FEDERATION BANCAIRE DE L'UNION EUROPEENNE

Le Secrétaire Général

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Mrs Danièle Nouy
Secretary General,
Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
CH - 4002 BASEL

Brussels, 30 July 2003

Dear Mrs Nouy,

Subject: Comments on Consultative Paper 3 (CP 3)

The European Banking Federation (FBE) welcomes the opportunity to comment on the version of the New Basel Accord contained in CP 3.

Pillar 2 Supervisory Review Process

The FBE would encourage the Basel Committee to clarify the scope and purpose of the Pillar 2 Supervisory Review Process to ensure consistent interpretation of the Accord by supervisors. The FBE is concerned that the proposed introduction of a series of specific issues that banks and supervisors should focus on when carrying out the supervisory review is moving toward a system of automatic additional capital requirements driven less by the specific circumstance of each bank and more by a general regulatory requirement. This would be an unacceptable outcome, not least because these requirements have not been included in the calibration of the Accord.

Calibration and Implementation

The FBE believes that further calibration of the Accord should be carried out before implementation in 2006. Additional quantitative impact studies would help to assess methodology convergence and increase confidence in the New Accord.

The FBE agrees with the Basel Committee that the successful implementation of the New Accord will require enhanced co-operation between supervisors, especially for the cross-border supervision of complex groups. The FBE welcomes

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the Accord Implementation Group's intention to develop principles to facilitate closer practical co-operation and information exchange among supervisors, but this work must be driven by clear principles included in the Accord itself and the introduction of a practical mechanism to govern the relationship between a bank's home and host state(s) and resolve a conflicting rule situation.

The FBE believes that the Lead Supervisor concept should be introduced and would welcome an opportunity to discuss with the Accord Implementation Group how this might be delivered in practice.

In principle, the FBE supports a "top-down" solution (ie the home state applying Pillar 1 capital requirements across a bank group). This might be delivered by forming a college of supervisors for international banking groups, guided by a framework of principles in the Accord itself.

This framework of principles should include the following:

- no bank would be subject to more than one approach to the calculation of minimum capital requirements in any one jurisdiction;
- the Pillar 1 capital requirements applied in the home and host states would be the consolidated figure at the level of the group to produce a single minimum capital requirement. This would ensure that the home state maintained control;
- Pillar 2 would be applied at the top consolidated level and supervisory responsibilities would be exercised by the home state supervisor. Only in exceptional circumstances should Pillar 2 requirements be exercised by a host state supervisor.

If an appropriate "top-down" solution cannot be delivered, the FBE would be prepared to discuss whether an acceptable, but still co-ordinated, approach (ie both home and host states would apply Pillar 1 capital requirements) could be developed. The same principles as above should apply.

National discretions

The FBE remains concerned about the number and scope of national discretions proposed in the Accord. The FBE would encourage the Committee to review the national discretions in the light of the QIS 3 data and remove those that are no longer necessary. In particular, the FBE would urge the Committee to remove those national discretions that will have a material impact on the competitive position of banks operating in the same market only on the basis of their nationality, e.g. the treatment of claims on banks in the Standardised Approach and the maturity adjustment. Those national discretions that remain should be removed as soon as possible. In the meantime, their impact should be kept under review and supervisors should explain publicly how they are used.

Pro-cyclicality

The pro-cyclical impact of the Accord is an issue that has been debated during the preparation of the New Accord. The FBE notes that a pro-cyclical pattern is characteristic of banks' activities and that possible measures to limit the extent to

which the Accord is likely to accentuate this pattern have both advantages and disadvantages. The FBE suggests, however, that there is a case for further discussion of possible measures to limit the pro-cyclical impact of the Accord.

Pillar 3

The FBE has appreciated the constructive dialogue which has taken place with the Basel Committee (through the Transparency Group) on the development of the disclosure requirements in Pillar 3. Its detailed comments of a general nature on Pillar 3 cover the following issues:

- the centrality of international accounting standards;
- the need to avoid requiring overlapping disclosure obligations;
- the level of prescription in Pillar 3;
- the need to keep the Pillar 3 disclosure requirements under review;
- the implications of the two types of information required in the tables – some relates to balance sheet information, some is based on regulatory information.

The following documents are enclosed:

- enclosure 1 contains the FBE's detailed comments on Pillars 1, 2 and 3 of the New Accord;
- enclosure 2 illustrates the impact of the proposed effective maturity formula and sets out a possible alternative;
- enclosure 3 proposes possible measures to limit the pro-cyclical impact of the Accord that the Committee might wish to consider;
- enclosure 4 contains a mock up example of how the proposals in Pillar 3, as we understand them, might be implemented;
- enclosure 5 provides specific comments on the outstanding issues on the disclosure requirements contained within CP 3 - Pillar 3.

Yours sincerely,

Nikolaus BÖMCKE
Secretary General

Enclosures: 5

EUROPEAN BANKING FEDERATION'S DETAILED COMMENTS ON CONSULTATIVE PAPER 3 PILLARS 1, 2 AND 3

Scope of application

Deductions of investments from capital

The FBE remains concerned about the impact of the proposal that deductions of investments should be made 50% from Tier 1 capital and 50% from Tier 2 capital.

2. The 1988 Accord (Annex 1, C) states that "investments in unconsolidated banking and financial subsidiary companies" should be deducted "from total capital", and paragraph 24 of the Accord states that such investments should be deducted "from the capital base".

3. The FBE notes that the New Basel Accord does not make any proposals to reform the definition of the capital base. In view of this, the FBE believes that no proposals should be made to change the rules determining the capital base.

Pillar 1 – Minimum Capital Requirements

Standardised Approach

Claims on banks

4. The FBE continues to believe that one option for the treatment of claims on banks should be mandatory. The two options proposed in paragraph 37 of CP 3 would result in claims on the same bank being treated differently depending on the jurisdiction in which they arose.

5. The risk weight for single A rated banks in Option 2 would lead to distortions relative to both the current Accord and to Option 1 and IRB approaches. Within the European Union, the cliff effect would be accentuated by the European Commission's proposal to allow the permanent partial use of the IRB framework for sovereigns and banks.

6. The FBE urges the Committee to retain option 1, but with the risk weight for short-term claims in option 2 being made a feature of option 1. The FBE also suggests applying this approach to claims on public sector entities.

Claims secured by residential property

7. The FBE supports the Committee's proposal to apply a 35% risk weight to lending fully secured by mortgages on residential property. The FBE is, however, concerned that a national discretion has been added in paragraph 51 of CP 3 on the treatment of past due residential mortgage loans. The FBE believes that this national discretion should be removed.

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IRB Approach

LGD floor

8. The FBE believes that the introduction of a transitional LGD floor of 10% for residential retail exposures (paragraph 235) is inconsistent with the concept and objectives of the IRB Approach. But if the LGD floor is retained, the FBE would urge the Committee to apply the floor at the level of the portfolio and *not* at the level of each sub-segment within the portfolio.

LGD estimates

9. The FBE is particularly concerned about the requirement to use recession case LGD estimates in paragraph 430. This is a major proposal with significant consequence for the capital impact of the new Accord. On the basis of the data collected in QIS 3 the FBE would ask the Committee to estimate, and make public, their own assessment of the impact.

10. The FBE understands the concerns that the Committee is seeking to address but strongly questions whether a uniform requirement to use recession case LGDs is an appropriate or sound response, especially as default weighted averages are required for LGD estimates. The proposal may not fit with the evolution of a market, will penalise banks with a longer data series, will fail to reward improvement in bank risk management practice, fail the use test and result in an overstatement of required capital.

11. The FBE questions the need for this requirement in the context of a standing requirement to base LGD estimations on seven years data, on multiple requirements to be conservative, to utilise stress tests and, of course, have regard to Pillar 2.

Treatment of qualifying revolving retail exposures

12. The FBE remains concerned about the treatment of QRRE proposed in paragraphs 202 and 203. The differentiation in the treatment of QRRE and other product offers such as personal loans is not justified by an assessment of the risks.

13. The FBE believes that the addition of a third retail exposure class as proposed would:

- distort the market by producing a cliff effect between the capital treatment for similar products;
- encourage banks to define their product offer to fit the regulatory rule;
- increase complexity in the treatment of retail assets.

14. The FBE notes that the Committee's comments in paragraphs 76-78 of the Overview document suggest that it shares these concerns. The FBE would encourage the Committee to address them by making the third retail exposure

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class product neutral with entry into the class defined only by the volatility of the portfolio in question.

Claims on banks in the Foundation Approach

15. The FBE believes that the 45% LGD assigned to senior claims on banks not secured by recognised collateral (paragraph 256) is too high when assessed against the low loss rate experience. The FBE suggests that a one third reduction in the LGD to 30% would better reflect the risks. The 75% LGD on subordinated claims on banks (paragraph 257) should be reduced to 50%.

16. The FBE notes that the differentiation in the treatment of sovereigns, banks and corporates in the Standardised Approach is not reflected in the IRB approach. The FBE believes that it would be consistent with the Committee's objectives to introduce such a differentiation.

Effective maturity

17. The effective maturity adjustment has a critical impact on the amount of capital allocated to market and trade finance activities. The FBE does not believe that the maturity formula is appropriate to be applied to maturities of under one year. The excessively conservative result produced by the formula means that the exemption from the one year maturity floor in paragraph 291 has no substantive impact.

18. The impact of the proposed formula is illustrated in enclosure 3, and a possible alternative approach is set out.

19. The FBE also believes that the effective maturity of 6 months proposed for repo-style transactions in paragraph 288 should be reduced to 3 months.

Rules for equity exposures

20. The FBE is disappointed that the Committee has not amended the rules on the treatment of equity exposures. The FBE continues to believe that the internal models method produces disproportionate capital requirements and creates a disincentive to move from the standardised approach. It would penalise a banking strategy model common in many countries.

21. The FBE would urge the Committee to mitigate the negative impact of the rules by:

- *removing the proposed risk weight floors in internal models* - or at least the proposed floors (200%-300%) for the market-based approach – which are not justified by an assessment of the risks;

- *using monthly instead of quarterly returns for market based approaches* to take account of the liquidity of equity markets. This would partially ease the overstatement of capital requirements and permit the availability of a longer sample series;

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- *eliminating the simplified market model* or using it as a ceiling for capital requirements for other approaches;

- *applying to equity portfolios, using either the PD/LGD or market based methods, the grandfathering provisions* (10 years from publication date on a national discretions basis).

22. The FBE also suggests that the New Accord should apply a lower risk weight to development and leveraged buy-out (LBO) funds than that applied to classic venture capital funds. A study conducted by the French Equity Investment Association on a significant sample (10% of invested capital in France for the last 10 years) shows that the 400% risk weight in the simple risk weight method is too high for such particular investments.

Recognition of provisions

23. The FBE urges the Committee to revert to the approach for recognising provisions contained in paragraph 333 of the QIS 3 Technical Guidance Note. The approach proposed in paragraph 348 of CP 3 is too restrictive.

24. The limits set out in paragraphs 346 and 347 should also be removed. The FBE believes that there are no grounds to prevent portfolio specific general provisions in excess of EL from being used to reduce any other capital charges. The FBE notes that provisions such as country risk provisions may pertain to several portfolios.

IRB minimum requirements

25. The FBE welcomes the proposal in paragraph 413 to allow flexibility in the application of data requirements for data collected prior to the date of implementation of the New Accord.

26. The FBE would also urge the Committee to:

- bring data requirements for the Advanced IRB approach within the scope of the transitional arrangements to deliver an LGD data requirement of 4 years at implementation;

- change the minimum data storage standard to a requirement that banks should hold the current rating and rating history.

27. The FBE believes that the requirement for banks to retain sufficient data to be able to conduct a retrospective rating is disproportionate.

28. More generally, the FBE would encourage the Committee to rationalise the minimum requirements by improving the focus on the objectives that a qualifying bank's risk rating system must fulfil and reducing the degree of prescription on how this should be achieved.

29. The FBE is concerned that the current approach may lead some supervisors to invalidate an efficient rating system. It is important that the minimum

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requirements do *not* result in one kind of rating system (for example, a model-based system) being considered as the only acceptable approach.

30. The FBE believes that the New Accord should *not* contain implicit or explicit incentives to mechanical quantification of PD, LGD and EAD based exclusively on historical data and calculation formulae. On the contrary, the Accord should favour strong analytical processes tracking separately:

- the valuation of guarantees;
- the valuation of collateral;
- residual “unsecured” recoveries on the obligor;
- and the probability that the borrower returns to non-defaulted status.

31. Supervisors could usefully focus on the quality of the assessment of each component taken individually, and then on their overall aggregation to compute LGD.

32. The FBE also believes that expert human judgement has an essential role to play in the assessment of PD, LGD and EAD, particularly in the field of corporate lending. To illustrate, most of the impact of personal guarantees or liens on a borrower’s strategic assets comes not from the activation of these guarantees and collateral but from the means of pressure on the borrower that they represent. Therefore, tracking the proceeds from the use of each guarantee or collateral in a recovery process would be a costly process that would not improve the risk assessment – it may in fact lead to an incorrect assessment of LGDs if used mechanically.

33. Human judgement is also essential in fields where few comparable default and loss examples exist such as specialised lending, bank and sovereign lending, as well as for the financing of industries where defaults are rare such as insurance companies. Complex structured lending is also a field where mechanical quantification would produce unsatisfactory results. In these cases, expert judgement would use tools such as comparisons with other industries or countries, scenarios based on the knowledge of the client, or other means that would not be available from statistical models. Such judgement would be likely to produce more robust results than the average historical data.

34. The FBE would encourage the Basel Committee to place emphasis on the quality of the overall assessment process, making appropriate use of the data sources that are relevant and available within each sub-segment taking advantage of the quality of the system as a whole.

35. Validation of PD, LGD and EAD estimates (“back-testing”) should also be part of this framework. The FBE believes that default and loss estimates assigned to the exposures of a given sub-segment should be considered as validated in regard to realised losses, even when numerous default and loss observations are not available for the specific sub-segment if:

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- the bank's assessment method for the sub-segment is consistent with the assessment methods used for other comparable exposures;

- and if back-testing does not produce evidence that the bank's estimates are flawed.

36. One technique that could be used jointly or alternatively with global validation for LGD estimates would be a separate testing of some or all components (collateral values, guarantee enforcement and unsecured recoveries).

Securitisation

37. The FBE welcomes the constructive dialogue with the industry on the development of the securitisation framework but believes that the result is more conservative than can be justified by an assessment of the risks. A central plank of the FBE's expectation remains that no more capital should be held for securitised assets (whoever holds the assets) than for assets that have not been securitised and are held on the bank's balance sheet.

38. The FBE has particular concerns in the following areas:

- *Supervisory formula*

  The continued use of floor capital charges creates a premium that, for some classes of assets, (for instance retail-backed exposures) will require multiples of extra capital when compared to unsecuritised assets. This is unjustified and the floor should be removed.

- *Ratings Based Approach*

  The FBE does not agree that a tranche's loss rate is dependent on its thickness. Securitisations exhibit a waterfall situation, whereby seniority is the only determinant of pay-off. This is reflected in K_{IRB}, something that has already been taken into account in the underlying pool's estimate of LGD.

  The capital weights for securitised structures should be set at a rate only marginally (if at all) above the rate used for corporates.

  We would note that the Ratings Based Approach is founded solely on the corporate risk weighting function irrespective of the assets on which a securitisation is based. This contrasts strongly with the approach taken to assets on balance sheet where the difference in the relationship between EL and UL is reflected in the provision of different risk weighting functions. The use of the corporate risk weighting function contributes materially to the disproportionate level of capital held for securitisations based on retail assets. The FBE would propose that the capacity to look through to the underlying asset base is introduced and the risk weighting function varied to reflect the underlying asset class.

- *Liquidity facilities*

  The 20% credit conversion factor for liquidity facilities is too high and its introduction would de-stabilise a large part of the ABCP market were it introduced. Losses under liquidity facilities have rarely exceeded 0.03% as they are protected by subordinate tranches of credit enhancement. Historical experience suggests that a 1% CCF is more appropriate.

<u>Operational risk</u>

39. The FBE is disappointed that there remains little incentive for banks to move from the Basic to the Standardised approach for the calculation of the operational risk charge, and the additional investments required for AMA might not be off-set by the potential capital gain. This undermines the Committee's intention that the Accord should encourage banks to move to a more risk sensitive approach, and we would once again urge the Committee to address this issue. In particular, the FBE suggests that no beta in the Standardised Approach should be higher than the 15% alpha in the Basic Indicator Approach.

40. The FBE welcomes the proposal in paragraph 637 to allow a bank on the AMA approach to recognise the risk mitigating impact of insurance. The FBE does not, however, believe that it is necessary to require insurance provided by a captive to be laid off to an independent third party entity as the captive's capital is fully deducted.

41. The FBE believes that there is a case for the Committee to extend the use of insurance to banks on the Basic Indicator and Standardised approaches. All banks should have an opportunity to use insurance as part of their overall risk management strategy.

Pillar 2: Supervisory Review Process

42. The FBE shares the view of the Committee that the Second Pillar of the New Basel Accord will be critical in determining the impact of the new regime for individual firms and the global banking industry. The FBE attaches considerable importance to clarifying the scope and purpose of Pillar 2.

43. In its original form, the Supervisory Review Process provided a framework which affirmed that it was the responsibility of a bank to assess its own capital needs and the supervisor's role was to review and challenge this process and intervene promptly where necessary, including being able to set higher minimum capital standards for an individual bank. The FBE broadly supported this objective and understood its value.

44. The FBE is concerned that the clarity of purpose and scope of Pillar 2 has become confused and that this will directly threaten prospects for coherent implementation. This concern is based on:

- a general blurring of the purpose of Pillar 2 and of the relationship between Pillars 1 and 2;

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- and specifically the proposal in CP 3 for the introduction of a series of supplementary specific risk issues (Section C, paragraphs 719 – 755).

45. The FBE is extremely concerned that Pillar 2 is moving toward a system of automatic capital add-ons, driven less by the specific circumstance of each bank and more by a general regulatory requirement. This would be unacceptable, not least because these requirements have *not* been included in the calibration of the Accord.

46. The FBE would ask the Committee to consider the following major issues:

- **Capital impact:** Pillar 1 is calibrated to generally deliver an adequate regulatory capital charge and will require banks to meet high qualitative and quantitative standards. Additional capital requirements under Pillar 2 should therefore be the exception and not the rule.

- **Objective benchmark:** We would encourage the Committee to set an objective benchmark in Pillar 2 to provide a goal on which implementation could converge.

  To illustrate, the FBE suggests the following benchmark: *banks should seek to identify material divergences from the assumptions underpinning the Pillar 1 minimum requirement that threaten to crystallise over the next year and thereby undermine continued compliance with the minimum requirements*. Without such a benchmark, divergent approaches are likely.

- **Specific risk issues:** The introduction of specific risk issues in Section C sits awkwardly in the context of Pillar 2. These issues should be re-integrated into the general framework. Principle 1 requires the incorporation of bank-specific risks into the capital assessment and with Pillar 1 already covers some of the issues re-opened here. Moreover, specifically regarding asset securitisation the New Accord does not sufficiently recognize that banks should be encouraged to use state-of-the –art portfolio management techniques, an observation that also applies in the context of Pillar 1.

- **Net adjustment within Pillar 2:** Any additional capital requirement should be a net adjustment within Pillar 2. That is, whilst Pillar 2 rightly focuses upon model fit, there can be no presumption that this fit is always negative. We strongly believe that a net adjustment is required where the under and overstatements of required capital produced by poor model fit are netted off. For example, the positive impact of diversification of risk should be recognised. Diversification gives grounds for a negative adjustment within Pillar 2, offsetting unmeasured risks and the results of stress testing. Pillar 2 should not simply sum the areas of capital deficiency and disregard the areas of capital surplus.

- **Level of application:** Pillar 2 should be applied at the top consolidated group level by the home supervisor. It should not be applied, except in exceptional circumstances, by host supervisors.

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- **Disclosure:** We support the Committee in proposing that no bank level disclosure of measures required under Pillar 2 should be made.

47. The FBE believes that these measures would contribute to clarifying the scope and purpose of application of Pillar 2, which is fundamental to achieving convergence in implementation.

48. The FBE would also encourage the Committee to delete paragraph 700 of CP 3. It would not be appropriate for supervisors to assess reputational and strategic risks.

Pillar 3: Market Discipline

The centrality of international accounting standards

49. FBE recognises the central importance of international accounting standards, in particular in the light of the EU Regulation 1606/2002 requiring listed companies to adopt IAS from 2005, and the International Accounting Standards Board (IASB)/Financial Accounting Standards Board (FASB) convergence agreement. In the view of the FBE, therefore, disclosure requirements mandated by regulators should start from a position that recognises the existence of information required to be published under IAS.

50. Where regulators believe that jurisdictions that do not follow IAS (or which are not converging with US GAAP) do not require banks to provide sufficient disclosure, additional requirements may be imposed on banks from those jurisdictions.

51. As presently drafted, Pillar 3 sets out wide-ranging disclosure requirements, without regard to what banks in many jurisdictions are already required to disclose. The FBE considers that the emphasis in Pillar 3 should be on supplementing the accounting disclosure requirements to the minimum extent necessary, taking into account IAS requirements.

The need to avoid overlapping disclosure requirements

52. The result of drafting disclosure requirements without having regard to what is already required in bank financial statements is to prescribe a regime that duplicates disclosures which are there already. In particular, the review of old IAS30 (Disclosures in the Financial Statements of Banks and Similar Financial Institutions) will lead to a disclosure regime for banks that will encompass a large proportion of the detail that regulators see as desirable.

53. We recognise that the review of IAS30 will not be published until after CP3 is finalised, but an Exposure Draft has already been drafted, together with a Basis for Conclusions and Implementation Guidance – all of which will have been put to the last IASB Board meeting. Hence it should be possible to ensure that the provisions of Pillar 3 take full account of, and do not duplicate, the direction and content of the draft text of the revised IAS30.

The need to keep Pillar 3 under review

54. It is essential that requirements placed on banks to disclose information, whether under accounting standards or under a regulatory regime, are consistent. This is important both at the point new requirements are introduced and also more generally, as requirements change. As market practice evolves, the information that is seen as necessary to be publicly available is also likely to change - there should therefore be a mechanism for ensuring that the requirements by regulators remain in step with the market.

55. Once the New Accord is in place, a framework should be created for regularly reviewing Pillar 3, to keep its coverage in step with current disclosure requirements and changing market practice. We propose that a small group of representatives, both practitioners and those from the Basel Transparency Group, meet on at least an annual basis to agree amendments to reflect recent changes to accounting rules or market practice. This would have the twin benefits of ensuring that the disclosure requirements of the Accord are regularly updated and reducing the likelihood that the Accord will need to be "refreshed" in the foreseeable future.

The level of prescription in Pillar 3

56. CP 3 has addressed some important concerns of the banking industry, with some of the disclosure requirements having being positively amended. In particular, the disclosure requirements:

- have been reduced, especially for securitisation disclosures (table 9);
- take into account the issue of proprietary information e.g. the removal of the disclosure requiring details of a bank's strategy for Capital Adequacy (table 3).

57. However, concerns remain about the level of detailed prescription in Pillar 3, and about whether most readers will have the knowledge and understanding of the technicalities to be able to interpret the data safely. We believe that there is a significant risk of confusion, especially as some of the tables contain data that clearly links to numbers in the financial statements, whereas other tables set out data from a regulatory perspective – this latter data will not be able to be tracked back to the financial statements, and readers who try to make this connection will risk being confused and may well draw the wrong conclusions.

58. If the disclosures required under Pillar 3 were supplementary to the requirements of IAS30 as revised, the amount of detail contained in the Pillar 3 requirements could be substantially reduced.

59. On a specific technical point, the Pillar 3 document contains several references to "past due" and "impaired".

60. In some instances these terms could be construed as being interchangeable - referring to a single category. However, in table 4 (g) they are shown as being two separate items. The Exposure Draft of revised IAS 39 (Amendments to IAS 32, Financial Instruments: Disclosure and Presentation, and IAS 39, Financial

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Instruments: Recognition and Measurement) paragraph 110 identifies the objective evidence which should be considered to determine whether financial assets are impaired. One of the criteria is “breach of contract, such as a default or delinquency in interest or principal payments.” There are six other criteria listed in paragraph 110 to be considered when deciding whether a financial asset is impaired. Therefore, under IAS the concepts of past due and impairment are distinct.

61. Some additional clarification of the meaning of the terms “past due” and “impaired” as used in the Pillar 3 requirements would, therefore, be welcome.

Two types of information in the Pillar 3 tables

62. As mentioned above, the tables in Pillar 3 are of two distinct types (as set out in the attachment to this enclosure). Some of the information is essentially a further analysis of information already contained in the bank’s consolidated balance sheet. Other tables may contain information with a different scope of consolidation – many exclude insurance interests, and others include data in respect of associates. Where these disclosures are made with a different scope of consolidation under accounting requirements, banks may rely on them to fulfill the applicable Pillar 3 expectations provided they explain material differences between the accounting disclosure and the supervisory basis of disclosure (CP3, paragraph 763).

63. Where the information is not met by accounting disclosure, and if regulators require this latter data to be made public, this could be achieved by preparing a separate dossier of regulatory information which could be filed separately, and perhaps made publicly available over the company’s website. There must be considerable doubt, however, as to the need to send all this latter information to every shareholder. If shareholders were made aware that the information is available, they could access the information electronically.

64. The FBE strongly believes that the disclosure requirements in Pillar 3 should be segregated into the two types of table we describe. Only the first should be required to be published in the financial statements, and then only to the extent that this was not already covered by the requirements of IAS 30.

Mock up of implementing the Pillar 3 proposals

65. Enclosure 4 to this letter offers an example of how the requirements regarding some of the qualitative and quantitative disclosures might be put into practice once the New Accord is implemented. In doing this, we are not indicating our acceptance of the requirements in their current format. We do not consider this document either as a standard format which would be generally accepted and implemented by European Banks. Rather, the document has been prepared to show how the current Pillar 3 requirements may be put into practice. We have separated out the information that links to accounting disclosure from that which is drawn up on a regulatory basis of disclosure. We hope the Committee may find this helpful.

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Concluding remarks

66. Enclosure 5 to this letter provides our detailed specific comments on the outstanding issues on the disclosure requirements contained within CP 3 - Pillar 3. The FBE would be very keen to meet to explain in more detail the thoughts behind the comments set out in this letter and to find ways to make compliance with all the disclosure requirements on banks as efficient, understandable and cost effective as possible.

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Attachment to Enclosure 1

TABLE FOR PILLAR 3 DISCLOSURES

Financial Reporting and Regulatory Reporting

Table No	Financial Reporting	Regulatory Reporting
1 a)	Y	
1 b)	Y	
1 c)	Y	
1 d)	Y	
1 e)	Y	
1 f)	Y	
2 a)	Y	
2 b)	Y	
2 c)	Y	
2 d)	Y	
2 e)	Y	
3 a)	Y	
3 b)	Y	
3 c)		Y
3 d)	Y	
3 e)		Y
3 f)	Y	
4 a)	Y	
4 b)	Y	
4 c)	Y	
4 d)	Y	
4 e)	Y	
4 f)	Y	
4 g)	Y	
4 h)	Y	
5 a)		Y
5 b)		Y
6 a)	Y	
6 b)		Y
6 c)		Y
6 d)		Y
6 e)		Y
6 f)		Y
6 g)		Y
7 a)	Y	
7 b)	Y	
7 c)	Y	
7 d)	Y	
7 e)	Y	
7 f)	Y	

Table No	Financial Reporting	Regulatory Reporting
8 a)	Y	
8 b)		Y
8 c)		Y
9 a)	Y	
9 b)	Y	
9 c)	Y	
9 d)		Y
9 e)		Y
9 f)		Y
9 g)		Y
9 h)		Y
9 I)		Y
10 a)	Y	
10 b)		Y
11 a)	Y	
11 b)		Y
11 c)		Y
11 d)		Y
12 a)	Y	
12 b)		Y
12 c)		Y
13 a)	Y	
13 b)		Y

EFFECTIVE MATURITY ADJUSTMENT

Introduction

This paper discusses the impact of the effective maturity adjustment proposed in paragraph 290 of CP 3 and sets out an alternative formula developed by a Member Association.

2. The effective maturity adjustment will have a critical impact on the amount of capital allocated to market and trade finance activities. The maturity formula proposed would produce an excessively conservative result. In practice, the exemption from the one year maturity floor in paragraph 291 of CP 3 would have no substantive effect.

Calculation of the maturity adjustment below one year

3. This paper assumes that the Committee is proposing that the maturity adjustment formula applied to maturities under one year is the same as that which applies to longer maturities i.e.:

(0.08451 – 0.05898 x log(PD))^2

4. For transactions with more than one-year remaining maturity, this formula represents the surplus of capital due to **migration risk**, i.e. the statistical probability that credit quality declines before the transaction expires.

5. By definition, migration risk only appears beyond the liquidity horizon. Below this, banks are exposed only to **default risk**. Thus applying the same formula on both sides of the liquidity horizon is not appropriate and theoretically inconsistent with the underlying assumptions of the IRB model.

6. A formula measuring default risk under one year should smoothly lead from a zero capital charge for intraday transactions to the full one year capital charge for one year transactions. Table 1 below shows that, in practice, the formula does not produce this result.

Table 1

PD	Current capital adjustment (1D)*	Current capital adjustment (3M)
0.03%	0.399	0.547
0.05%	0.508	0.629
0.10%	0.622	0.715
0.20%	0.709	0.780
0.40%	0.776	0.831
0.50%	0.795	0.845
0.70%	0.820	0.864
1.00%	0.844	0.883
2.00%	0.884	0.912
3.00%	0.903	0.927
5.00%	0.924	0.943
10.00%	0.948	0.961
15.00%	0.959	0.969
20.00%	0.966	0.975

* *Based on 220 business days*

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7. The results show that even overnight transactions receive weak capital relief from the current formula. This excessively conservative result means that the exemption from the maturity floor in paragraph 291 of CP 3 has no substantive impact.

Alternative proposal

8. An alternative way to adjust capital requirements for eligible transactions below one year is proposed below.

9. The Basel Committee is also encouraged to apply the carve-out treatment to:

- exposures with a maximum original maturity of 6 months rather than the 3 months currently proposed;
- all assets included in the “purchased receivables” regulatory portfolio as they represent trade receivables and cannot be considered as term financing.

10. The proposal assumes that:

- market and trade transactions are not part of the ongoing financing of the obligors and cannot be rolled over without motivation, such obligors and transactions are continuously monitored, and a complete assessment is performed before the bank engages in each transaction;
- the "liquidity horizon" of a model must be consistent with the overall rating practice of banks: it represents the moment when all current transactions will have been reviewed at least once. Below this horizon, the bank is exposed to default risk; beyond, it is exposed to migration risk;
- if a bank can demonstrate that it reviews and re-rates all the exposures of a given portfolio with shorter periodicity, then the liquidity horizon could be adjusted downwards so as to reflect the fact that the bank is not able to provide new credit to a counterpart whose credit quality would have declined;
- in order to remain consistent with the objective that the whole banking system has a 1 year PD of 0.1%, equivalent to a A- rating, the confidence interval of the IRB formula has to be increased so as to match with the PD of a A-rated firm at a closer time horizon. As such, the results of the IRB formula with a short-term PD are "annualised": if the bank is not able to provide new credits to counterparts whose credit quality has declined, it is still exposed to default without rating downgrade during the life of each transaction. The one year capital charge is therefore calculated as, for example, capital for twelve one month transactions with identical credit quality at origination. In no case does this amount to a calculation of capital charges for a complete cessation of business.

11. The maturity adjustment would be obtained by reducing the PD of the transactions through a simple interpolation formula, such as:

$$PD_n = 1 - (1 - PD_1) \wedge n$$

where PD_n is PD at horizon *n*, n is the fraction of one year corresponding to horizon *n*, and PD_1 is the one year PD.

12. In this framework, capital requirements would remain calculated by using a correlation based on the one-year PD.

13. Symmetrically, the confidence interval would have to be equal to:

$C_n = C_1 \wedge n$

where C_n is the confidence interval at horizon *n*, n is the fraction of 1 year corresponding to horizon *n*, and C_1 is the one year required confidence interval (this interpolation formula being identical to the one proposed for PD). For example, the confidence interval for a 3-month transaction would be 99.9% ^ (1/4) = 99.975%.

14. The results of this alternative method are shown in Table 2.

Table 2

1-year PD	Proposed PDn (1D)*	Proposed PDn (3M)	Proposed PD adjustment (1D)*	Proposed PD adjustment (3M)	Proposed capital adjustment (1D)*	Proposed capital adjustment (3M)
0.03%	0.000%	0.01%	0.005	0.250	0.136	0.602
0.05%	0.000%	0.01%	0.005	0.250	0.135	0.594
0.10%	0.000%	0.03%	0.005	0.250	0.131	0.586
0.20%	0.001%	0.05%	0.005	0.250	0.124	0.579
0.40%	0.002%	0.10%	0.005	0.250	0.117	0.570
0.50%	0.002%	0.13%	0.005	0.250	0.113	0.566
0.70%	0.003%	0.18%	0.005	0.251	0.108	0.560
1.00%	0.005%	0.25%	0.005	0.251	0.102	0.553
2.00%	0.009%	0.50%	0.005	0.252	0.088	0.534
3.00%	0.014%	0.76%	0.005	0.253	0.080	0.524
5.00%	0.023%	1.27%	0.005	0.255	0.073	0.516
10.00%	0.048%	2.60%	0.005	0.260	0.073	0.526
15.00%	0.074%	3.98%	0.005	0.265	0.078	0.544
20.00%	0.101%	5.43%	0.005	0.271	0.082	0.562
				Confidence interval:	99.9997%	99.975%

** based on 220 business days*

15. All other parameters being unchanged, Table 2 shows that the maturity adjustment would be stronger (ie more favourable) for the highest PD levels. This is counter-intuitive, but results from the correlations used in the IRB formula which decrease when PDs increase.

16. The rationale for this relationship between PD and correlation is generally weak, and becomes unsustainable in the case of short-term transactions. Table 3 shows that acceptable results are achieved with constant correlations. For the purpose of the calculations in Table 3, the correlation level has been set at 18%, which is the average of IRB corporate extreme values.

Table 3

1-year PD	Proposed capital adjustment (1D)*	Proposed capital adjustment (3M)
0.03%	0.069	0.386
0.05%	0.070	0.386
0.10%	0.071	0.393
0.20%	0.072	0.408
0.40%	0.077	0.436
0.50%	0.078	0.449
0.70%	0.082	0.473
1.00%	0.089	0.507
2.00%	0.105	0.594
3.00%	0.117	0.651
5.00%	0.130	0.708
10.00%	0.141	0.735
15.00%	0.147	0.739
20.00%	0.154	0.744

** Based on 220 business days*

17. If the Basel Committee adopts an alternative formula for maturity adjustment below one year, it would be important to ensure that no excessive distortion is created with banks using approaches where no maturity adjustment is allowed (e.g. Foundation IRB or the Foundation "SL" IRB).

POSSIBLE MEASURES TO LIMIT THE PRO-CYCLICAL IMPACT OF THE NEW BASEL ACCORD

A pro-cyclical pattern is characteristic of banks' activities. Research into the extent to which the New Basel Accord is likely to accentuate this pattern draws different conclusions. Some research suggests that the Accord will have a stronger pro-cyclical impact than expected, which could impact on the ability of banks to lend throughout the economic cycle. The FBE notes that the level of regulatory capital is not within the discretion of banks.

2. Other research on economic capital suggests that it is normal for capital requirements to increase during an economic downturn, and the impact on lending will be driven by macro-economic factors rather than the impact of the Accord. Some research also suggests that the impact of defaulted loans on global capital requirements is greater than the impact of rating transition, suggesting that pro-cyclicality is a feature of the present system.

3. In sum, whilst there is no dispute as to the importance of the issue views within the industry differ as to the scale of any impact and the risk or reward associated with the various methodological solutions under discussion. The FBE would invite the Committee to consider again the pro-cyclical impact of the New Accord, the possible consequences of any increase in the cyclicality of regulatory capital requirements and possible mitigation strategies additional to the measures already proposed.

PD Sensitivity Analysis

4. In two member states, banks performed sensitivity analyses in order to quantify the potential pro-cyclicality of the New Accord. The analysis was based on the QIS 3 data spreadsheets. The PDs/PD bands for the non-defaulted assets were multiplied. The calculated PD shifts as well as their effect on risk weighted assets can be seen in the following table:

PD shifts	-20%	20%	50%	100%	150%
Effect on Basel 2 RWA	-11%	9%	21%	37%	51%

5. Sensitivity results at the participating banks were similar, with differences in portfolio structure having only a minor effect on sensitivity.

6. Results based on QIS 3 spreadsheets differed only slightly from the calculation based on the original portfolio data. The results are also consistent with similar studies performed by regulators.

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Summary of findings

7. Analysis of publicly available PD data series show the following changes over the last five years (2002 versus 1998):

KMV Credit Monitor EDF™ Corporates Europe	+ about 500 %
S&P Credit Pro™ Migration data	+ about 900 %
Moody's Corporate Bonds	+ about 360 %

8. Changes (in terms of PD) to the individual portfolios at the participating banks vary significantly due to risk measurement instruments developed and risk management strategies applied. However, in several of the individual portfolios PDs doubled in the observed period.

9. What is the reason for the large discrepancy between externally observed PD shifts and those of bank-internal portfolios? Portfolios of banks are actively managed. Banks in general try to avoid large changes in provisioning of their portfolios and hence keep the average credit quality of a portfolio as constant as possible. Such a strategy might be much harder to maintain in an environment where pro-cyclical capital requirements increased volatility in the financial system as a whole.

10. Working with a scenario of average PD shifts of 100% appears to be cautious though reasonable, given the developments in the actively managed bank portfolios over the last years. As shown in the table above, a PD increase of 100% will cause regulatory capital requirements to grow by around 40% (effect of defaulted assets not yet taken into account). A volatility of +/- 40% in regulatory capital requirements would put a serious strain on the stability of any financial sector.

Expected consequences

11. If these calculations prove correct and assuming that the results can be applied to the European banking industry in general, the possible consequences are serious. Most seriously given banks limited capacity to raise new capital in a downturn, or to restructure their portfolio, there may be a direct impact upon bank capacity to provide credit to the economy. This may hasten entry into and prolong recession. Alternatively such volatility in economic capital may already exist within bank portfolios and be within the capacity of existing risk management strategies. We acknowledge the argument made by various Committee members that increased risk measurement capability in the banking industry is in itself a counter-cyclical impulse.

12. Again, the FBE considers these concerns to be of sufficient significance to warrant further investigation and research.

13. The FBE puts forward a number of possible measures for consideration. The FBE accepts that each solution has both advantages and disadvantages. If after further consideration the Committee feels unable to include one of these solutions in the final Accord, the FBE would encourage the Committee to keep the pro-cyclical impact under review, including during the period of parallel running.

Further quantitative impact studies would provide further valuable data to assess the pro-cyclical impact.

Discussion of possible measures

A. Capital requirements based on 3 year average PDs/ratings

14. The minimum capital requirement could be based on the current exposure, but with average customer specific PDs/ratings applied. For example, the average could extend to three years, so that PD/rating data for the current and the two preceding years would be used.

Advantages:

15. A clear advantage is that portfolio changes would be captured as the current exposure is used (mirroring the fact that bank portfolios are actively managed). In addition, banks expect that the respective implementation burden will still be acceptable. Only moderate changes to the RWA calculation in the New Accord would be required.

Disadvantages:

16. Risk sensitivity would be reduced. It could be argued that this is a first step to abandoning the "point in time" treatment for capital requirements.

B. Internal Credit Risk Models

17. Internal models could be used to measure credit risk. Internal risk models take into account the specific granularity and correlations of bank's individual portfolios, and produce results that are comparable between banks.

Advantages:

18. Diversification, granularity and concentration are explicitly taken into account. And as internal models are already integrated into banks' processes, the use of such models would create an increased acceptance of the New Accord. It would also bring the treatment of credit risk into line with the treatment of market risk and operational risk.

Disadvantages:

19. The validation and regulation of the use of internal models for credit risk would be more complex than for the approach proposed in CP 3.

C. Elimination of Expected Loss in the Risk Weight Function

20. The elimination of capital charges for expected loss would flatten the risk weight curve and thus reduce the pro-cyclical impact of the Accord. It would also avoid the potential for double-charging.

Advantages:

21. The approach could be implemented by a simple adjustment to the risk weight formula. The exclusion of EL from the risk weight function would have a smoothing effect on capital requirements over time, and is already implicitly recognised in the Committee's proposed approach on qualifying revolving retail exposures.

Disadvantages:

22. The materiality of margin income has been questioned.

D. Providing for counter-cyclical loan loss reserves

23. A steady yearly provisioning of the expected loss would avoid capital requirements increasing due to defaulted loans.

Advantages:

24. The same advantages as C above, plus an increase in risk awareness.

Disadvantages:

25. It is not consistent with the IASB's fundamental principles and work to produce a widely accepted definition of such provisioning. Substantial accounting and tax issues would need to be resolved, making this option difficult to implement at present.

E. Individual confidence level with ex-post Supervisory review under Pillar 2

26. Allowing banks to adjust the confidence level for credit risk would also produce a smoothing effect. A minimum confidence level for all banks of, say 99.5% could be set. The adequacy of the confidence level used by a bank would be subject to supervisory review.

Advantages:

27. This approach recognises a bank specific portfolio and risk structure, improving the risk sensitivity of the Accord to the circumstances of each bank. It provides banks with a clear choice between reducing exposure to higher risks or increasing capital.

Disadvantages

28. The validation and regulation of this approach would be more complex than the approach proposed in CP 3. The potential for regulatory discretion could result in an unlevel playing field and a lack of clarity.

Conclusion

29. The FBE believes that it would be desirable for the Basel Committee (or its relevant working groups) to discuss the issues set out in this paper in the next few weeks with a view to finding the best possible solution.

BASEL II – PILLAR 3

Mock Up Example

Financial Reporting

Responses

1 d)

(Table only required where investment in Insurance Companies is not deducted).

Inv in Insurance Co's	€XM
Reg Cap requirement	(€XM)
Surplus cap of Ins Co's	€XM

2 b - d)

Components	Amount
Paid-up share cap	€1,641M
Reserves	€13,409M
Minority Interests	€522M
Innovative instruments	€2,790M
Other cap instruments	€XM
Less	
▪ Goodwill	(€4,158M)
▪ Inv in Subs (50%)	(€XM)
Net Tier 1 Capital	€14,204M
Tier 2 Capital	€9,191M
Less Inv in Subs (50%)	(€XM)
Net Tier 2 Capital	€9,191M
Tier 3 Capital	€203M
Total	€9,394M
Deductions from total Capital	(€1,407M)
TOTAL	€22,191M

2 e)

Total eligible capital **€172,748M**

3 a)

Capital adequacy and the use of regulatory capital are monitored by the Group, employing techniques based on the guidelines developed by the Basel Committee on Banking Supervision (the Basel Committee) and European Community Directives, as implemented by the Financial Services Authority (FSA) for supervisory purposes.

These techniques include the risk asset ratio calculation, which the FSA regards as a key supervisory tool. The FSA sets ratio requirements for individual banks in the UK at or above the internationally agreed minimum of 8%. The ratio calculation involves the application of designated risk weightings to reflect an estimate of credit, market and other risks associated with broad categories of transactions and counterparties.

Regulatory guidelines define three 'tiers' of capital resources. Tier 1 capital, comprising mainly shareholders' funds and including Reserve Capital Instruments and Tier One Notes, is the highest tier and can be used to meet trading and banking activity requirements. Tier 2 includes perpetual, medium-term and long-term subordinated debt, general provisions for bad and doubtful debts and fixed asset revaluation reserves. Tier 2 capital can be used to support both trading and banking activities. Tier 3 capital comprises short-term subordinated debt with a minimum original maturity of two years. The use of tier 3 capital is restricted to trading activities only and it is not eligible to support counterparty or settlement risk. The aggregate of tiers 2 and 3 capital included in the risk asset ratio calculation may not exceed tier 1 capital.

3 b)

	Capital
Portfolio - standard	€XM
Portfolio - IRB	€XM
Corporate	€XM
Res. Mortgages	€XM
Qualifying Rev. retail	€XM
Other retail	€XM
Securitisation	€XM

3 d)

	Capital
Market Risk – standardised approach	€XM
Market Risk – IMA approach	€XM
Tier 3	€XM

3 f)

	Total Ratios	Tier 1 Ratios
Top consolidated group	%	%
Significant subsidiary 1	%	%
Significant subsidiary 2	%	%

4 a)

Credit is the Group's most significant risk and its approach to managing credit risk varies according to the nature of the business.

In consumer businesses, where there are large numbers of accounts, a systems driven environment prevails. Credit decisions are made with the aid of statistically based scoring systems and account management is likewise automated.

Mid-range credits are approved and reviewed according to a hierarchy of discretions, whereby discretionary limits are set according to the skills, experience and seniority of the sanctioning teams, in addition to the quality of the borrower as measured by the credit grading structure.

Large value wholesale loans are referred to the Group Credit Committee or are sanctioned within business risk management departments. Besides loans, these include significant credit exposures

arising from money market, foreign exchange, derivatives, securities dealing and other similar products.

The Group Credit Risk Director provides central credit risk review and oversight.

Functional areas assist the Group Credit Risk team and line businesses in setting policy and standards, defining the Group's risk appetite and providing the capability for effective risk management, including the regular review and challenge of business credit risk positions. These central risk functions add value by undertaking reporting, analysis, strategy and portfolio activities that support corporate governance, overall portfolio management, capital allocation for risk, Basel II implementation and credit decisions within business areas.

Internal ratings are used to assess the credit quality of borrowers. Each internal rating corresponds to a probability of default (PD), which is the statistical probability of a customer defaulting within a 12-month period. This internal rating is derived from different sources depending upon the borrower, e.g. internal model or credit rating agency.
Where internal models are used they are based upon up-to date account, market and financial information. The models are reviewed regularly to monitor their robustness relative to actual performance and revised as necessary to optimize their effectiveness.

Severity is the estimated amount of loss expected if a loan defaults, calculated as a percentage of the exposure at the date of default. It recognises that the loss is usually substantially less than the exposure. The value depends on the collateral, if any, seniority or subordination of the exposure, work-out expenses relative to the loan value and other considerations. The outcome is heavily dependent on economic conditions that determine prices that can be realised for assets or whether businesses can be refinanced.

Exposure in the event of default represents the expected level of usage of the credit facility when default occurs. For example, the customer may not have drawn the loan up to the approved limit or may already have repaid some of it.

For derivative instruments, exposure in the event of default is the estimated cost of replacing contracts with a positive value if counterparties fail to perform their obligations. This cost is monitored on an ongoing basis.

ABC Bank uses mechanisms such as credit derivatives and securitisations to reduce the uncertainty of returns from the credit portfolio. The cost of these transactions is treated as a deduction from the related category of income. The benefits are reflected in reduced credit risk provisions, reduced volatility of earnings and consequently an improved return on economic capital.

General provisions reflect losses that, although not specifically identified, are known from experience to be present in the lending portfolio at the balance sheet date.

These provisions are adjusted at least half yearly by an appropriate charge or release of general provisions based on statistical estimates. The general provisions take Risk Tendency (statistically expected losses) into account, based on models that are systematically updated to reflect evolving loss experience.

Specific provisions are raised for:

- *Individual counterparties when the Group considers that the creditworthiness of a borrower or counterparty has undergone deterioration such that the recovery of the whole or part of an outstanding advance is in serious doubt.*
- *Homogeneous portfolios comprised of large numbers of individually small lendings, where the characteristics of the portfolio permit statistical models to be used in estimating specific provisions. These statistical models are consistent with the Group's policy of raising provision when recovery is doubtful. These provisions are raised in parts of Retail banking, SME and Wholesale banking.*

Write-off occurs immediately to the extent that the whole or part of the debt is considered unrecoverable.

General provisions are raised to cover losses which are judged to be present in loans and advances at the balance sheet date, but which have not been specifically identified as such. These provisions are adjusted at least half yearly by an appropriate charge or release of general provision based on a statistical analysis. The accuracy of this analysis is periodically assessed against actual losses. Gradings are used to rate the credit quality of borrowers. Each grade corresponds to an Expected Default Frequency and is calculated by using manual or computer driven score-sheets validated by an analysis of the Group's own historical data. This grade can be derived from different sources depending upon the borrower (e.g. internal model, credit rating agency). The general provision also takes into account the economic climate in the market in which the Group operates and the level of security held in relation to each category of counterparty. The general provision includes a specifically identified element to cover country transfer risk calculated on a basis consistent with the overall general provision calculation. General provisions are created with respect to the recoverability of assets arising from off-balance sheet exposures in a manner consistent with the general provisioning methodology.

The aggregate specific and general provisions, which are made during the year, less amounts released and recoveries of bad debts previously written off, are charged against operating profit and are deducted from loans and advances. Impaired lendings are written off against the balance sheet asset and provision in part, or in whole, when the extent of the loss incurred has been confirmed.

If the collection of interest is doubtful, it is credited to a suspense account and excluded from interest income in the profit and loss account. Although it continues to be charged to the customers' accounts, the suspense account in the balance sheet is netted against the relevant loan. If the collection of interest is considered to be remote, interest is no longer applied and suspended interest is written off. Loans on which interest is suspended are not reclassified as accruing interest until interest and principal payments are up-to-date and future payments are reasonably assured. Assets acquired in exchange for advances in order to achieve an orderly realisation continue to be reported as advances. The asset acquired is recorded at the carrying value of the original advance updated as at the date of the exchange. Any subsequent impairment is accounted for as a specific provision.

If the collection of interest is doubtful, it is credited to a suspense account and excluded from interest income in the profit and loss account. Although interest continues to be charged to the customer's account, the amount suspended is netted against the relevant loan. Loans on which interest is suspended are not reclassified as accruing interest until interest and principal payments are up-to-date and future payments are reasonably assured. If the collection of interest is considered remote, interest is no longer applied.

Assets acquired in exchange for advances in order to achieve an orderly realisation continue to be reported as advances. The assets acquired are recorded at the carrying value of the original advance as at the date of the exchange.
Any impairment is accounted for as a specific provision.

Specific provisions are raised when the Group considers that the creditworthiness of a borrower has deteriorated such that the recovery of the whole or part of an outstanding advance is in serious doubt. Typically, this is done on an individual basis, although scope exists within the retail businesses, where the portfolio comprises homogeneous assets and where statistical techniques are appropriate, to raise specific provisions on a portfolio basis.

4 b)

Example on the basis that average figures not required

Types of Exposure	Amounts
Loans, commitments & non	
derivative off b/s exposures	€XM
Securities	€XM
OTC derivatives	€XM

4 c)

Geographic Spread	Amounts
UK	€135,900M
Other EU	€12,579M
USA	€6,138M
Rest of the World	€5,599M
Trading Business	€45,176M

4 d)

Counterparty type	Amounts
Counterparty A	€XM
Counterparty B	€XM
Counterparty C	€XM
Counterparty D	€XM
Counterparty E	€XM

4 e) Institutions should have the option to adopt alternative choices of maturity band e.g. less than 1 year, 1 to 5 years and 5 years +. The example provided illustrates only one choice.

Maturity date	Loans etc	OTC derivatives
Less than 3 months	€75,050M	€8,345M
Over 3 months < 6 months	€XM	€5,426M
Over 6 months < year	€17,195M	€7,169M
Over a year < 5 years	€31,262M	€31,940M
Over 5 years	€81,165M	€13,926M

4 f)

Counterparty type	Impaired loans	Spec & Gen allowances	P & L Fig
UK	€XM	€XM	€XM
Other EU	€XM	€XM	€XM
USA	€XM	€XM	€XM
Rest of the World	€XM	€XM	€XM
Trading Business	€XM	€XM	€XM

4 g)

Geographic Spread	Impaired loans	Spec & Gen allowances
UK	€XM	€XM
Other EU	€XM	€XM
USA	€XM	€XM
Rest of the World	€XM	€XM
Trading Business	€XM	€XM

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4 h)

	Specific Allows
Opening balance	**€XM**
Charge-offs during period	**€XM**
Amounts set aside or rever'd	**€XM**
Any adjustments	**€XM**

6 b)

THIS PARAGRAPH (EXCEPT THE TABLE) IS ALSO INCLUDED UNDER TABLE 4

Internal ratings are used to assess the credit quality of borrowers. Each internal rating corresponds to a probability of default (PD), which is the statistical probability of a customer defaulting within a 12-month period. This internal rating is derived from different sources depending upon the borrower, e.g. internal model or credit rating agency. The table below shows ABC Bank's internal rating and the associated expected probability of default, together with comparisons with credit rating agency ratings. The rating agency comparisons shown are indicative only and, in practice, will vary over time depending on the position within an economic cycle.

Where internal models are used they are based upon up-to date account, market and financial information. The models are reviewed regularly to monitor their robustness relative to actual performance and revised as necessary to optimize their effectiveness.

Internal Rating	Probability Minimum	Of Default Maximum	(PD) Mid Point	S & P Equivalent Rating	Moody's Equivalent Rating
1.2	0.02%	0.04%	0.025%	AAA/AA+/AA	Aaa/Aa/A1
1.5	0.05%	0.09%	0.075%	AA-/A+	A2
1.8	0.10%	0.14%	0.125%	A/A-	A3
2.1	0.15%	0.19%	0.175%	BBB+	Baa1
2.5	0.20%	0.24%	0.225%	BBB+	Baa1
2.8	0.25%	0.29%	0.275%	BBB	Baa2
3	0.30%	0.59%	0.450%	BBB/BBB-	Baa2/Baa3
4	0.60%	1.19%	0.900%	BB+/BB/BB-	Ba1/Ba2
5	1.20%	2.49%	1.850%	B+/B	Ba3
6	2.50%	4.99%	3.750%	B-	B1
7	5.00%	9.99%	7.500%	CCC-	B2/B3
8	10.00%+	-	15.000%	CC/C	Caa/Ca/C

7 a)

Investment securities are debt securities and equity shares intended for use on a continuing basis by the Group and identified as such. Investment securities are stated at cost less any provision for impairment. The cost of dated investment securities is adjusted for the amortisation of premiums or discounts on purchase over the period to redemption. The amortisation of premiums and discounts is included in Interest receivable.

Other debt securities and equity shares are stated at market value and profits and losses arising from this revaluation are taken directly to the profit and loss account through dealing profits. Listed securities are valued based on mid-market prices and unlisted securities are valued based on the Directors' estimate, which takes into consideration discounted cash flows, price earnings ratios and other valuation techniques.

In the case of private equity investments, listed and unlisted investments are stated at cost less any provision for impairment.

Investment and other securities may be lent or sold subject to a commitment to repurchase them. Securities lent or sold are retained on the balance sheet where substantially all the risks and rewards of ownership remain with the Group. Similarly, securities purchased subject to a commitment to resell are treated as collateralised lending transactions where the Group does not acquire the risks and rewards of ownership.

The Group's principal equity related contracts are equity and stock index swaps and options (including warrants, which are options listed on an exchange).

An equity swap is an agreement between two parties to exchange periodic payments, based upon a notional principal amount, with one side paying fixed or floating interest and the other side paying based on the actual return of the stock or stock index. No principal amounts are exchanged.

An equity option provides the buyer with the right, but not the obligation, either to purchase or sell a specified stock or stock index at a specified price or level on or before a specified date.

7 b)

	B/S Value	Fair Value
Equity Investment	€XM	€XM

7 c)

Equity Investment	
Listed	
Publicly traded	€XM
Privately traded	€XM
Unlisted	
Publicly traded	€XM
Privately traded	€XM

7 d)

Gross gains/(losses) of €XM/(€XM) were realised on the sale of equity investments in 20XX.

7 e)

Unrealised Gains/Losses	€XM
Revaluation Gains/Losses	€XM
Tier 1 capital	€XM
Tier 1 and/or Tier 2 capital	€XM

7 f)

Capital	Amounts
Investment securities available for sale	€XM
Other participating interests	€XM
Total	€XM

8 a)

THIS PARAGRAPH IS ALSO INCLUDED UNDER TABLE 4

The Bank uses mechanisms such as credit derivatives and securitisations to reduce the uncertainty of returns from the credit portfolio. The cost of these transactions is treated as a deduction from the related category of income. The benefits are reflected in reduced credit risk provisions, reduced volatility of earnings and consequently an improved return on economic capital.

The Group enters into master agreements with counterparties whenever possible and, when appropriate, obtains collateral. Master agreements provide that, if an event of default occurs, all outstanding transactions with the counterparty will fall due and all amounts outstanding will be settled on a net basis.

Where the amounts owed by both the Group and the counterparty are determinable and in freely convertible currencies, and where the Group has the ability to insist on net settlement which is assured beyond doubt, and is based on a legal right under the netting agreement that would survive the insolvency of the counterparty, transactions with positive fair values are netted against transactions with negative fair values.

The Group obtains collateral in respect of customer liabilities where this is considered appropriate. The collateral normally takes the form of a lien over the customer's assets and gives the Group a claim on these assets for both existing and future liabilities.

The Group also receives collateral in the form of cash or securities in respect of other credit instruments, such as stock borrowing contracts, and derivative contracts in order to reduce credit risk. Collateral received in the form of securities is not recorded on the balance sheet. Collateral received in the form of cash is recorded on the balance sheet with a corresponding liability or asset. These items are assigned to deposits received from bank or other counterparties in the case of cash collateral received, and to loans and advances to banks or customers in the case of cash collateral paid away. Any interest payable or receivable arising is recorded as interest payable or interest income respectively.

The Group's principal credit derivative related contracts include credit default swaps and total return swaps. A credit derivative is an arrangement whereby the credit risk of an asset (the reference asset) is transferred from the buyer to the seller of protection.

A credit default swap is a contract where the protection seller receives premium or interest related payments in return for contracting to make payments to the protection buyer upon a defined credit event. Credit events normally include bankruptcy, payment default on a reference asset and downgrades by a rating agency.

A total return swap is an instrument whereby the seller of protection receives the full return of the asset, including both the income and change in the capital value of the asset.
The buyer in return receives a predetermined amount.

9 a)

Loans and advances to customers include balances which have been securitised. In accordance with Financial Reporting Standard 5 (FRS 5), 'Reporting the Substance of Transactions', these balances are either accounted for on the basis of linked presentation or separate recognition of the gross assets and related funding.

10 a)

The market risk management policies of the Group are determined by the Group Risk Oversight Committee, which also recommends overall market risk appetite to the Board Risk Committee. The Group's policy is that exposure to market risk arising from trading activities is concentrated in our investment banking division and that residual market risk in other parts of the bank is tightly controlled and significantly limited.

The Group Market Risk Director is responsible for the effectiveness and efficiency of the Group's market risk control framework, and is assisted by risk management departments in the Group's businesses and a central market risk management team.

The Group Risk Oversight Committee allocates a total Daily Value at Risk (DVaR) limit for the Group and delegates the day to day control and monitoring of market risk to the Group Market Risk Director, who sets limits for each business area. To assist this process, a market risk report is produced daily, which summarises the Group's market risk exposures against agreed limits. Data for this report is supplied by the business areas. This daily report is sent to the Group Risk Director, the Group Market Risk Director, the Group Finance Director and the appropriate Business Risk Directors.

A more detailed market risk report is presented each month by the Group Market Risk Director to the Group Risk Oversight Committee. This report brings to the attention of all Committee members current Group market risk exposures and issues along with relevant background information. Each business area of the Group is accountable for identifying, measuring and managing all market risks associated with its activities. In managing market risk, businesses must consider asset liquidity risk and funding liquidity risk where these issues are relevant.

The Bank uses the DVaR measure as the primary mechanism for controlling market risk. DVaR is an estimate, with a confidence level of 98%, of the potential loss which might arise if the current positions were to be held unchanged for one business day. Daily losses exceeding the DVaR figure are likely to occur, on average, only twice in every one hundred business days.

Our investment banking division calculates DVaR using the historical simulation method with an historical sample of two years. As stated above, the calculation assumes a one-day holding period and is performed to the 98% level of confidence.

The Bank recognises the importance of assessing the effectiveness of DVaR. The main approach employed is the technique known as back-testing, which counts the number of days when trading related losses are bigger than the estimated DVaR figure. The regulatory standard for back-testing is to measure DVaR assuming a one day holding period with a 99% level of confidence. For our investment banking division's regulatory trading book, there were two instances in 2002 of a daily trading revenue loss exceeding the corresponding back-testing DVaR.
This is the same result as recorded for 2001.

Where DVaR does not adequately measure the risk, alternative methods are used such as Annual Earnings at Risk. Annual Earnings at Risk measures the sensitivity of annual earnings to shocks in market rates at the 99th percentile for change over a one-year period. This rate shock is consistent with the standardised rate shock recommended by the Basel II framework for assessing banking book interest rate risk.

To facilitate the identification, measurement, control and reporting of market risk, ABC Bank has categorised market risk into three broad categories as described below:

(i) Trading market risk
Trading includes transactions where our investment banking division acts as principal with clients or with the market. A detailed analysis of this risk is provided below.

(ii) Asset and liability management
The Group encounters risks in managing its assets and liabilities.

(iii) Other market risks
In some instances, the Group incurs market risks that do not fit into the above categories. The principal risks of this type are Asset Management Structural Market Risk and Defined Benefit Pension Scheme Risk.

Defined benefit pension scheme risk arises if the Group has to increase its level of funding for the final salary schemes. This would occur if the value of the assets was insufficient over time to cover the projected liabilities.

As mentioned earlier, the Group's policy is to concentrate trading activities in our investment banking division. Trading includes transactions where our investment banking division acts as principal with clients or with the market. For maximum efficiency, the bank manages client and market activities together. In our investment banking division, trading risk occurs in both the Trading book and the Banking book as defined for regulatory purposes.
In anticipation of future customer demand, the Group maintains access to market liquidity by quoting bid and offer prices with other market makers and carries an inventory of capital market and treasury instruments, including a broad range of cash, securities and derivatives. Trading positions and any offsetting hedges are established as appropriate to accommodate customer or Group requirements. our investment banking division takes principal positions in the interest rate including credit spread, foreign exchange, equity and commodity markets based on expectations of customer demand or a change in market conditions.

Derivatives entered into for trading purposes include swaps, forward rate agreements, futures, credit derivatives, options and combinations of these instruments

In our investment banking division, the formal process for the management of risk is through the investment banking division Risk Management Committee. Day to day responsibility for managing exposure to market risk lies with the senior management of our investment banking division, supported by the Global Market Risk Management Unit that operates independently of the trading areas. Daily DVaR utilisation reports are produced across the main business areas and the five main risk factor categories, namely interest rate, credit spread, foreign exchange, equity and commodity risk.

Any DVaR excess at the business level, risk factor level or total level, along with the relevant background information and proposed way forward, is reported to the senior management of investment banking division and the Group Market Risk Director. The Group Market Risk Director will present these DVaR excesses to the Group Risk Oversight Committee.

As DVaR does not provide a direct indication of the potential size of losses that could arise in extreme conditions, investment banking division uses a number of complementary techniques for controlling market risk. These include revenue loss triggers and stress tests. The latter are based on both historical and hypothetical extreme movements of market prices and are reviewed as part of the detailed market risk presentation at the fortnightly Traded Products Risk Review meeting. The attendees at this meeting include the senior management of investment banking division, the Group Risk Director, the Group Market Risk Director and the Group Treasurer. The meeting is chaired by the Chief Executive of investment banking division.

If the potential loss indicated by a stress test exceeds an agreed trigger level, then the positions captured by the stress test are reviewed and discussed by investment banking division Market Risk and the respective Business Head(s). The minutes of the discussion, including the merits of the position and the appropriate course of action, are then sent to the Group Market Risk Director.

11 a)

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12 a)

In addition to credit, market and treasury risk, ABC Bank faces a number of other risks. These risks are managed within the overall risk management framework.

Non-financial risk, which is inherent in all business activities, is the direct or indirect loss resulting from inadequate or failed internal processes, people and systems or from external events. The Group's businesses are dependent on the ability to process a large number of transactions efficiently and accurately.
Non-financial risk and losses can result from fraud, errors by employees, failure to properly document transactions or to obtain proper internal authorisation, failure to comply with regulatory requirements and Conduct of Business rules, equipment failures, natural disasters or the failure of external systems, for example, the Group's suppliers or counterparties. This risk is commonly called operational risk, but ABC Bank uses the term 'Non-financial risk' to emphasise the breadth of issues encompassed by this risk category.

The Group has established a comprehensive non-financial risk framework to manage the risks included in this broad category. The framework and policies implement the Non-Financial Risk Governance Standards approved by the Board Risk Committee.

Although the Group has implemented risk controls and loss mitigation actions, and substantial resources are devoted to developing efficient procedures and to staff training, it is only possible to be reasonably, but not absolutely, certain that such procedures will be effective in controlling each of the non-financial risks faced by the Group.

Responsibility for managing non-financial risk is divided between the businesses and the corporate centre. The main responsibility rests with the business units and functional service areas where the

risks exist. Business Risk Directors are accountable for the implementation of and compliance with Group standards and policies.

In the corporate centre, the Group Non-Financial Risk unit, which incorporates Group IT Security, Group Operational Risk, Group Business Continuity Management, Group Insurance and Group Security, have the responsibility through the delegated authority of the Non-Financial Risk Director to establish, maintain and exercise governance over the policies and processes that are encompassed in the framework.

Measures of performance (key risk indicators) have been established that give the Group Non-Financial Risk unit the ability to monitor the risks against agreed thresholds and challenge business performance where appropriate. This is enhanced by comprehensive reporting from businesses to the corporate centre of both periodic and event-driven data.

Specific quarterly reports are prepared and submitted to the Group Risk Oversight Committee and Board Risk Committee.

The information also feeds into a risk scorecard for each business. During 2003, this will form the basis of an allocation of Economic Capital for non-financial risk, giving each business an incentive to improve its risk control.

Coupled with the non-financial risk framework, this approach forms the basis of the Group's response to the requirements of the Basel II Capital Accord. In this respect, as in others, ABC Bank aims to qualify for the Advanced Measurement Approach and the lower level of regulatory capital that this implies.

*It is recognised that non-financial risk cannot be eliminated and that thresholds can be reached where the cost of minimising these risks outweighs the potential benefits.
The Group will continue to assess the risks and invest in appropriate management and mitigation systems.*

Assessment of the management of non-financial risk is undertaken by the Group Internal Audit function. This provides executive management and the Board with a view of the adequacy and effectiveness of non-financial risk management, through an avenue outside the hierarchical organisation structure.

13 a)

Interest rate risk is the risk of loss arising from adverse movements in the level or volatility of market interest rates. The interest rate risk arising from the UK banking operations is aggregated and managed by Group Treasury, which is also responsible for the overall Group position.

Overall mismatches of fixed rate assets and liabilities are managed in the aggregate by Group Treasury through the use of interest rate swaps and other derivatives. Care is taken to ensure that the management of the portfolio is flexible, as market circumstances and customer requirements can rapidly change the desired portfolio structure. Group Treasury can exercise some discretion within limits prescribed by Group Market Risk with respect to the risk management of these positions and flows.

The exposure is then passed to the market mainly via independently managed dealing units within investment banking division who treat these transactions as part of their normal trading activities, and also via third parties. Risks arising in the Group's other banking operations are managed in a similar way.

Retail market risk is the risk to earnings from retail products (generally in personal and corporate banking), which can be adversely affected by movements in the level or volatility of market rates and prices and/or customer behaviour. The retail market risk embedded within retail contracts is measured using behavioural models and then converted into wholesale swap and option exposure which is transferred to Group

Treasury at an appropriate market rate transfer price. This leaves residual risk within the business to the extent that the wholesale contract does not replicate the customer product behaviour. This risk is controlled by limits set by Group Market Risk.

Management of the non-trading positions inherent in the Group's balance sheet include the structural interest rate risk associated with interest free deposits, other interest free or fixed rate liabilities as well as the Group's shareholders' funds. The positions arising from these balances are managed by the maintenance of assets with fixed interest rates over several years, including loans and advances to customers and debt securities, and also variable rate assets.

International banking operations also incur market interest rate risk. Policies for managing this risk are agreed between Group Treasury and Group Market Risk and are applied through Asset and Liability Management Committees (ALCOs). Guidance on the scope and constitution of ALCOs is provided by Group Treasury, who maintain regular contact with the businesses on treasury issues. Compliance with the policy is controlled via a comprehensive financial risk reporting framework including interest rate gap limits or value at risk limits issued by Group Market Risk. These limits allow banking books to be managed by local treasury operations in an orderly fashion, either through investment banking division or, where necessary, through local markets.

Regulatory Reporting

3 c)

	Capital
Equity – market-based	€XM
Equity – simple risk weight	€XM
Equity – IMA	€XM
Equity – PD/LGD	€XM

3 e)

	Capital
Op Risk – basic approach	€XM
Op Risk – standardised approach	€XM
Op Risk – AMA approach	€XM

5 b)

(i)

Risk Weight	Amounts £
0%	€XM
10%	€XM
20%	€XM
50%	€XM
100%	€XM
150%	€XM
1250%	€XM
Deductions from Capital	(€XM)
Total	€XM

(ii)

Risk Weights	HVCRE	Amounts £	SL Products	Amounts £
Strong	100%	€XM	75%	€XM
Good	125%	€XM	100%	€XM
Satisfactory	175%	€XM	150%	€XM
Weak	350%	€XM	350%	€XM
Default	625%	€XM	625%	€XM

Equities	Risk Weights	Amounts £
Publicly traded	300%	€XM
All others	400%	€XM

6 d)

	Drawn plus EAD on undrawn
IRB Approaches	%

6 e)

(i)

PD Grades	Corporate	Equities	Res. Mortgages	Qualifying Rev. Retail
Grade 1	€XM	€XM	€XM	€XM
Grade 2	€XM	€XM	€XM	€XM
Grade 3	€XM	€XM	€XM	€XM
Grade 4	€XM	€XM	€XM	€XM
Grade 5	€XM	€XM	€XM	€XM
Grade 6	€XM	€XM	€XM	€XM
Grade 7	€XM	€XM	€XM	€XM
Grade 8	€XM	€XM	€XM	€XM
Grade 9 -default	€XM	€XM	€XM	€XM

(ii)

Grade	LGD
Grade 1	%
Grade 2	%
Grade 3	%
Grade 4	%
Grade 5	%
Grade 6	%
Grade 7	%
Grade 8	%
Grade 9 -default	%

(iii)

Sector	Undrawn Commitments	Average EAD
Corporate	€XM	€XM
Equities	€XM	€XM
Res. Mortgages	€XM	€XM
Qualifying Rev.		
Retail	€XM	€XM

(iv)

PD Grades	Retail
Grade 1	€XM
Grade 2	€XM
Grade 3	€XM
Grade 4	€XM
Grade 5	€XM
Grade 6	€XM
Grade 7	€XM
Grade 8	€XM
Grade 9 -default	€XM

Or

EL Grades	Retail
Grade 1	€XM
Grade 2	€XM
Grade 3	€XM
Grade 4	€XM
Grade 5	€XM
Grade 6	€XM
Grade 7	€XM
Grade 8	€XM
Grade 9 -default	€XM

6 f)

Sector	Actual losses
Corporate	€XM
Equities	€XM
Res. Mortgages	€XM
Qualifying Rev.	€XM
Retail	€XM
Other Retail	€XM

6 g)

Sector	Est. Losses 2001	Actual losses 2001	Est. Losses 2002	Actual losses 2002
Corporate	€XM	€XM	€XM	€XM
Equities	€XM	€XM	€XM	€XM
Res. Mortgages	€XM	€XM	€XM	€XM
Qualifying Rev.	€XM	€XM	€XM	€XM
Retail	€XM	€XM	€XM	€XM
Other Retail	€XM	€XM	€XM	€XM

8 b & c)

Portfolio details	Eligible financial Collateral	Other eligible IRB Collateral pre haircuts	Covered by Credit Derivatives / G'tees
Portfolio 1	€XM	€XM	€XM
Portfolio 2	€XM	€XM	€XM
Portfolio 3	€XM	€XM	€XM
Portfolio 4	€XM	€XM	€XM
Portfolio 5	€XM	€XM	€XM
Portfolio 6	€XM	€XM	€XM

9 d)

Exposure type	Traditional	Synthetic
Home equity	€XM	€XM
Credit cards	€XM	€XM
Auto	€XM	€XM

9 e)

Exposure type	Impaired	Past due	Losses
Home equity	€XM	€XM	€XM
Credit cards	€XM	€XM	€XM
Auto	€XM	€XM	€XM

9 f)

Exposure type	Retained	Purchased
Home equity	€XM	€XM
Credit cards	€XM	€XM
Auto	€XM	€XM

9 g)

Risk weight bands	Retained	Purchased
Sovereigns	€XM	€XM
PSEs	€XM	€XM
MDBs	€XM	€XM
Banks	€XM	€XM
Securities firms	€XM	€XM
Corporates	€XM	€XM
Reg retail portfolio	€XM	€XM
Residential prop	€XM	€XM
Comm. real estate	€XM	€XM

9 h)

Securitised revolving exposure

Origin Interest	Invest Interest
€XM	€XM

9 I)

Exposure type	Amount	Gain/(Loss)
Home equity	€XM	€XM
Credit cards	€XM	€XM
Auto	€XM	€XM

10 b)

Type of Risk	Capital Requirement
Interest Rate	€XM
Equity Position	€XM
Foreign Ex.	€XM
Commodity	€XM

11 d)

	VaR Estimates	Actual Outcomes
Aggregate	€XM	€XM
High	€XM	€XM
Mean	€XM	€XM
Low	€XM	€XM

(Alternatively, a graph comparing VaR estimates against actual loss experience in the Profit and Loss Account may be used).

13 b)

	+ X (say 100) basis points shift in yield curve	- X (say 100) basis points shift in yield curve
Currency	Increase (decline) in earnings	Increase (decline) in earnings
£	£XM	£XM
$	$XM	$XM
€	€XM	€XM

Enclosure 5 to No. 0670

FEDERATION BANCAIRE DE L'UNION EUROPEENNE

FBE response to CP3 – Pillar 3

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Scope of application
Table 1

	Pillar 3 Requirement	FBE Dec' Response	Change to Requirements from CP3	Comments from FBE – June 2003
Qualitative Disclosures	a) The name of the top corporate entity	Agreed	No change	Agreed
	b) Outline of differences in the basis of consolidation for accounting and regulatory purpose	Agreed, but the disclosure should only be from the view of the consolidated entity.	No change	Agreed
Quantitative Disclosures	c) Restrictions or major impediments	Agreed	No change	Agreed – on the basis that the disclosure should only be from the view of the consolidated entity.
	d) Aggregate amount of surplus capital	The proposed disclosure is inconsistent with Basel's preferred treatment of insurance subsidiaries: these subsidiaries are to be deducted under Pillar 1 as the Basel Committee believes that "when measuring regulatory capital for banks, it is appropriate to deduct banks' investments in insurance subsidiaries".	No change	This requirement is inconsistent with the Accord's preferred treatment for insurance subsidiaries under Pillar 1. The FBE believes that this requirement should only be required for those countries where investment is not deducted. Disclosures under 1 b) and 2 b) provide sufficient disclosure for capital requirements. Therefore, sections 1 e) and f) are not required. The FBE believes that the requirement for disclosure of surplus capital in insurance companies is as a footnote to an analysis of the components of total capital and not as a deduction from capital. This would then be consistent with Paragraph 14 of CP3, which indicates that the amount of surplus capital (ie the lower of the amount of a bank's investment in an insurance subsidiary, and the insurance subsidiary's capital

				requirement) may be recognised.
	e) Aggregate amount of capital deficiencies	We do not agree because, in our opinion, it is the responsibility of the supervisor to ascertain that these subsidiaries are well capitalised and it is not the bank's task to disclose under-capitalisation of other financial institutions.	No change	See note 1 d)
	f) Aggregate amount of the firm's total interests in insurance entities	We disagree. Since insurance entities will be systematically deducted because of Pillar 1 (see our comments above), this information cannot be significant. We believe, moreover, that this is information to be provided to supervisors within the framework of Pillar 2, and not to the market on the basis of Pillar 3. We do not agree that there should be comparisons where two equal choices are given. However, where there is a preferred choice with an acceptable alternative, we believe that it would be acceptable to provide a reconciliation between the acceptable alternative and the preferred choice.	No change	See note 1 d)

Capital Structure
Table 2

	Pillar 3 Requirements	FBE Dec' Response	Change to Requirements from CP3	Comments from FBE – June 2003
Qualitative Disclosures	a) Summary information on terms & conditions	Agreed	No change	Agreed
Quantitative Disclosures	b) Amount of Tier 1 capital	Agreed Banks should not be required to publish their capital structure any more frequently than they are required to issue financial reports to the market. In fact, accounting rules (such as IAS) organise this aspect and one should merely apply them. We do not agree that there should be mandatory quarterly disclosure of capital adequacy ratios and their components. In many parts of the world there is no requirement for quarterly financial reporting and we do not believe that it is appropriate to disclose regulatory capital details without the corresponding financial information. To do so would invite speculation on capital ratio movement figures, and encourage the analyst community to infer price-sensitive information from the capital data and thereby place banks in an impossible position to challenge erroneous extrapolation of the capital movement figures without selectively disclosing other price-sensitive data. For significant subsidiaries, it should only be disclosed if these subsidiaries are listed.	New requirement re surplus capital from insurance companies.	See note 1 d) There should not be a line in the table for "surplus capital from insurance companies", as this number can only be a footnote. Nonetheless, the detail for points 2 b), c) & d) should be incorporated into one table.
	c) Amount of Tier 2 and 3 capital	Agreed	No change	Agreed – but see note 2 b)
	d) Deductions from Tier 1 and 2 capital.	Agreed	No change	Agreed – but see note 2 b)
	e) Total eligible capital.	Agreed	No change	Agreed

Capital Adequacy
Table 3

	Pillar 3 Requirements	FBE Dec' Response	Change to Requirements from CP3	Comments from FBE – June 2003
Qualitative Disclosures	a) Summary discussion of bank's approach to assessing adequacy of its capital	We do not agree with "strategy" and would prefer "Capital Management". Also, only a brief discussion should be required. We strongly oppose disclosure of the group's capital management strategy and contingency planning.	Particular reference to "strategy" now removed – now talks only of "approach". Also, information on contingency planning now deleted.	Agreed
Quantitative Disclosures	b) Basel requirement for credit risk	We agree on the basis of our understanding that disclosures will be limited to one total amount. Any further division would be premature before 2006 for banks as well as the market.	Minor amendments to portfolio definitions. However, also introduces new requirement of "securitisation exposures".	Agreed
	c) Basel requirement for equity risk		**New clause.**	Agreed
	d) Basel requirement for market risk	Now acceptable on the basis of our understanding that disclosures will be limited.	Reduced requirements now introduced.	Agreed
	e) Basel requirement for operational risk	Now acceptable on the basis of our understanding that disclosures will be limited.	Reduced requirements now introduced.	Agreed
	f) Total Tier 1 capital ratio	Disclosures for significant banking subsidiaries should be limited to those which are required to publish financial statements in their own right, and should be included into the subsidiary's accounts (because of timing difficulties)	No change	The requirement to publish ratios should be restricted to subsidiaries that are separately listed. The FBE sees no reason to publish the details of significant stand alone or sub-consolidated subsidiaries in the Group Accounts, as they are already available separately. The level of capital in the Group is the important number – financial risks can be moved around a Group relatively easily, irrespective of where the capital is, so the value of separate disclosure was questionable.

Credit Risk: general disclosures for all banks
Table 4

	Pillar 3 Requirements	FBE Dec' Response	Change to Requirements from CP3	Comments from FBE – June 2003
Qualitative Disclosures	a) General disclosure for credit risk: • Definitions • Description • Discussion	Agreed	No change	Agreed.
Quantitative Disclosures	b) Total gross credit risk exposures	We do not agree with the requirement to provide average balances, unless item is traded because it is difficult to shift significant amounts of credit risk, which is not traded. The average should only be required where the period end position is not representative of the risk positions of the bank during the period.	Stills calls for average balances but this is now tempered by the fact that this is required for "major types of credit exposures" rather than different types…	▪ Agreed – on the basis that disclosure of credit risk averages is only required if the year-end numbers are not representative. Some banks, however, remain concerned about this requirement. ▪ We note the willingness to not require banks to incur additional costs – for which we are grateful. We would hope the final version of Pillar 3 not to be more onerous. ▪ This table calls for the disclosure of gross credit risk exposures after accounting offsets but without taking into account the effects of credit risk mitigation techniques, e g collateral and netting (footnote 118). Under the standardised approach, regulatory mitigation is provided by offsetting the balances, so the financial reporting netting already reflects the regulatory mitigation. Under the IRB approach, however, netting is treated like collateral and applied to the gross balances, which would mean grossing up the financial reporting balances. This requirement also needs to be viewed in the light of IAS 32, as the netting allowed in the financial reporting will be greatly reduced under this IAS as currently drafted.
	c) Geographic distribution of	Agreed assuming that the geographical areas are wide (e.g. 5 or 6 in total) and in line with	Greater clarity now provided, breakdown now required in	Agreed. We understand that the geographic, industry and

	exposures	internal management reporting.	terms of "significant areas" by "major" (rather than different) types of credit exposure.	counterparty distribution of exposures required under Pillar 3 will be the same as applied by banks according to IAS. This should be mentioned in the document.
	d) Industry/counterparty type distribution of exposures	Agreed at one line disclosure, assuming 5 or 6 counterparty classes.	Greater clarity now provided, breakdown now required in terms of "major" (rather than different) types of credit exposure.	See the comments under 4 c).
	e) Residual contractual maturity breakdown	We agree that this is relatively straightforward to disclose, but do not consider that this disclosure reflects the way the risk is managed. For risk management purposes, the portfolio is managed based on its behavioural maturity characteristics and not its contractual maturity. Therefore this disclosure may be meaningless or positively misleading if taken to be a measure of risk exposure. Behavioural data is not amenable to the same kind of detailed quantitative analysis as contractual maturity and would be more appropriately dealt with in qualitative disclosures.	Although there is some clarification in that it now seeks breakdown by "major" rather than "different" types of credit exposure. It does not address the fundamental objections to the requirement.	Only agreed if IAS 30 also requires characteristics on a contractual basis. FBE understands that as currently drafted, IAS 30 does not require contractual basis analysis.
	f) By major industry or counterparty: • Amount of past due/impaired loans • Specific and general allowances • Charges for specific allowances	Agreed. We do not agree that this is an appropriate general credit risk disclosure. The breakdown of "past due/impaired" loans by industry sector may allow conclusions about individual customer relationships. Furthermore days past due are not relevant to all lending books, e.g. overdrafts, trade finance. We also see no point in disclosing the number of days past due for impaired loans, since they have already been identified as impaired. The number of days past due is only relevant where the loan is past due but not yet impaired e.g. 80 days overdue when the impairment criterion is 90 days overdue.	Requirement for analysis of days overdue is now removed. Additionally, breakdown is now by "major industry." Rather than geographic distribution/industry type. However, they have now added in requirement on specific and general allowances and charges for specific allowances and charge-offs during the period.	Agreed - on the basis that footnote 125 suggests that the full general provision will not have to be allocated. Furthermore, that the breakdown is provided by a geographical split. The breakdown by major industry is an IAS 30 requirement.
	g) Amount of	Agreed	Effectively a new clause,	Agreed.

	impaired loans		however, requirements seemingly, less onerous although it now requires data by geographic area.	
	h) Reconciliation of changes in allowances for loan impairment	Agreed	Effectively a new clause, however, requirements seemingly, less onerous as details by types of credit exposure no longer required.	Agreed.

Credit Risk: disclosures for portfolios subject to the standardised approach and supervisory risk weights in the IRB approaches
Table 5

	Pillar 3 Requirements	FBE Dec' Response	Change to Requirements from CP3	Comments from FBE – June 2003
Qualitative Disclosures	a) Standardised: • Names of ECAIs and ECAs • Types of exposure • Description • Alignment	Disclosure of details of the process used to transfer public issue ratings to comparable assets in the banking book should not become part of the disclosure requirements. To point out, whether public issue ratings are used or not should be sufficient.	No change	The FBE believes that the disclosures by banks might be confusing to the market if each bank is obliged to publish this information in isolation. The FBE thinks that this disclosure is only operative if banking supervisors publish a standard mapping.
Quantitative Disclosures	b) Amount of outstandings in each risk bucket	Unnecessary and too costly. This potentially presents a misleading picture of the credit risk profile, particularly if numerous local ratings agencies are used. There are significant variances in the performance of individual ratings, the rated instruments and a bank credit facility. Transposing bank internal ratings into multiple external ratings in order to calculate regulatory capital could present a misleading view of the risk profile. We recommend that quantitative disclosures be based on a bank's internal rating risk profile, restricted to material portfolios, with the qualitative disclosures as proposed.	Largely unchanged although now also seeks details on "any specialised lending products"	Agreed, provided the number of buckets is limited.

Credit Risk: disclosures for portfolios subject to IRB approaches
Table 6

	Pillar 3 Requirements	FBE Dec' Response	Change to Requirements from CP3	Comments from FBE – June 2003
Qualitative Disclosures	a) Supervisor's acceptance	Agreed	No change.	Agreed.
	b) Explanation and review of: • Structure of internal rating systems • Use of internal estimates • Process for managing and recognising credit risk mitigation • Control mechanisms for the rating systems	We believe that this information is not useful. This information is more typically provided under Pillar 2. We are concerned that detailed disclosures for PD, LGD, and EAD data might be sensitive, if thinly broken down, and might lead to erroneous judgements by non-informed market participants (against the background of rumour-driven market volatility).	Now proposing an IRB approach rather than PD/LGD. Also requires details of control mechanisms for rating systems.	The requirement should be in accordance with IAS 30, which should be sufficient. Moreover, disclosing the mapping between internal and external rating might be confusing to the market if each bank is obliged to publish this information in isolation because each bank has its own risk apprehension. Finally, we do not consider this information to be useful because banks provide already PD estimates associated with internal ratings.
	c) Description of internal ratings for: • Corporates • Equities • Residential mortgages • Qualifying revolving retail • Other retail	Agreed	Some changes to definitions although on the face of it these are not significant. However, now also seeking description of deviations where determined to be material.	Banks are concerned about the possibility of non-expert investors being misled by this kind of data about the bank's risk profile. Numbers coming from models are hypothetically dangerous without proper knowledge. When working with models, the emphasis should be on qualitative information. Data relating to the model's performance and back-testing should be reported to regulators only.
Quantitative Disclosures risk assessment	d) Percentage of total credit exposures	Apply IAS rules only	Now seeks percentage rather than "percentage amount"	See our comments under 6, c).
	e) For each portfolio (except retail): • Presentation of exposures • Default-weighted average LGD • Amount of undrawn commitments	Not useful. Needs convergence of regulatory practice.	Details no longer required for "retail portfolio". New requirements for banks on IRB advanced approach.	See also our comments under 6, c). We are concerned about the volume of data and about their confidential nature. However, if the disclosures are limited, they would be acceptable.

	For retail portfolios: Either - Disclosures on a pool basis Or – Analysis of exposures on a pool basis			
Quantitative disclosures: historical results	f) Actual losses in preceding period for each portfolio		**New clause**	Some banks find these requirements onerous. The information to be disclosed should not in any event be increased. The numbers coming from models are potentially dangerous without detailed knowledge of the methodologies behind them. Therefore, such information should be dealt with in Pillar 2 and disclosed to supervisors only.
	g) Bank's estimates against actual outcomes over a longer period.		**New clause**	See our comments under 6, c).

Equities: disclosures for banking book positions
Table 7

	Pillar 3 Requirements	FBE Dec' Response	Change to Requirements from CP3	Comments from FBE – June 2003
Qualitative Disclosures	a) General equity risk: • Difference between holdings with capital gains • Policies covering valuation and accounting of equity holdings	Agreed	No change	Agreed.
Quantitative Disclosures	b) Value disclosed in balance sheet & fair value	Unnecessary. If there are public quotations for stocks and shares, they represent – given the liquidity of markets – the fair value. Apart from that, no other theoretically founded at the same time realisable model for the calculation of fair values of illiquid positions exists. In the light of the crucial significance of a permanent or long-term equity financing of small and medium-sized businesses by financial institutions, information is irrelevant for these cases.	No change	For those countries where IAS is adopted, the requirement for a comparison with fair values should not be required - IAS 39 prescribes the fair value as the screen price.
	c) Type and nature of investment: • Publicly traded • Privately held	Agreed	No change	Agreed.
	d) Cumulative realised gains (losses)	Realised gains are automatically disclosed in the financial statements. Unrealised or latent gains (losses) are already disclosed at a global level in Europe. There is therefore no need for specific requirements.	No change	Agreed.
	e) Total unrealised or latent revaluation gains	No previous comment	Now also seeks details for Tier 1 as well as Tier 2 capital.	Agreed.
	f) Capital requirements broken down by equity groupings	N/A	Move from IRB approach to capital requirements	Agreed.

Credit risk mitigation: disclosures for standardised and IRB approaches
Table 8

	Pillar 3 Requirements	FBE Dec' Response	Change to Requirements from CP3	Comments from FBE – June 2003
Qualitative Disclosures	a) General qualitative disclosure requirement with credit risk mitigation: • Policies and processes for use of on and off-balance sheet netting • Policies and processes for collateral valuation • Description of main types of collateral • Main types of guarantor/credit derivative counterparty • Information about (credit or market) risk concentrations	Should remain practical (i.e. summarised).	Substantial revision	We do not believe that disclosing information on "the main types of guarantor/credit derivative counterparty and their credit worthiness" would help an investor in understanding a bank's risk profile. Indeed, there are many ways to exercise a guarantee (conditional, partial, etc.) which the proposed disclosure requirements do not reflect. Credit risk mitigation techniques must meet regulatory requirements. This should suffice.
Quantitative Disclosures	b) Total exposure covered by: • Eligible financial collateral • Other eligible IRB collateral Before the application of haircuts		**New clause**	Agreed.
	c) Total exposure covered by guarantees/credit derivatives		**New clause**	Agreed.

Securitisation: disclosures for standardised and IRB approaches
Table 9

	Pillar 3 Requirements	FBE Dec' Response	Change to Requirements from CP3	Comments from FBE – June 2003
Qualitative Disclosures	a) General disclosure requirements with respect to securitisation including: • Bank's objectives • Role played by the bank in the securitisation process	We agree to provide general, high-level disclosures. But one has to consider that assets are securitised for a variety of reasons including to manage portfolio risks, to reduce regulatory capital requirements and to fund new business. In practice, the rationale for securitising assets will therefore be a combination of, to a lesser or greater extent, all of these factors. This rationale is confidential to the institution and should not form part of a disclosure requirement.	New requirement re "synthetic" securitisations. Also, details of objectives in relation to securitisation and also the extent of the bank's involvement.	Agreed.
	b) Bank's accounting policies for securitisation activities including: • Whether transactions are treated as sales or financings • Recognition of gain on sale • Key assumptions for valuing retained interests • Treatment of synthetic securitisations	The requirement should be in accordance with IAS. If derecognition is absolute, there should be no requirement for any further disclosures. Where risks or rewards are retained, then disclosures should be limited to the retained interests.	Requirement for "procedures" now dropped.	The requirement should be in accordance with IAS, which should be sufficient.

	c) Names of ECAIs used	Agreed	No change	Agreed.
Quantitative Disclosures	d) Total outstanding securitised exposures		Move to “outstanding exposures” rather than “assets”.	Agreed.
	e) For exposures securitised: • Amount of impaired/past due assets securitised • Losses recognised by the bank during the current period		Substantial revision	Disclosures on credit risk that has been passed on, using a securitisation vehicle, could potentially lead to confusion and misinterpretation by investors. The FBE believes, therefore, that the Basel Committee should remove the requirement for disclosure in cases where the clean break criteria have been met.
	f) Aggregate amount of securitisation exposures by exposure type		**New clause**	Agreed.
	g) Aggregate amount of securitisation exposures by risk weight bands		**New clause**	Agreed.
	h) Aggregate outstanding amount of securitisation exposures by originator’s and investor’s interest		**New clause**	Agreed.
	i) Summary of current year’s securitisation activity		Summary by exposure rather than asset type.	Agreed.

Market Risk: disclosures for banks using the standardised approach
Table 10

	Pillar 3 Requirements	FBE Dec' Response	Change to Requirements from CP3	Comments from FBE – June 2003
Qualitative Disclosures	a) General disclosure requirement	Agreed	No change	Agreed.
Quantitative Disclosures	b) Capital requirements for: • Interest rate risk • Equity position risk • Foreign exchange risk • Commodity risk	Agreed	No change	Agreed.

Market Risk: disclosures for banks using the internal models approach (IMA) for trading portfolios
Table 11

	Pillar 3 Requirements	FBE Dec' Response	Change to Requirements from CP3	Comments from FBE – June 2003
Qualitative Disclosures	a) General disclosure requirement	Agreed	No change	Agreed.
	b) For each portfolio: • Characteristics of models • Stress testing • Backtesting/validating	Agreed	No change	Agreed.
	c) Scope of acceptance	Agreed	No change	Agreed.
Quantitative Disclosures	d) For trading portfolios: • Aggregate VaR • High, mean and low VaR • Comparison of VaR estimates	Agreed	Change in the type of average used "mean" rather than the "median".	Agreed, but with a point of clarification. VaR is a statistical estimate calculated using actual data, so it is not possible to compare "estimated" versus "actual" VaR. The comparison normally made is of the VaR compared with the actual loss experience in the profit and loss account for the same period. The wording "A comparison of VAR estimates with the actual outcomes" should

				be clarified to reflect this. Also, it appears to FBE that the period end VaR would be the same as aggregate VaR and so it is not necessary to require both.

Operational Risk
Table 12

	Pillar 3 Requirements	FBE Dec' Response	Change to Requirements from CP3	Comments from FBE – June 2003
Qualitative Disclosures	a) Operational risk capital assessment	Agreed	No change	Agreed.
	b) Advanced measurement approach	We partially agree: "a discussion of important driving factors" is however not necessary. This could require the disclosure of confidential information that may be commercially sensitive.	Now seeks "relevant internal and external" factors as well as scope and coverage for partial use.	Agreed.
Quantitative Disclosures	c) Operational risk capital charge	Too prescriptive. We are strongly opposed to any quantitative disclosures with respect to operational risk other than in aggregate. Any disclosures should be restricted to operational risk management objectives and policies.	Now requires additional breakdown before and after any reduction in capital resulting from the use of insurance.	Details before and after the use of insurance is likely to be confidential information that insurers would not want to release. The disclosure should be provided post the reduction to capital from the use of insurance.

Interest rate risk in the banking book (IRRBB)
Table 13

	Pillar 3 Requirements	FBE Dec' Response	Change to Requirements from CP3	Comments from FBE – June 2003
Qualitative Disclosures	a) General disclosure requirement	Agreed	Now also seeks assumptions regarding loan prepayments and behaviour of non-maturity deposits	Agreed.
Quantitative Disclosures	b) Increase (decline) in economic value	We disagree, dealt with under Pillar 2. Moreover this information is competitively sensitive. We object to this because there is a practical difficulty of determining what the economic value of the bank is for a complex banking group. This measure also suffers from subjectivity and lack of comparability between banks. The figures in the proposed disclosures will inevitably be subjective to a greater degree than other figures disclosed in accounts. Also, although the concept of a parallel shift in interest rate curves is a widely applied stress test, such parallel shifts are rare in practice and the reality is that market movements are more complex than this. The effects are not limited to the interest rate. Such a rate movement would affect the wider economy including levels of unemployment and more generally, levels of economic activity.	Scope now widened so that as well as economic value, earnings or "relevant measure used by management" may be used. Also requires breakdown by currency (as relevant).	IAS 30 will require disclosures "through the eyes of management" with a minimum requirement to discuss what is significant in the context of the business. Therefore, currency issues will only be disclosed where this is significant.