Mr Bernie Egan
Program Director, Basel II
Australian Prudential Regulation Authority
GPO Box 9836
SYDNEY NSW 2001

25 July 2003

Dear Bernie,

Re: Third Consultative Paper – New Basel Capital Accord

APRA requested feedback from the Commonwealth Bank Group (the Bank) on *the Third Consultative Paper – New Basel Capital Accord* (CP3). Our comments are based on the fact that the Bank is targeting the Advanced IRB approach for credit risk and the Advanced Measurement approach for operational risk.

The Bank welcomed many of the changes that have been made to this version of the New Basel Capital Accord (the Accord), in particular we view the introduction of transitional arrangements as a positive development. There are still several key areas where we have issues with CP3, in particular the treatment of both securitisation and operational risk under Pillar 1 of CP3.

Specific comments on CP3 are provided for your consideration. We will send a separate letter to APRA, detailing areas of CP3 where the Bank is looking for further guidance or clarifications on national discretion issues.

Please feel free to contact Peter Job on 02 9378 5372 if you would like to discuss the Bank's submission.

Yours sincerely

Mick A Leonard

Executive General Manager, Group Risk Management

cc: Katrina Squires, APRA

1 PILLAR 1 – MINIMUM CAPITAL REQUIRMENTS

There are several areas of the CP3 document where further clarification is required from the Basel Committee. These are detailed below.

1.1 Residential Mortgage Loans

Paragraph 199 (a) bullet point 2 – "…so long as the credit is extended to an individual…Loans secured by a single or small number of condominium or co-operative residential housing units in a single building or complex also fall within the scope of the residential mortgage category. National Supervisors may set limits on the maximum number of housing units per exposure."

- The Bank finds this is a confusing and ambiguous statement requiring more explicit definition. The suggestion is that national supervisors may establish exposure thresholds to distinguish between retail and corporate exposures for 'off the plan' purchases, existing dwellings and for occasions where more than one dwelling (including vacant land allotments) is held as security.

1.2 Minimum LGDs

Paragraph 235 – Minimum LGDs for retail exposures secured by residential properties of 10%

- Given the Bank's long loss history in this area, there is no statistical substantiation for a minimum LGD of 10% which is clearly excessive. The minimum LGD requirement should be removed.

1.3 Recourse for Receivables

Paragraph 332 – "The estimates for PD and LGD (or EL) must be calculated for the receivables on a stand-alone basis; that is, without regard to any assumption of recourse or guarantees from the seller or other parties."

- The approach is not consistent from a market and/or risk perspective. Banks often only enter such arrangements given that they can achieve full recourse, hence, mitigating some of the credit risk. Receiveables with recourse should be treated as per other rated PD/LGD products, those without recourse should be assessed on a stand alone basis. Recognition of the various types of recourse available for receivables in calculating PD/LGD estimates is required.

1.4 Economic Cycle

Various paragraphs, for example paragraph 434

- The ratings process often refers to data that should "ideally cover at least one economic cycle". More specific guidance is required.

2 PILLAR 2 – SUPERVISORY REVIEW PROCESS

2.1 Treatment of Interest Rate Risk in the Banking Book

There is potential for interest rate risk to be treated inconsistently across Australian incorporated banks. Banks adopting the more sophisticated approaches will need to hold a "mandatory capital requirement" to cover these exposures i.e. a Pillar 1 charge. However, for other banks this need will be determined on a "case-by-case basis", using a risk measurement approach prescribed by APRA i.e. a Pillar 2 charge.

The Bank would like to see consistency in APRA's approach to the treatment of interest rate risk in the banking book. This risk should be treated in the same way across all banks, i.e. either in Pillar 1 or Pillar 2, regardless of the approach which they adopt.

2.2 Timing of APRA's provision of information

The Bank recognises the pivotal role that APRA plays in our implementation of Basel II. In particular, under Pillar 2, APRA has an ability to exercise its "national discretion" - effectively imposing additional capital charges above the minimum capital requirements outlined under Pillar 1.

The lack of clarity around these national discretion issues causes the Bank concern as Australian banks are unable to enter into effective debate. This impacts in two areas.

- How will the national discretion issues impact the local industry relative to other jurisdictions?
- To what extent will the benefits suggested in QIS3 be eroded by the exercise of national discretion?

There is a need to incentivise banks through regulatory capital reductions. In addition, it inhibits some of our internal processes, such as development of a fully developed cost / benefit analysis for the Basel II project.

3 PART 4: THE THIRD PILLAR – MARKET DISCIPLINE

3.1 General Comments

The disclosure of substantial amounts of information raises concerns, specifically:

- The proprietary nature of the suggested content (Table 13 – the term on non-maturity deposits).
- In our view, the "one location" for all information will tend to be the annual accounts. This could result in an over emphasis on risk in the accounts. (para. 764)
- We consider semi-annual reporting is unnecessarily onerous. (para. 767)
- We question the commercial value of additional disclosure for asset securitisation, given that the information is generally available in the market. (Table 9)

4 SECTION IV - SECURITISATION FRAMEWORK

Please note that this is largely an extract from the Australian Securitisation Forum's *Submission to APRA on the Second Working Paper on the Treatment of Asset Securitisations (October 2002)*

4.1 Derivatives

- The securitisation requirements do not address the treatment of other derivatives such as cross-currency swaps. Guidance is required.

4.2 Transition Arrangements

- Transition arrangements for securitisation deals should be defined for transactions that mature post 2006, as per equity transactions in paragraphs 236-238.

4.3 Rating Based Approach

Paragraph 585 – Refer ABS Risk Weights table.

- Weightings for IRB banks investing in lower rated tranches are more severe than the Standardised risk weights. An IRB bank investing in a securitisation tranche should be able to use its sophisticated risk infrastructure to assess the PD and/or LGD of the exposure, as it would do for other investments. However, should a rating scale be imposed it should reflect the underlying risk and be consistent with other exposure types. For instance, the Rating Based Approach uses a floor of 7% risk weight, a gross over-compensation given the nature of AAA rated transactions.
- Neither the Rating Based Approach (RBA) nor the Supervisory Formula Approach (SFA) adequately accommodate the 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 SFA does not adequately account for the seniority of the facilities. For example, some facilities support the 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 SFA the facilities should attract the same risk weightings as the senior notes. This issue equally applies to liquidity facilities provided to asset backed commercial paper vehicles.

4.4 Supervisory Formula

Paragraphs 589 -592

- When determining the capital requirements for securitisation exposures, the technical instructions do not differentiate between the notional securitised exposures and the actual underlying pool. For example, the SFA methodology for retained securitisation exposures is applied to the size of the tranches securitised, and not the actual pool balance. Clarification is required.

4.5 Special Purpose Entities

Paragraph 517 (c) – "Eligible guarantors are limited to core market participants as defined in paragraph 142. Banks may not recognise SPEs as eligible guarantors in the securitisation framework."

- The operational criteria indicate that a SPE is not an acceptable provider of credit protection. However, a cash funded credit linked note issued directly by a Bank can be treated as cash collaterised. Banks should be able to enter into credit default swaps with SPE's providing that entity's obligations are supported by eligible collateral or guarantees.

4.6 Calculating K_{IRB}

Paragraph 603 – "When it is not practical for the bank to use either the 'bottom-up' approach or the 'top-down' approach for calculating K_{IRB}, the bank may, on an exceptional basis use…the highest risk weight assigned under the standardised approach to any of the underlying individual exposures covered by the liquidity facility…"

- Advanced banks should be able to use the highest risk weight assigned as per its own rating process, commensurate with the rest of its banking business, rather than use the risk weights applicable under the Standardised approach. If the supporting facilities are unrated, then the SFA should be applicable. If there is insufficient data for the SFA, then and only then should the standardised risk weights apply.
- Even if third party data were available, how can the sponsor validate that the data is qualitative? A reasonable basis for the ongoing estimation of risk of third party assets is required.

4.7 Off Balance Sheet Facilities

- The requirements do not contemplate the credit conversion treatments for all off balance sheet facilities, although a CCF appropriately adjusts for differences in the maturity of a facility e.g. a redraw facility and basis swaps have different risk characteristics to that of a letter of credit because the facilities operate differently. The Bank seeks a CCF treatment that is consistent with the current regulatory framework.

4.8 Eligible Liquidity Facilities

Paragraph 538 – "Banks are permitted to treat off-balance sheet securitisation exposures as eligible liquidity facilities if the following minimum requirements are satisfied:…"

- It is expected that the proposed criteria for eligible liquidity facilities outlined in this paragraph 538 (a) through (e) will practically operate in most instances. However, to incorporate these criteria into existing programmes would involve a lengthy process of re-documentation. The intent would be more simply and sufficiently captured by points (a), (b) and (d) only.

Paragraph 539 – "…the bank may apply a 20% CCF to the amount of eligible liquidity facilities with an original maturity of one year or less…"

- Undrawn commitments less than 1 year already qualify for a 20% Credit Conversion Factor (CCF). The CCF for eligible liquidity facilities less than 1 year should be reduced from 20% to 10% to reflect the limited circumstances under which the facilities can be drawn.
- The 100% CCF for eligible liquidity facilities provided by an IRB bank is too conservative. A credit rating does not adequately reflect either the probability of being drawn or the amount drawn at default. Rather, it assesses the credit risk assuming the facility is utilised.

Paragraph 540 – "Banks may apply a 0% CCF to eligible liquidity facilities that are only available in the event of a general market disruption (i.e. where a capital market instrument cannot be issued at any price)…"

- The definition of market disruption as not being able to issue securities "at any price" will not operate in Australia. A more appropriate mechanism should apply in the domestic market. The suggested text is "i.e. as defined by the National Supervisor for the domestic market".

4.9 Maturity Mismatch

- In relation to maturity mismatch, the Bank believes that the Basel Committee should encourage the further development of a dynamic market for hedging credit risk. As a mismatch effectively only represents a potential forward credit exposure, it is arguable how much capital is required to be held in advance of such an exposure actually crystallising. The guidelines do not take into effect the mitigating effect of early prepayments on the expected size of such forward exposures. A mismatch should be tolerable within prescribed maturity bands without requiring additional capital.

4.10 Synthetic Securitisations

Paragraph 517 – "For synthetic securitisations, the use of CRM technicques…for hedging the underlying exposure may be recognised for risk-based capital purposes only if the conditions below are satisfied:…(a) through (g)"

- In a synthetic securitisation, an originating bank may not have any direct exposure against the portfolio of reference entities against which protection is purchased. This typically occurs when entities refinance or the Bank actively reduces its exposure to mitigate credit risk. Where the actual exposure is smaller than the notional synthetic portfolio, the current proposals do not provide explicit guidance as to how to assign the risk weightings. The Bank suggests the notional portfolio tranches be deemed to be reduced from the highest-ranking tranche downwards. For example, if an originating bank holds actual exposures totalling 60% of the notional portfolio and only retains the top 40% of the synthetic deal (i.e. it has purchased protection for the first 60% of losses), then it should hold no credit capital against its "retained tranche".

4.11 External Credit Assessments

Paragraph 525 (b) – "…eligible credit assessment must be publicly available… In addition, "private ratings" will not qualify for this condition, even if they are available to all parties of the transaction."

- A private rating should be sufficient. The choice of public versus private rating in practice reflects the distribution strategy being employed.

4.12 Clean-Up Calls

Paragraphs 518-520

- Many Australian residential mortgage backed securities (RMBS) transactions include a time-based call under which the assets can typically be repurchased at fair value after a certain date (typically 7 years, more than twice the average life of the loans). It is possible that the outstanding balance at call date could exceed 10%. Clarification is sought that such time-based call options are not subject to the requirements of paragraphs 518-520, consistent with current regulatory practice. In addition, call options may be exercised for the purposes of transferring the assets or securities to another pool which will be financed via a new RMBS or asset backed securities (ABS). In this case, the percentage outstanding may be greater than 10%. Therefore, an exception to the 10% outstanding needs to be made if either (i) it is a time based option exercised as described above or (ii) the exercise of the clean up will ultimately be funded by the issue of a new RMBS or ABS.

4.13 Standardised Banks

- The absence of a cap similar to K_{IRB} creates a disadvantage for standardised banks - an approach that can result in an increased capital requirement creates clear disincentives for banks to become involved in securitisation. Standardised banks can use techniques like securitisation to prudently manage portfolio concentration risks. Such risks are particularly relevant in the Australian market, where there is a limited pool of corporate obligors. Regional banks also need to manage geographic concentration risk.

- There are no inferred ratings available under the standardised approach, even though the requirements for applying inferred ratings for IRB banks is very conservative. If a senior unrated exposure meets the inferred ratings test, a standardised bank should equally be able to infer a rating and apply the appropriate Standardised risk weighting.

- The "look through" approach for standardised banks does not take into account the benefit of external credit enhancements such as mortgage insurance and letters of credit.

5 SECTION V – OPERATIONAL RISK

5.1 Definitions

Paragraph 607- Definition of operational risk given by "risk of loss from inadequate or failed internal processes, people and systems or from external events. Includes legal risk, but excludes strategic and reputational risk

- Lack of clarity on impact types. Does the definition of operational risk include indirect (brand damage, loss of revenues, cost of improving processes) as well as actual loss?
- Previous releases focus on the "direct" loss components as included, with "indirect" loss components excluded. Pending any further clarification, this will be the working assumption.

Paragraphs 612 and 613, Definition of gross income – note 89 states as defined by national supervisors and/or national accounting standards

- Creates potential competitive issues with variations in national supervision and/or accounting standards (for example accrual versus market value accounting?, high inflation/margin countries). We need to define income on the basis of generally accepted accounting principles and international accounting standards.

5.2 Standardised Approach

Paragraph 615

- Insurance not included in business lines - Clarification is required on how insurance businesses are to be handled in Basel II. Also clarification is required on impacts on a funds management business contained within a licensed insurance company.
- Mapping internal business structure to business lines - Will mapping to the business lines be at the discretion of the bank.

Paragraph 617

- Use of the average annual level of gross income over the past 3 years. Will banks be required / allowed to amend the average where there has been a significant change in the business structure, for example, a business acquisition or divestment?
- Calibration of betas - alpha should act as a ceiling for the beta factors, that is, no beta should exceed alpha. It is possible to have betas for standardardised approach to be greater than those for the basic indicator approach, especially for banks with high proportion of corporate finance, trading / sales, payment / settlement business lines.

5.3 Advanced Measurement Approach and Standardised Approach

Paragraph 618 - AMA qualification subject to supervisory approval

- How will the Basel Committee encourage a fair approach by various national supervisors towards AMA qualification?

5.4 Advanced Measurement Approach

Paragraph 628 - Raises possibility of refinement of proposals based on outcomes of review given the time of review (by end of 2006) and given that the AMA specifies a bank must use this approach one-year prior to implementation of the New Capital Accord.

- Any review of the proposals at this late stage will impact the cost benefit & capability of any bank to qualify for AMA. Any review must be done in complete consultation with industry participants & in consideration of the heavy investment made in AMA development.

5.5 General

Guidelines/criteria on non-insurance recoveries in capital calculation

- These have not been addressed