefore move to even the Foundation IRB approach) seem fairly remote.

This situation is confirmed by a very recent global survey of internal ratings based models, conducted by the International Swaps and Derivatives Association

(ISDA), the British Bankers Association (BBA) and the Risk Management Association (RMA)[4]. This survey found that:

- Banks use statistical models for parts of their portfolios where sufficient data exists for robust estimation. Most banks surveyed used statistical models for their middle market corporates and for their retail portfolios.
- Expert judgement models are used where data is sparse, particularly for large corporates, banks and sovereigns.

We are therefore heartened by the inclusion of a pragmatic way forward in the second bullet point of para 424 – developing models that map to external rating agency scales. There are statistical techniques that would suit this approach, particularly those that focus on proving something is "not broken".

As for middle market models, where getting enough data to validate some ratings tools is not such an issue, we also feel that supervisors should acknowledge that validation is not an exact science but involves some judgement. There will be legitimate differences of opinion concerning adequacy thresholds, in terms of both the appropriate test and then the correct threshold. Typically, greater data availability in the Retail asset class means that more standardised adequacy thresholds can be used, while the sparser data in the Corporate asset class means that more judgement is likely to be exercised.

Similarly, as the ISDA/BBA/RMA survey noted, even when banks use the same external data set (such as those from rating agencies), there will be legitimate differences when applying this data to internal data, such as default definitions, time horizons, inclusion of LGD data and even a view on the applicability of bond default data to bank loans (where typically banks have far greater ability to intervene to protect their interests, compared to bondholders).

4.3. Data retention

Like most banks, we accept that we will need to store more credit related data than we have collected historically, and that we will need to store data for longer. However, we are concerned by very wide ranging requirement of para 391 which requires that the data stored "should be sufficiently detailed to allow retrospective reallocation of obligors and facilities" as banks develop new and more sophisticated models. Given the wide range of factors that might ultimately be found to have predictive power, such a requirement essentially means that we should try to keep everything "just in case". We believe that this is onerous, and in any case the presumed objective of the requirement would be achieved by back testing of new models as part of the normal validation process. There should be no additional requirement for retrospective reallocation.

Secondly, the relevance of quite old loss data also needs to be questioned. Indeed, the Retail rules explicitly state that a bank "need not give equal importance to historical data if it can convince its supervisor that more recent data is a better predictor of loss rates".[5] Relevance is particularly important where there have been very large changes in credit underwriting standards and recovery processes. In Australia, the last significant recessionary period was in the early 1990s. As a result of this experience, ANZ made a major investment in risk management that led to fundamental changes in credit processes. For example, the former system of grading productive customers into a combination of three categories based on a blend of risk of default and collateral cover was replaced by more granular scales of PD and LGD. Trying to restate data from the

[4] www.rmahq.org/Basel2/Global_Internal_Ratings_ Validation_Survey.pdf
[5] CP3, para 428

former system (if available) would be very labour intensive and in any case reflects quite different risk management appetites and standards. It is therefore difficult to see how these transactions would satisfy the "relevance" test in para 412.

4.4. Supervisory slotting in Specialised Lending

While we welcome the introduction of an Advanced approach to HVCRE where a bank has estimates of PD, LGD and EAD for these exposures, we believe that the "supervisory slotting" approach may need to be recalibrated, particularly at the low risk end.

For example, we believe that a new category of "Very Strong" should be created (say with a 50% risk weight for Specialised Lending and 75% for HVCRE), as the current proposal ends at "Strong" which is aligned to a rating of BBB- or better. This is a very wide bucket, and fails to recognise the relatively low risk of some projects. Indeed, a recent US study that compared the slotting treatment in QIS 3 to the practice in 17 of the largest institutions in the US and Canada found that the slotting risk weights in QIS 3 were much higher.[6] We would prefer that the current proposal to allow lower risk weights for "strong" and "good" exposures in special circumstances should be codified into separate categories, to make the use of these concessions (at national discretion) more transparent.

Excessive capital requirements for project finance may reduce the attractiveness of this type of lending, particularly as far as syndicating exposures to banks with a limited appetite for large project finance deals. If syndication becomes less attractive, then the market is likely to become more concentrated, possibly increasing the risk of the remaining financiers.

4.5. Simulation models in project finance

As noted above, default data for project finance is sparse, and in any case the highly "bespoke" nature of this segment raises issues around the relevance of pooled and external data to a bank's own loss experience.

We believe that simulation models that cover the effects of price/timing changes in key variables in the project are the most appropriate way to assess the risk of major projects, but note that because of the sparse default data, they are unlikely to satisfy strictly the model development/validation requirements of paras 379 and 463-468.

ANZ is one of a relatively small number of internationally operating banks that are active in project finance. In much the same way that not many banks have specialised in project finance and invested in the appropriate risk management tools, we believe that some national supervisors may lack appropriate exposure to this segment which warrants an innovative approach to assessing project finance models.

We therefore recommend that the Committee establish a dedicated working party of supervisors and banks involved in project finance to develop supervisory guidelines for validating credit risk tools used in project finance.

[6] Risk Management Association (2003), *Measuring Credit Risk and Economic Capital in Specialized Lending Activities – Best Practices*

4.6. LGD floor for residential properties

We are puzzled by the introduction of a 10% LGD floor for Retail loans secured by residential real estate for the three year transition period of the new Accord.[7] As a point of principle, in the Advanced IRB approach, LGDs should reflect a bank's own loss experience, tempered with some conservatism. There should be no need for a floor, as the LGD should take into account stressed periods and in any case is subject to review by national supervisors. If supervisors have any concerns with "very long run cycles" (the reason given in para 235), then the normal LGD process enables them to intervene.

Our historical loss experience with residential mortgages implies a considerably lower LGD estimate than 10%. There are several characteristics of the Australian market which are recognised as contributing to low loss rates in housing:

- Lenders mortgage insurance is typically required for loans with high loan to valuation ratios
- Home ownership is embedded in our culture, so that homebuyers will give high priority to repayments even in times of economic stress
- Our legal system gives us full recourse to defaulting borrowers, unlike some other jurisdictions.

ANZ therefore believes that this floor is not appropriate for all jurisdictions – the need for conservatism should be met through the normal LGD estimation and overview process.

4.7. Treatment of contingent exposures

We seek clarification of the treatment of contingent exposures under the Advanced IRB approach, particularly for performance and bid bonds. There are good arguments for recognising the contingent nature of the exposure any one of PD, LGD and EAD, but note that the choice will produce different risk weights. Our preference is to recognise the contingent nature of the facility in the probability it will default and cause loss, but seek guidance.

4.8. Conservatism in PD, LGD and EAD estimates

We support the general requirement for conservatism when developing PD, LGD and EAD estimates based on limited data, but believe that there should be some quantification or guidelines around the extent of conservatism required. Otherwise, we are concerned that supervisors may adopt different standards, thus leading to competitive equity issues.

We are particularly concerned with the conservatism required whereby the LGD must be biased towards the worst part of the cycle to overcome a lack of PD/LGD correlation in the capital function. This should have been taken into account by the extra capital charge in the high volatility property asset class.

Further, we recommend that this be given priority within the AIG, and acceptable standards developed and used globally.

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[7] CP3, para 235

4.9. Treatment of High Volatility Commercial Real Estate

Paragraph 195, describing the categorisation of high volatility commercial real estate, confuses concepts and gives poor guidance to national regulators. The reason for any additional regulatory capital should be founded on:

a) The higher systematic default correlation because of common source of repayment (i.e. sale of assets), and
b) Correlation between aggregate PDs and LGDs for asset reliant lending that would otherwise receive too much benefit in the regulatory capital function which treats LGD as unsystematic (whereas PD is systematic).

Paragraph 195 refers to "higher loss rate volatility", which is not the issue since institutional lending is the highest on that metric. Moreover, it requires that national supervisors classify assets based on PD volatility (which is different to loss rate volatility and not necessarily focussed on the main driver for additional capital).

The section on high volatility commercial real estate should therefore be worded more carefully to ensure it accurately reflects the economic reasons for any additional regulatory capital.

5. Securitisation

5.1. Pillar 1 issues

5.1.1. Standardised Approach issues

While ANZ's objective is to target the Advanced IRB approach, we have some concerns about the Standardised approach to the extent that its inconsistency is likely to impact the securitisation market as a whole. There are several discrepancies that should be eliminated so that the overall capital treatment is indifferent to the securitise versus non-securitise decision:

- At lower rating levels, there is a difference between the capital treatment afforded to corporate exposures and those relating to securitised exposures.[8] The current guidelines are such that when the overall regulatory capital for a typical securitisation transaction is aggregated, the level of capital in total is in excess of what would be required to be held had the underlying portfolio not been securitised.
- Similarly, the disparity between the capital treatments for an investing bank and an originating bank for the lower rated tranches (below BBB-) in para 529 should also be removed.
- Relative to the IRB approach, the standardised approach imposes higher capital requirements on most investment-grade tranches and lower capital requirements on certain non-investment grade tranches. Differentials in capital treatments may lead to new gaming techniques, whereby standardised banks sell high-quality tranches to IRB banks and purchase lower quality ones from IRB banks, resulting in a double-sided erosion of the asset quality of standardised banks.
- The absence of a K_{IRB}-like cap, or inferred ratings mechanism, creates a disadvantage for standardised banks which may create a disincentive for these banks to adopt securitisation to contribute to the management of portfolio concentration risk.

[8] Compare paras 37 and 528

- Para 537 imposes a blanket 100% credit conversion factor for any off balance sheet facilities other than eligible liquidity facilities. This is inconsistent with non-securitised assets as it fails to differentiate between various facilities that have different risk characteristics. Furthermore, these facilities have received more appropriate treatment in the past. For example, a performance guarantee for property construction within a securitisation received a 50% weighting.

5.1.2. IRB Approach issues

Neither the Ratings-Based Approach ("RBA") nor the Supervisory Formula ("SF") approach adequately address off-balance sheet facilities provided to securitisation vehicles. The off-balance sheet facilities are unlikely to meet the proposed definition for inferred ratings and the SF does not adequately account for the seniority of the facilities. For example, many of our facilities support collections available for both AA- and AAA rated notes, have priority in terms of repayment and rank pari passu in the event of a wind up.

The inferred ratings approach should be modified to take into consideration other off balance sheet facilities, and under the SF approach, the facilities should attract the same risk weighting as the senior notes. This issue also applies to liquidity facilities provided to Asset Backed Commercial Paper ("ABCP") vehicles, where the securities are typically issued in a single tranche and therefore only have a single credit rating.

5.1.3. General issues

The exclusion in para 525 of a private rating that is available to all parties of a transaction from the criteria for an acceptable external credit assessment is inappropriate. The choice of a public versus private rating is based on distribution strategies for the notes, and does not alter the underlying credit quality of the exposure being assessed as the rating agencies use the same methodology for private and public ratings. Private ratings should be afforded the same treatment for capital calculations as public ratings.

The exclusion in para 517 of SPEs from being eligible guarantors for the use of CRM techniques with regard to synthetic securitisations is inappropriate. The key issue is the collateral backing, which provides credibility to the guarantor, not the nature of the guarantor. The range of eligible guarantors should be consistent throughout the entire Basel framework, not imposing unnecessary restrictions on securitisations.

5.2. Pillar 3 issues

We are generally comfortable with the proposed disclosures as long as they are on an aggregate basis and do not involve disclosure of profitability information.

We believe that most of the proposed quantitative disclosure is of limited use to anyone except our competitors (and even then it is likely that it would be of limited use). Even most banking analysts would be unable to make use of this unless it revealed some use of off-balance sheet entities that would seriously change their view of the credit quality of the banking book.

6. Operational Risk

We are generally happy with changes made to the treatment of operational risk. The new emphasis toward less prescriptive requirements is welcome, as is the general inclusion of insurance discounts in the Advanced Measurement Approaches (AMAs).

6.1. Capital

6.1.1. Incentives to move to AMA

Our experience in QIS 3 was that we would have to hold more capital under the AMA than Standardised or Basic approaches, and we understand that a number of other institutions have reached similar conclusions. Our concern is that even with the insurance discounts which may be available in the AMA, the incentives embedded in the current operational risk calibration may be insufficient to encourage banks to pursue the AMA option.

In this respect, we believe that the value of the alpha and betas may need to be reviewed to ensure that appropriate incentives exist for banks to implement the AMA.

6.1.2. Implementation and validation of AMA models

ANZ believes that purely statistical validation of Operational Risk capital measures is not possible. Accordingly, ANZ strongly believes that the language in paragraph 628 referring to independent model validation should be modified in order to explicitly acknowledge the limitations of purely statistical approaches for this purpose.

ANZ believes that a flexible approach to AMA validation is required. Importantly, validation mechanisms must be compatible with a bank's internal risk management practice.

Such validation methodologies may include, for example, developmental evidence and internal consistency checks with the bank's experience of its key operational processes and the effectiveness of its key controls. This will include, but not be limited to, an understanding of the implications of the bank's internal operational loss experience, control failures, near misses and an assessment of the relevance and implications of the loss experience of other industry participants. Importantly, ANZ believes that an essential component of AMA validation is the "use test" of the model as part of the day-to-day risk management process in the bank. Executive management and business managers should review and ratify the methodology.

Furthermore, the implementation and interpretation of the "use test" regarding the four AMA elements (internal data, external data, scenario analyses, and business environment/control factors) should be flexible, permitting banks to use different methodologies and emphasizing different elements based on compatibility with their own internal operational risk management processes.

6.1.3. AMA soundness standard

The operational risk proposal suggests that a 99.9% confidence interval be established for any model seeking recognition within the Advanced Measurement Approaches (AMA). ANZ believes that attaining this level of confidence will be very difficult at this stage since it is unclear exactly how operational risk models will function.

ANZ recommends that guidelines should be developed for supervisory discretion around the AMA soundness standard.

6.1.4. Alternative Standardised Approach

ANZ soes not support the introduction of an Alternative Standardised Approach and recomends its elimination. Level playing field issues are likely to arise if only some jurisdictions offer the ASA in whole or in part. Moreover the introduction of such an approach encourages regulatory capital arbitrage between the operational risk capital measurement approaches.

6.1.5. Alignment of internal and Basel definitions of operational risk

Para 629 (a) specifies that the internal operational risk measurement system must be consistent with the scope of operational risk defined in para 607. We would prefer this to read "aligned to" rather than "consistent with" as this would allow for some customisation of the measurement system to recognise the internal business requirements of institutions. As the risk measurement system needs to be integrated into business practices rather than simply being required for Basel compliance, we believe that we should be allowed to create easily mapped hybrid categories and subcategories where this assists in measuring and managing risks in institutions.

6.2. Insurance

ANZ supports the intent expressed in para 637, but recognises that there is a considerable amount of further work to be carried out to clarify the recognition of insurance mitigation. The Committee needs to provide clarity promptly, to enable banks to develop compliant processes.

6.3. Loss event classification scheme

ANZ generally supports the proposed loss classifications for use in the operational risk regulatory framework. However, we would like to underscore that the classifications and related decision tree for determining how to use the classifications were designed at a rather early stage in the evolution of the regulatory capital framework. It is highly likely that additional data and experiences will require the framework to adapt. Therefore, ANZ recommends that the Basel Committee incorporate flexibility into the standards and expressly indicate that the classifications are likely to evolve with industry practice over time.

In this context, ANZ believes that the detailed loss event classification scheme in Annex 7 should be expanded to explicitly capture "project risk". Banks typically use a project structure to implement major system or process changes, and historical experience has demonstrated that failure in project design and particularly implementation can lead to significant cost overruns. A separate category for project risk would allow for this important risk to be explicitly captured rather than having to be modelled/mapped within the existing categories.

Accordingly, we believe that Project Risks should be explicitly added as a level 2 category within Execution, Delivery and Process Management.

7. Interest rate risk in the banking book

7.1. Calculation

ANZ agrees with the principle that banks should hold sufficient capital to underpin all material risks, including interest rate risk in the banking book. In fact, our internal EVA™ framework allocates economic capital for, amongst other things, mismatch risk and the risk arising from the investment of capital and other non-interest bearing items.

Within our EVA™ framework, we calculate internal capital allocations for interest rate risk using a "value at risk" methodology. It is important to note that this market value based economic capital methodology is made within the context of a broader interest rate risk management framework, which includes both accrual and market value risk limits.

One conceptual issue that we have with the Basel Committee's proposal is that a capital allocation regime based solely around a market value perspective of interest rate risk will inevitably drive bank management behaviour towards lower market value risk. Given that global accounting practices predominantly employ accrual accounting for the banking book, an unintentional consequence might be an increase in accrual income volatility - in our view, this would not be a desirable outcome. For example, a bank may seek to lower its interest rate risk capital allocation by adopting a very short strategy for the investment of its capital – a strategy which would minimise market value volatility but significantly increase the potential volatility in accrual earnings.

Despite the nature of our internal capital allocation methodology (i.e. market value based), this problem is mitigated at ANZ because the coexistence of clear accrual income and market value risk limits precludes a focus on reducing market value risk at the expense of increased accrual income volatility.

7.2. Need for consistency for coverage

We do however have concerns that the provision of significant discretions to individual national regulators has the potential to produce an uneven international playing field. Firstly, regardless of the extent of homogeneity in the domestic banking population, the reality is that the major Australian banks operate extensively in the global market place. It is therefore critical that these banks are not placed at a competitive disadvantage relative to their international peers. This will occur if APRA introduces a regulatory capital charge for interest rate risk that is not adopted by other major regulators.

Furthermore, we believe that if a supervisor chooses to implement a regulatory capital charge for interest rate risk on the banking book, then for reasons of domestic competitive equity any capital charge must apply equally to all banks under its jurisdiction. If the supervisor believes that interest rate risk on the banking book is a valid risk for which capital should be allocated, then all banks should be affected. A regulatory capital charge should not simply be confined to those institutions with the capability to measure the particular risk – indeed, there is an argument that those institutions without the necessary infrastructure should be penalised. At the very least, banks that have made the investment in superior systems and processes to capture and better manage interest rate risk should not be penalised via an additional capital charge.

It is for this reason that we are concerned about APRA’s proposal to require only those banks using the sophisticated internal ratings based (IRB) model for credit risk to hold capital for interest rate risk in the banking book.

8. Pillar Two

8.1. The purpose of Pillar 2

We are concerned that the proposed coverage of Pillar 2 is expanding – from the bank-specific assessment approach to include Pillar 1 type requirements that apply to all banks – and that this expansion of coverage may lead to higher than current capital levels which would be contrary to the expressed intent of the reform process.

We believe there has been substantial "scope creep" in Pillar 2 from the January 2001 draft of the new Accord. It was clear then that individual banks were primarily responsible for their own capital assessment based on their own risk profile. Pillar 2 was described as the supervisory review process:

> Supervisors would be responsible for evaluating how well banks are assessing their capital adequacy needs relative to their risks. This internal process would then be subject to supervisory review and intervention, where appropriate.[9]

Pillar 2 was therefore seen as a mechanism to require additional capital to the minimum capital calculated under Pillar 1 (or to take other appropriate action, such as a reduction in risk profile or improvements to risk management processes), based on an individual, top-down assessment. The current draft for Pillar 2 goes well beyond this, such as mandating that capital should be held for (inter alia) concentrations, interest rate risk on the banking book, "residual risk" and securitisation.

We are particularly concerned that if the calibration of Pillar 1 has been set to maintain the approximate level of capital within the financial system (i.e. about 8% of risk weighted assets), then the Committee has not factored in the extra capital that Pillar 2 will require all banks to hold. We note that none of the Quantitative Impact Studies have collected data on the issues now proposed for capital under Pillar 2. Unless the calibration reflects both Pillar 1 and 2 capital, then it is most likely that the overall result of the new Accord will be higher capital levels, a result that would be at odds with the reform's objectives.

We therefore recommend:

- The "add ons" to regulatory capital framework proposed under Pillar 2 be reconsidered (otherwise Pillar 1 capital would need to be recalibrated to reflect the extra capital to be held under Pillar 2),
- Pillar 2 should be used as a "top down" process, so that supervisors challenge the appropriateness of a bank's capital assessment. Supervisors should not simply require appropriate action to rectify deficiencies (which may include extra capital), but should take a "net" approach, so that positive attributes (such as the effect of industry/geographic diversification on the volatility of earnings and risk generally) are considered with deficiencies.

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[9] Basel Committee on Banking Supervision (2001), *The New Basel Accord: An Explanatory Note*, p5

8.2. Competitive effects of national discretion

We accept that just as banks have different risk appetites, supervisors will also have different views on the relative importance of the risks that concern the banks they supervise. However, supervisors should recognise that their domestic rules may have competitive effects on the banks that they supervise which operate internationally. Banks in one jurisdiction that are supervised by an excessively conservative regulator which adds "buffer on buffer" are likely to be obliged to hold more regulatory capital than some of their competitors. This requirement to hold more capital (with the attendant pressure to chase returns to generate competitive returns on capital) may mean that these banks are forced out of lower risk but finely priced market segments, such as highly rated corporates, and instead into riskier segments.

For example, APRA's intention to impose regulatory capital on Australian banks for interest rate risk on the banking book may mean that Australian banks will be out of step with our international competitors, whose supervisors may not require them to have capital set aside for this risk.

8.3. Pillar 2 and transparency

We believe that heavy reliance on Pillar 2 may in fact lead to less transparency in banking markets. The current process of disclosing both risk weighted assets and Tier 1 and 2 capital means that investors have a clear understanding of a bank's regulatory capital position. For example, an investor can assess if a bank is carrying too much capital, leading to pressure on the bank to either use it or return it. In this way transparency helps the efficient allocation of capital within the market.

Going forward under Basel II, Pillar 3 is based on disclosing Pillar 1 capital to investors, as the basis for comparability between banks.[10] However, extra capital buffers required under Pillar 2 will be less transparent as they are not required to be disclosed, as they will be based on supervisory discretion. Part of the market discipline that Pillar 3 is trying to engender may perversely be undermined by heavy use of Pillar 2 discretion. Furthermore, we do not believe that the situation would be helped by separate disclosure of Pillar 2 capital, as the reasons for supervisory concern may be of considerable commercial sensitivity. For example, information about portfolio concentrations may be of interest to competitors, and legitimate differences of opinion over strategic risk issues could lead to market concern.

[10] CP3, para 759

9. Pillar Three

9.1. Alignment with accounting standards

Banks typically have disclosure requirements imposed by regulators, accounting standards and stock exchange listing rules. So that the disclosure burden is not onerous, it is important that (where possible) there is consistency between the disclosure rules. Besides the obvious additional work in simply disclosing extra information, inconsistencies between Pillar 3 and accounting standards would be confusing for end users of the information.

We therefore strongly endorse the ongoing work of the Committee and international accounting authorities to ensure that disclosure requirements are consistent.

9.2. Level of disclosure for IRB portfolios

While we are generally happy with the reduced disclosure burden, we still have concerns around the amount of detail that we will have to disclose in Table 6 (which covers disclosure for portfolios under the IRB approaches). Our concern centres on part (e) of the quantitative disclosures for this table, as we would be required to present detailed information at the pool level for the retail asset class. Retail exposures are required to managed at a pool level, where pools must be made up of large numbers of homogenous loans that share characteristics such as product type, collateral type and/or coverage, delinquency, seasoning etc. This approach leads to multiple pools being established and therefore multiple pools being reported.

Requiring disclosure at the pool level would therefore seem to be excessive, both in terms of the length and detail provided to potential competitors (such as monoline non-bank specialists), and in proportion to the amount required for the combined Corporate, Bank and Sovereign asset class.

9.3. "Innovative instruments"

Table 2 requires that "innovative instruments" be separately disclosed as part of the quantitative disclosure for a bank's capital structure. We believe that this has the potential to mislead over time, as what is "innovative" today frequently becomes widely accepted and mainstream tomorrow. It would be better to require that the terms and conditions of each Tier 1 capital instrument (other than share capital and reserves) be disclosed separately as part of the qualitative disclosures.

9.4. Gross credit exposures

Table 4 requires that banks disclose credit risk exposures on a gross basis – before netting and collateral is taken into account. We accept that collateral should not be recognised here, as its effect is subject to some uncertainty (for example, the delay to be able to use the collateral), but we do not believe that banks should report exposures on a pre-netting basis. We only report net exposures where there is a valid and legally binding netting agreement in place, and as the counterparty by definition has offsetting exposures, there is no uncertainty about how much is owed.

Further, footnote 118 uses the term "after accounting offsets", which we understand to mean "after provisioning". We would normally report gross loans and advances, and then separately disclose the total provision for doubtful debts before disclosing the net loans and advances. It would be onerous to have to report the loans and advances after individual provisioning.

We therefore recommend that the definition of gross exposures should be after setoffs and before provisions.

10. Concluding remarks

The current draft reflects the considerable progress that the Basel II reform process has made towards a more risk sensitive capital framework. Some work remains, but most of the work ahead will need to be on implementation issues, particularly developing common standards to ensure competitive equity within and between jurisdictions.

We trust that our comments are useful, and that they will be given full consideration.

We are happy to discuss any aspect of this document and elaborate on its content. Please contact Morris Batty, Basel II Programme Executive (telephone +61 3 9273 5790) or Tom Appleby, Manager Basel II Programme (telephone +61 3 9273 4665) for further clarification on the issues raised.