European Association of Co-operative Banks
Groupement Européen des Banques Coopératives
Europäische Vereinigung der Genossenschaftsbanken

Brussels, July 2003

COMMENTS ON THE THIRD CONSULTATIVE DOCUMENT "THE NEW BASEL CAPITAL ACCORD"

INTRODUCTION

The European Association of Co-operative Banks (EACB) is one of the main associations of the European credit industry. Its core objective lies in defending the professional interests of its members.

The association represents one of the leading banking groups in Europe. Its membership base of more than 30 organizations comprises co-operative banking groups from the 15 European Union Member States, but also from Central and Eastern European countries. These represent 37 million Members, 101 million customers, 505,000 employees in more than 50,000 business points and deposits of about EUR 1,209,000 million.

The activities of the EACB's members are mainly focused on their respective national or regional markets. Even where they are identified as having an international dimension, they are nonetheless groups of that are composed of medium-sized or small-scale institutions. Their second salient feature is that they are universal banks, but within which the retail-banking arm, geared to promoting the personal segment and SMEs, definitely takes precedence. Indeed, co-operative banks are among the leading providers of capital to small businesses and private customers in Europe.

The Association welcomes the fact that the Basel Committee has published a third set of documents for consultation on a new capital requirements framework for banks. The members appreciate that important modifications to the general framework have taken place, which will lead to more appropriate solutions and comment on the following issues:

A. GENERAL REMARKS

LEVEL PLAYING-FIELD

The members of the EACB welcome the more risk-sensitive approach of the new Basel accord. They underline that the risks undertaken by financial institutions, regardless of their legal form, should be treated the same. However, there should be no question of the new capital adequacy system leading to a consolidation of the banking sector or the placing of any institution in the financial services sector at a competitive disadvantage. Therefore, the rules should be easily manageable for smaller institutions also.

CO-OPERATION OF HOME-COUNTRY-SUPERVISORS AND HOST-COUNTRY-SUPERVISORS

Internationally active banks deal with supervisors in their home country as well as in other countries in which they operate. As regards the practical implementation of Basel II, there are many issues under pillar 1 and pillar 2, where both the home country supervisors and the host-country-supervisors have to decide on the same issue (e.g. the use of one of the proposed approaches for credit risk as well as operational risk). For an efficient implementation of the Basel II Accord it would be proposed if such bank could primarily deal with just one supervisor (preferably the home-supervisor) to agree upon the use of one of the proposed approaches for credit risk as well as operational risk. The other host supervisors should then accept the approval.

After implementation, the yearly supervisory review process also requires an efficient process and we propose a similar approach for dividing work between home and host supervisors. Competition between supervisors should be avoided at any price.

We therefore suggest to the Accord Implementation Group (AIG) to establish a practice of regular meetings between supervisors of each major banking group. Maybe the number of supervisors involved could be limited to around 5, representing the major business entities within a banking group. The goal would be to streamline the planning of the examination and the validation processes as well as the compliance process without contravening the legitimate and necessary needs of host regulators regarding subsidiaries in their jurisdictions.

PROCYCLICAL EFFECTS

The new rules will generate procyclical effects, despite the adjustment of risk weighting curves. The “fair value” accounting rules of the IAS (IFRS), whose implementation in the EU will coincide with that of Basel II, will considerably increase such cyclical effects. Research on the macro-economic impact of Basel II should be in the focus of the Committee’s future work. The EACB suggests examining the introduction of caps in order to avoid any excessive increase of capital charges due to procyclical effects.

B. CAPITAL CHARGES

INCENTIVES TO APPLY THE IRB/FLOORS DURING TRANSITION PERIOD

The EACB takes the view that for the time being, the incentives to apply the IRB instead of the standardized approach are not sufficient yet. There should be stronger incentives to encourage the move on to more advanced approaches: internal rating (IRBA), advanced measurement approach (AMA). On the other hand, the standardized approach must remain a serious (and competitive) method for smaller banks and institutions. There should be no question of the new capital adequacy system placing any institution in the financial services sector at a competitive disadvantage to its international peers as a result of diverging capital requirements.

The EACB's members object to certain "floors" or limits that will limit the advantages that banks might draw out of the new Basel framework, like, for example, the minimum LGDs of 10% for housing loans until the end of 2008. There is no appropriate justification for this limit, in particular in cases of significant over-collateralisation. Therefore, we suggest reconsidering the use of "floors" for the reduction of capital or for minimum LGDs. (nr. 23; 235).

We underline the importance of rendering some measures more flexible to avoid cliff effects, e.g. the distinction between the retail and SME portfolios (the criterion being 1 million in loans outstanding for a group) and the SME and corporate portfolios (turnover of 50 million Euros irrespective of whether the branch of activity).

PERMANENT PARTIAL USE

The members of the EACB appreciate the provisions on the phased roll-out as they are described under Nr. 225 ss. of the consultation documents. These rules will contribute to increased flexibility that will allow a proper application of the Basel accord. However, they suggest allowing the permanent application of the standardised approach to certain parts of the lending portfolio after the introduction of the IRB approach. The possibility of a permanent partial use of the IRB approach should be established in the following cases:

- State and bank debts
  In many cases, the portfolios containing loans to the state or to other banks may be material in volume, but not regarding the number of assets.

- Unavailability of PD and LGD,
  Banks will face the impossibility to collect historical data to calculate PD and LGD (only in advanced method for this latter) for some portfolios, since there have been insufficient cases of defaults during the 10 last years and there are no external ratings available for mapping. This would in particular be the case for many classes of sovereigns and cause problems both for smaller and bigger credit institutions. Therefore, banks should be authorized to keep the standardized approach for such portfolios or to retain a single PD at 0% (and a LGD at 0% in advance approach) for all of the relevant counterparts.
  Furthermore, banks that operate in many countries, may find themselves in a situation, where the circumstances do not allow determining PDs or LGDs (takeover of a "non-sophisticated" bank, fundamental changes of the political and economic systems of a country; no established legal system for loan-recovery;) and need to apply the standardized approach for the activities in certain countries.

- Immaterial Exposures
  The "materiality" threshold (nr. 228) is strongly supported, since it would contribute to higher efficiency of the IRB processes. But this should also apply to the group/consolidation level. Within a group of companies it must be possible to treat the risks or, more precisely, the business volume of a subsidiary as being of subordinate importance for the overall group, thus treating it as "non-material". Even if the parent company of the group and other major group companies work with the IRB approach, it should be possible for the "non-material" group companies to calculate their capital underlying according to the standard method and continue to include these values in the consolidated consideration.

- Other Exceptional circumstances
  The members of the EACB ask the Basel Committee to also consider the fact that special situations may occur in groups of banks, in which subsidiaries are active in different fields of business. Difficulties could arise for some subsidiaries which are specialized in some credit products and which do not have the same customers base as the other entities, for which the internal rating tool is not relevant since they do not manage the customer accounts, which are not on the same computer and data platform as the other entities of the groups, and of which the amount of operations could be regarded as immaterial on an individual basis but would be material on a global basis.

TREATMENT OF EQUITY

The European cooperative banks, with their decentralised, labour-sharing network structure, own many holdings in the service providers of their network, such as data-processing centres, central banks, securities service banks, etc. The investments in these holdings are long-term, serve no speculative purposes and come about exclusively on account of the network structure. In fact, they represent the essence of the cooperative structure.

With the current proposals, groups structured in this way would be disadvantaged compared to competitors established in other forms, since they could only avoid the higher capital charges in this field by relinquishing their decentralised, labour-sharing network structure. Neither the transition period nor the threshold of 10% of Tier 1 and 2 solve the problem. The Basle regulations would hence have an impact on structural policy without this being necessary or appearing to be justified.

Hence should the Basle regulations keep to higher capital charges for holdings than exposures, we consider it appropriate that holdings existing on the basis of the cooperative decentralised, labour-sharing network structure or which come into existence in the future through the grandfathering regulations should enjoy a more favourable treatment. In this respect, we could envisage the national supervisory authorities establishing which holdings are held on the basis of this structure and keeping a list of the relevant holdings of the institutions.

RISK MITIGATION: LEASING AND HOUSING LOANS

It would be highly desirable to extend the scope of the risk mitigation techniques to leasing as well. In fact, leasing provides for an important risk mitigant. The lessor keeps the property of the real estate during the whole period of the leasing contract. This title in land provides for an efficient collateral. Consequently, it would be advisable to include leasing as risk mitigant to the capital adequacy framework.

We also suggest including into the category of “housing loans” also those assets that are not covered by mortgages but which also serve housing finance, provided that they are collateralised in a manner that is equivalent or even better than mortgage collateral

REQUIREMENTS FOR THE APPLICATION OF IRB

The members of the EACB appreciate the intention of the new accord to introduce improved risk management techniques for credit institutions, applying more risk-sensitive criteria. In fact, the circle of credit institutions that may chose by themselves to step forward to the IRB approach should be as wide as possible.

Furthermore, it should be considered that the more sensitive risk measurement techniques (internal ratings-based procedures) would equally be applicable to smaller-sized credit institutions that should have the option to use the IRB approach. However, this Association is particularly concerned to realise that the qualitative criteria (paragraphs 349 et. al of CP3) for the implementation of such approaches will be difficult to implement in small and medium-sized co-operative banks (the majority of which have a small workforce of 50 employees or less) and might be disproportionate regarding the cost. These entities may chose to calculate the risk of default using rating and scoring techniques supplied by the co-operative group’s central institutions and can take that risk into account when granting loans and setting the price to be charged for services. Yet, formal criteria, such as numerous units or independent departments supervising one another cannot be met on an individual basis.

However, there should be no question of the new capital adequacy system leading to a consolidation of the European banking sector or the placing of any institution in the financial services sector at a competitive disadvantage to its competitors. To avoid any competitive disadvantages for the European economy, all regulatory requirements should be easily manageable even for smaller EU banks, which play an important role in SME-financing in most EU Member States. A more flexible and "principle-based" framework can encourage these locally active banks to further improve their risk management as an internal rating-based (IRB) approach without the significant cost burden of implementing a new system.

In this connection, the fact has to be underlined that in the structures of these – from the BIS point of view – small banks, personal supervision prevails (relationship banking), which is very often faster and more attentive than formal procedures. The formal aspect could however be catered for by central units in decentralised network structures too, thereby opening the way towards the internal ratings-based approach desired by the supervisors for these institutions too.

OPERATIONAL RISK

As regards the methods to determine operational risk, the members of the EACB take the view that the gap of criteria for the implementation of the standardised approach has been highly reduced and thereby reduced the progressiveness between these methods, as it existed under CP 2. If the ß-coefficients remain unchanged, the additional effort to implement the standardized method seem not to be compensated by a reduction of own funds, which, unfortunately can only be achieved by passing to the advanced methods.

C. PILLAR 2

For many members of the EACB, the pillar 2 supervisory review process still is an issue of serious concern.

It will be essential to develop transparent and convergent procedures for this process. The overall basis, however, is a fair and open dialogue between banks and supervisors and a further increase of co-operation between supervisors.

Furthermore, there is great concern that rules on the supervisory review process might in practice lead to an “add-on-system”, with systematic extra capital charges. We therefore recommend clarifying that extra capital charges will be applied only under very specific circumstances.

D. PILLAR 3

REQUIREMENTS IN GENERAL

As regards market discipline, it is the view of the EACB members that the proposed information requirements on complex and sensitive data on credit quality and defaults (PD, LGD, EAD) still seem too numerous (Nr. 774 ss.). Of course, supervisors should have access to any such information. But such detailed disclosures of sensitive information to the general public are not required for the comparability of banks and should not be mandatory. Different disclosure options and grades should be available to banks to correspond to the needs of different users of information (analysts, investors, public). This would ensure to develop disclosure standards that are market-driven; and market pressure would impose limits to the banks’ discretion regarding disclosure. Furthermore, in particular circumstances or in the case of smaller regional banks, we still see the danger that certain data may allow to draw immediate conclusions on sensitive issues related to specific customers of the bank.

NO DISCLOSURE OF ADDITIONAL CAPITAL

The consultation document (nr. 714) stipulates that under pillar 2 the supervisor can require banks to operate above the minimum required regulatory capital as calculated under Pillar 1. We strongly suggest that such additional capital requirements should not be disclosed the general public. The disclosure of such information would create confusion at capital markets and with the general public with respect to the actual minimum requirement. In order to avoid any misunderstandings and speculations, we recommend deleting the obligation for any additional capital requirements under Pillar 2.

E. Specific Technical Aspects

Indexation of numerical thresholds

There should be mechanisms to allow a regular adjustment of the numerical threshold values under pillar I to the rate of inflation and to changes in financial practice. These threshold values are very important and may have an important impact, e.g. those relating to SME financing. A non-indexation of these thresholds would, after some years, question the results negotiated.

Criterion for defining "qualifying revolving retail exposures" and FMI

Sub-paragraph (d) of paragraph 202 of the document stipulates "*The bank can demonstrate that the sub-portfolio exhibits a high ratio of FMI to expected loss. In general, FMI should cover the sum of expected losses and two standard deviations of the annualised loss rate on the sub-portfolio*"

In practice, our experts' calculations show that an FMI requirement of this amount (FMI + two standard deviations) prevent credit balances or credit cards from being considered as "qualifying". In keeping with our first set of calculations, an FMI of between 2.5% and 8.2% will be required depending on the type of credit card.

Moreover, we take the view that the arrangement where under the minimum FMI limit is calculated would need to be revised so that it makes more sense statistically: rather than "PD x LGD + 2 x sigma", it could be "PD + 2 x sigma) x LDG".

The formula shown in the footnote Nr. 67 would also need to be revised to avoid illogical results: instead of "min (0.75 x PD x LGD, FMI-2 x sigma), it should be "min (0, 0.75 x PD x LGD, 0.75 x (FMI-2 x sigma))"

Offsetting EL against general provisions for credit risks

Paragraph 348 of CP3 stipulates that *"General loan loss provisions that are in excess of the amount included in tier 2 capital (see 1988 Accord (updated to April 1998) paragraph 18 to 21 and 14) can be used to offset the EL capital charge to the extent that the EL capital charge, after offsetting specific provisions and portfolio-specific general provisions, exceeds the maximum amount of general loan loss provisions eligible for inclusion in tier 2. General provisions that meet these conditions should be multiplied by 12.5 and deducted from risk-weighted assets"*.

Our considered opinion is that this paragraph would need to be reworded in the realisation that the condition for offsetting EL (that the capital charge for EL exceed the proportion of general provisions calculated as TIER 2) is meaningless and could lead to serious inconsistencies: a 1-euro difference in the EL capital charge in the general provisions calculated as TIER 2 could give, or not give, the right to offset all capital charges for EL against the proportion of general provisions not computed as TIER 2.

USING INSURANCE POLICIES AS AN OPERATIONAL RISK MITIGATING TECHNQUE

We ascribe particular relevance to taking insurance on board as an operational risk mitigating technique and equally applicable to institutions not resorting to advanced measurement approaches (AMAs).

Spain has taken out this type of policy (bank mergers) for major co-operative credit groupings, thereby transferring these risks outside the sector. The policies in question have turned out to be crucial to mitigating the effects of irregularities, errors and default. They are not often used, but impact heavily on assets, particularly those that affect smaller-scale institutions.

When using insurance policies as mitigating techniques, we see no justification for setting an initial term of no less than one year as stated in the second indent of paragraph 638 of CP3. In Spain, these policies can be renewed if no action is brought by any of the parties.

LIMITING THE USE OF THE "SIMPLIFIED STANDARDISED APPROACH"

A prerequisite for using the "Simplified Standardised Approach" under paragraph 59 is that a bank may not act as "originator" in a securitisation process.

In terms of requirements, our argument is that it would be more rational for banks using the "Simplified Standardized Approach" not to maintain "first loss positions", corresponding to securitisations originated by them nor facilitate "credit enhancement", "liquidity facilities" or other type of financial support" for securitisations, but not to limit their options as originators.

ADMINISTRATION OF RETAIL PORTFOLIOS

Retail segment: The method of administration must be determinant when it comes to allocating loans to the retail segment's portfolios. Thus, a low value loan for whatever kind of counterparty should be assessed by the "retail evaluation methods", without account being taken of the overall global exposure for the counterparty at the consolidated level (1 million euros in the ratio).