

COMMISSION de SURVEILLANCE  
du SECTEUR FINANCIER

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Luxembourg, July 31st, 2003

Basel Committee on Banking  
Supervision  
Bank for International Settlements  
CH-4002 Basel

Mrs Danièle Nouy  
Secretary General

Fax : 0041 61 280 81 00

Dear Mrs Nouy,

We are pleased to send you the attached comments from the Luxembourg banking industry on the third consultative paper "THE NEW BASEL CAPITAL ACCORD", which the Basel Committee on Banking Supervision has issued in April 2003. The enclosed comments summarise the consultation, which the COMMISSION DE SURVEILLANCE DU SECTEUR FINANCIER has conducted with representatives of individual institutions, and the Luxembourg Bankers' Association.

The COMMISSION DE SURVEILLANCE DU SECTEUR FINANCIER agrees with the comments stated in the attached document.

Yours sincerely,

COMMISSION de SURVEILLANCE  
du SECTEUR FINANCIER



Arthur PHILIPPE  
Directeur



Jean-Nicolas SCHAUS  
Directeur Général

Enclosure.

**Response of the Luxembourg Banking Industry on the  
Third Consultative Document  
“The New Basel Accord”**

The present document contains the comments of the Luxembourg banking industry (hereafter, “the industry”) on the Third Consultative Document “The New Basel Capital Accord”.

**Credit Risk: Standardised Approach**

Regarding the risk weighting for bank exposures, a clear preference for option 1 has been indicated.

The industry welcomes the reduced risk weights of 75% for exposures within the regulatory retail portfolio, respectively 35% for claims fully secured by mortgages on residential property occupied or let by the borrower (100% if they are past due for more than 90 days).

The industry welcomes the recognition of specific provisions for past due loans.

**Credit Risk Mitigation**

As a general remark, the industry regrets the complexity of the CRM framework; in that context, the decision made by the Basel Committee to drop the “w” factor from Pillar I is welcomed. Moving residual risk to Pillar II is an acceptable compromise. However this adds to the long list of issues, which are up to national discretion and therefore could add complexity for globally active banks with reporting entities in multiple jurisdictions.

Regarding the treatment of repos, the industry considers that those transactions not eligible for the carve-out will lead to significantly increased capital requirements. Given their low risk character, this does not appear to be justified.

## **Credit Risk: Internal Ratings-Based Approach**

### **Roll-out provisions**

Given the important presence of subsidiaries of foreign financial groups in Luxembourg the roll out provisions (paragraph 225 to 231) may have a major impact on their activities and, under these circumstances, institutions in Luxembourg are to be considered under pressure to comply as soon as possible with the qualifying criteria for IRB where the parent group intends to apply for it in the home country. Also, there are data issues arising if the Luxembourg subsidiary is not engaging in the same activities as the parent group, which will make a local data gathering effort necessary, but, given small sample sizes, not always feasible.

The industry does not question the merits of a more risk-sensitive approach and its incentives towards the use of better risk management techniques, but wonders whether the punitive treatment (paragraph 227) can actually be economically justified. Indeed, disregarding a capital relief for a loan from an own funds-constrained foreign subsidiary, which is guaranteed by the parent group, but processed by the subsidiary itself will either lead to a withdrawal of the activities with a possible overall deadweight-loss, or push all entities of the group into an overly hasty and potentially flawed implementation process for new systems.

The industry welcomes the new flexibility the text is providing by the "phased roll out" provisions, but sees potential for improvement if a permanent partial use were to be explicitly recognised. This would encourage especially smaller and more specialised banks to focus on risk management improvements on their core businesses while remaining on simpler approaches for business areas with limited activities.

### **Definition of default**

Given the early provisioning rules in LuxGAAP, the industry is concerned that a large share of exposures may be categorised as defaulted although they are still performing, which will create a systematic circularity between provisioning and default. In their view it is important to distinguish between prudential specific provisions, where no default event as such has occurred, and those specific provisions, which are made after an actual default event has been identified. It is hence the industry's interpretation that "*charge-off or account-specific provision resulting from a significant perceived decline in credit quality*" does not address the case of prudential provisions described above.

### Asset Classes

Scarce data on Luxembourg's national commercial real estate market are not conclusive as to the need of the high-volatility commercial real estate sub-asset class. Moreover, the industry believes such a sub-asset class is redundant and only increases the complexity of the framework. Indeed, the industry believes there is a potential overlap since a lending bank can always use the basic specialised lending categories in the income-producing real estate sub-asset class in the case it has a doubt on the creditworthiness of a given project. Further, its implementation would become impossible in the European context as this regulation is by nature host-oriented and hence not all member states are bound to transpose it into their national regulations. Due to the principles of a single European market it would be impossible for a member state to impose higher risk-weights for EU branches operating on the host territory.

### Risk Weighted Assets

The industry welcomes the adjustments to the risk weight function for banks, sovereigns and corporates. Most respondents consider it to be sufficient to provide the right incentives for SME lending. Nevertheless, some industry participants expressed their concerns on the pro-cyclicality aspects of the new framework. They consider that short of any recognition of credit risk models no additional benefits due to diversification will be granted for international credit portfolios, where indeed pro-cyclical effects could be partially offset.

The equity framework should be flexible enough to accommodate for a large sample of institutions. The industry considers that the simple market-based approach is a valuable and feasible default option. Moreover, a bank should be allowed to use more than one approach at the same time, depending on the nature of its portfolio (e.g. *PD-LGD* approach for private equity and market-based approaches for listed equity). Institutions should have the right to opt, at their discretion, for the simple market-based approach to take account of the specific nature of their investment/holding activity (which, in relative terms, may be marginal or highly developed).

The newly introduced 10% LGD-floor for residential mortgages in the retail portfolio has been heavily criticised by the industry and contradicts the underlying philosophy of the advanced approach relying on banks' own estimates. The burden of proof should lie with the banks' themselves as to what extent their estimates are conservative enough to capture lower recoveries experienced in the case of a strong economic downturn.

### Recognition of collateral on subordinated loans in the FIRBA

Paragraph 246 now limits the recognition of collateral to the situation of senior collateralised loans. The industry is puzzled about this modification, since it considers that collateral is also effective in the case of subordinated loans, and urges the Committee to reconsider this.

### Maturity

The industry welcomes the shortening of the implicit maturity from 3 years since CP2 to 2.5 years, though this is still deemed too high. The calculation of the explicit maturity is more complex to calculate and leads to higher capital requirements for maturities exceeding 2.5 years, but gives substantial benefits to short term instruments.

The industry nevertheless regrets the Committee's position to leave the decision of whether to allow the implicit or the explicit maturity adjustment up to national supervisors, rather than at the bank level. Not only does the industry expect competitive distortions on cross-border transactions, but also fears possible interferences with banks' internal risk management practices.

### Securitisation

As regards the risk weightings in the Standardised Approach, the industry is concerned that banks investing in asset-backed securities would need to hold a much larger amount of capital than for corporate bonds of the same rating. There is no evidence to suggest that ABS are more risky than corporate bonds. Data produced by rating agencies show that sound cash flow structures coupled with rigorous rating criteria prove to be the key to the strong credit performance of structured securities. If retained, this treatment would also include a double counting by the way that the method of determining capital requirements is based on the ratings produced by ratings agencies and then an extra charge is added for asset-backed positions.

As regards the IRB Approach, one bank suggested that originating banks should also be allowed to use the RBA for externally rated retained tranches.

The industry has noted that a bank using the IRB Approach may apply the IRB capital requirement for the underlying exposures, if its capital requirement using the SF and/or the RBA is greater than it would have been had the underlying exposures not been securitised. This "cap" on capital requirements is considered absolutely adequate, since in the extreme case, a bank could securitise a portfolio but retain all tranches, in which case the overall risk position would not change, i.e. capital requirements should remain the same.

## **Operational Risk**

### **Approaches**

As for the determination of the operational risk capital charge, the industry regrets that the Basel Committee offers only little incentives to move from the Basic Indicator Approach to the Standardised Approach, in particular since several  $\beta$ s are higher than 15%. Not only is this considered to be in strong contradiction with alleged evolutionary approach of the framework, but also counterproductive as the Standardised Approach relies upon more prescriptive qualitative criteria.

### **Partial use**

The permission to use the AMA for some parts of the operations and the TSA or BIA for the remaining business is welcomed by banks. However there remain major concerns as to the roll out criteria set out in the CP3 rules text; the industry would welcome a permanent 'partial use' of the Advanced Measurement Approach.

### **Gross Income**

There is a demand for clarifying the meaning of footnote 155 of Annex 6. In this context, the agreement to revise the wording from 'exclude' to 'deduct' could bring clarification.

### **Business line mapping**

There is a general demand for further business line mapping guidance.

### **Insurance**

Many banks use systems for mitigating operational risk through insurance or captives. This is an important activity in the Luxembourg financial sector. Thus the industry did not welcome the limited recognition of insurance for the AMA and stresses again the necessity for recognition of insurance or all three approaches.

The industry is convinced that the 20% floor would reduce banks' current sound practices in the use of operational risk mitigants and thus asks for a revision of this proposal.

**Pillar II**

The industry considers that the relationship between the first and the second Pillar is not sufficiently clear. In particular the industry is worried that the new Pillar II provisions might lead to a certain automatism for setting higher regulatory capital requirements.

**Pillar III**

As regards Pillar 3, the banking industry maintains that new document is too detailed and thus needs to be streamlined further without however specifying which requirements are excessive.

Furthermore, as has been the case for the previous consultation, the industry insists on the necessity for consistency between the New Accord and IAS disclosure requirements in order to avoid duplication of work in preparing the information.