Subject: The New Basel Capital Accord – Euroclear comments

Dear Sirs,

Euroclear is pleased to provide comments and suggestions on the Consultative Document on the New Basel Capital Accord (hereafter “the Accord”), issued by the Basel Committee on Banking Supervision in April 2003.

We believe the Accord may have a significant impact on the banking industry in general, and on the capital required by Euroclear Bank in particular. We would like to highlight our areas of concern and to suggest recommendations to this effect.

We welcome the open approach taken by the regulators and, in particular, the decision to involve the banking industry in the discussion. We believe it represents an excellent approach in establishing a capital charge that is truly risk sensitive and correctly reflects the risk profile of each individual bank. Moreover, it will encourage banks to improve their risk management practices.

We think it is a step forward and are glad you took some of our previous comments into account (such as the “w” factor that disappeared).

In general, we share and support the comments made by the European Banking Federation and the Belgian Banking Association.

Sincerely,

Theo Van Engeland
Chief Financial Officer & Member of Management Committee of the Board of Directors
Content

I. The second Pillar
II. Operational Risk
III. Credit Risk
I. The second Pillar

The supervisory review process of the New Accord is intended not only to ensure that banks have adequate capital to support all the risks in their business, but also to encourage banks to develop and use better risk management techniques to monitor and manage their risks.

The second Pillar is the big challenge of the coming years due a) the need for consistency in the implementation process across countries and b) the need for adequate human resources not only on the side of all institutions being regulated but also on the regulators’ side.

Concerns:

- Application of consistent approach both within a country and across different countries to ensure a ‘level playing field’.
  - National discretion creates a risk of inconsistency.
    As a consequence, regulatory arbitrage could become a common practice given the opportunities for delocalising activities.
    Pillar II must be compulsory everywhere on identical terms, i.e. an entity in one country with a special risk profile needs to be treated as other entities with the same profile in (an)other country/countries.
  
  - Pillar II should not weaken the intention of Pillar I: it is a complement of (and not a substitute for) Pillar I.
    It will be challenging for the regulators to strike the right balance between i) flexibility, ii) consistency in implementation and iii) complexity as the rules are applicable to all international entities but when there is no international standard, it makes the situation very complex (e.g. it is not sure whether regulators will apply a multiplier in Pillar II with regard to the Pillar I minimum capital requirements ¹).

¹ For instance, in relation to Operational Risk, the application of such a multiplier would defeat the incentive to move to an AMA model.
Therefore, it is important to foster collaboration between banks, regulators and trade-bodies, and also between home and host supervisors to protect the level playing field, and to ensure a) home/host issues are resolved, b) cross-border implementation of Basel II and c) consistency across countries.

- Consolidation issues will become frequent: increased pressure on home and host regulators to define their roles with regard to overall assessment of capital adequacy at Group and subsidiary level.
  
  For example, relating to the Operational Risk, a balance must be struck between enabling each supervisor to fully satisfy its obligation to ensure the safety and soundness of the banks operating in its jurisdiction and enabling a bank to implement its AMA across multiple jurisdictions.

  - We encourage the Host supervisors to cooperate with, and rely on, Home supervisors to verify the conceptual soundness of the methodology and the risk data being used by the bank\(^2\).

\(^2\) Furthermore, the Host supervisor’s role should be limited to reviewing the integrity of implementation of methodology chosen in its jurisdiction rather than determining the conceptual soundness of the methodology itself.
- **Transparency and accountability**: will supervisors publish in advance the criteria to be used in the review of banks’ internal capital assessments, or will banks make their own judgment upfront and then be subject to reassessment by the supervisors?

  - Pillar II clearly states, "If a supervisor chooses to set target or trigger ratios or to set categories of capital in excess of the regulatory minimum, factors that may be considered in doing so should be publicly available". It is crucial that regulators’ criteria to increase capital requirements are transparent.

    - To make sure the same objective and known rules are applied to every entity, we insist on the need for Regulators to apply prudential practices and we fully support the Accord Implementation Group’s intention to publish more information about the Regulators’ capital requirements according to the risk profile.

- **Adequacy of supervisor resources** to perform increased responsibilities on a timely basis.
II. Operational Risk

Pillar I: Capital Requirements

Operational risk is clearly the area where the dialogue and cooperation between regulators and the banking community have been the most fruitful. We thank regulators for having accepted a lot of the industry’s comments and recognised the use of the Advanced Measurement Approaches.

The following points still deserve attention before implementation.

Calibration

It is important that the risk factors used under the different approaches to calculate capital requirements are correctly calibrated in order to guarantee the continuum principle and, thereby, fulfill the regulators’ purpose to motivate banks to improve their operational risk management practices, through decreased capital charges.

The calibration as it now stands offers little incentive, from a pure capital viewpoint, to move from the Basic Indicator Approach to the Standardised Approach, since the latter will result in a higher capital charge even though it will require significant investment in a risk management framework.

These factors were calibrated based on 1999-2001 data collected through the last two quantitative impact studies. Up to 2006, as banks establish, review and/or improve their operational risk management framework, more information and data will become available and should be collected by regulators to improve this calibration.

Given the current status of the calibration, we recommend that regulators allow sufficient flexibility to perfect the calibration before and after implementation. We encourage regulators to conduct further Quantitative Impact Studies for that purpose.

Loss categorisation

The categorisation of losses has been the subject of heated debate among banks. To this date everyone recognises the merits and shortcomings of the proposed
categorisation, but has nothing better to propose as of yet. As more and more data are collected, and expertise is built in terms of categorization, banks may wish to revisit this classification.

- We recommend that regulators allow sufficient flexibility to perfect the loss categorization before and after implementation.

Risk mitigation – Insurance

We welcome the recognition of insurance as risk mitigant under AMA, although the qualitative criteria remain very strict and difficult to meet given the current insurance market conditions. This recognition should be flexible enough to foster innovation and encourage banks and the insurance industry to develop a wider range of operational risk mitigation tools.

We are concerned about the treatment of captive insurance. Banks are required to deduct capital investments in insurance captives from the regulatory-eligible capital but are also prohibited to deduct the risk mitigation provided by captive insurance from the Pillar I regulatory capital. Further dialogue on this topic is necessary between banks and regulators.
III. Credit Risk

Impact of collateral on Euroclear capital requirements

Treatment of guarantees as risk mitigation

The proposal to use the weighted average of the weights assigned to the obligor and to the guarantor is not in line with, and in fact overstates the inherent risk.

- *We propose to use a methodology that encompasses joint probabilities of default of both the obligor and the guarantor or, at least, to use the lowest probability of default of both.*