Le Directeur Général Adjoint

Paris, July 29th 2003

Re: Consultative paper n°3

Dear Mrs Nouy,

The French Banking Federation welcomes the opportunity to comment on the third consultative paper, in the context of the continuing dialogue maintained by the Basel Committee with the banking industry.

The French Banking Federation has actively participated in elaborating the response of the European Banking Federation, which it fully supports. However, we feel useful to share with the Committee our own perspective and to insist on some points the French banking industry considers of the highest importance.

Our main remarks to the CP3 are listed there. They are presented by order of significance and structured in two sections: general concerns and technical matters.

A) General concerns

- **Diversification** of risks and activities are not taken into account even though everyone would agree that universal banks bear less systemic risks because of the low correlation between Retail and Wholesale activities but also between developed and emerging markets. We urge the Committee to consider this matter with great attention and, at least, to recognize diversification benefits as a major item which could alleviate other capital cushions requested by Pillar 2

- **Incentives** to adopt the most advanced risk management techniques are very low. In absence of a calibration adjustment to correct this situation, we urge the Basel Committee to ease, temporarily and in some cases permanently, the statistical and operational requirements which we generally consider as too high and prescriptive.

  Firstly, eligibility and validation criteria for the IRB methods should be made more flexible. The main recommendation in that respect would be to grant a transition period for Corporate exposures (including sovereigns and banks) of A-IRB banks (four years initial

Mrs Danièle NOUY
Secretary General
Basel Committee on Banking Supervision
Centralbahnplatz 2
CH – 4002 Basel

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observation period, for LGD and EAD, instead of seven years). In cases of scarce data, banks should also have the possibility to choose alternative methods as "expert judgements", sampling or internal model output under the supervision of their regulators. Conversely, for banks with more than 2 years of historical data for their residential real estate portfolio, the 10% LGD floor, which makes little sense from a statistical point of view and penalizes the less risky exposures, should be removed. The requirements relating to mechanical quantification, data collection, storage and back-testing should be alleviated, especially during the transition period.

Secondly, the French banks ask the Committee to allow, for high quality sovereign exposures (with external rating higher than AA- for example) the possible permanent use of the Standardized Approach or to provide the industry with standard PD and LGD for such cases.

- **Pro-cyclicality** and accounting standards are continuing concerns for the French banks. Some measures appear essential to avoid an excessive volatility of the future solvency ratio :

  - Make the accounting and regulatory reforms consistent, at least as far as Equity and provisioning definitions are concerned.
  - Reaffirm the 'through the cycle" approach of internal ratings.
  - Adjust the stress test hypotheses to the economic conditions in order to make them less stringent down the cycle.

- **Threshold effects**, both between and within portfolios, need to be softened. Even though the 1 M€ boundary for retail exposures is a relevant requirement, it may raise serious implementation difficulties. We ask the Committee to allow for flexibility and accept to maintain exposures beyond that threshold in the retail portfolio when such exceptions are not material and when they are managed as retail exposures. The use test should prevail on the threshold criteria except for regulatory gaming, which would then be sanctioned by the regulator.

  Another type of cliff effect appears with the Specialized Lending portfolio. The supervisory slotting criteria methodology defines four risk weight categories plus a default one. We ask the Committee to apply to the S/L portfolio the same principle than to the others portfolios (i. e. seven risk categories plus a default) and therefore soften the risk curve; in order to ease the implementation of the required modification, we would recommend that the three additional categories be defined as generic intermediary categories between the four existing ones.

- **Pillar II** : At the international level, co-ordination of supervision is an absolute need in order to avoid home/host regulators' concurrence and inconsistency and should be placed under the home regulator responsibility. Pillar II should only be applied at top consolidated level by the home supervisor.

  At the national level, we understand the capital add-ons as exceptional, only driven by specific circumstances, and not an ordinary practice, which then should have been included in the calibration of the Accord. Furthermore, specific measures applying to individual banks must remain an undisclosed request of the regulator for obvious stability reasons.

  Stress tests should be considered with care as already mentioned and cannot but be bank's specific. Country, industry, activity diversification may offset the possible add-ons whatever their origin.

- **Pillar III** : Significant improvements have been made by the Committee since the beginning of this project, mainly on Securitisation, but the members of the FBF believe that the requirements still remain too prescriptive, will deliver confusing signals to the market and induce proprietary information disclosure. Furthermore, the French banks believe that the

regulatory disclosures should be confined to the accounting ones, which are planned to be quite detailed.

B) Technical and specific matters

- **Improvements of measurement techniques**

  For *maturity below one Year*, the floor may be withdrawn for some short term financing at national discretion. We believe this option could be generalized as most regulators will choose it and as this measure is essential to the development of market and trade financing. However the current formula is correct only for maturity over the rating horizon and should be revised in order to give a more accurate and substantial relief of the capital requirements.

  Taking into account the *double default effect* is another improvement solicited from the Committee, in order to reflect the real hierarchy of risks and induce banks to adopt the best and soundest practices. Counter-party risk treatment of OTC derivatives should benefit from the latest development in risk measurement and we recommend the inclusion, as an option in the Accord, of the Expected Positive Exposure (EPE) or closely related measures. Such an amendment would be critical for the sound development of the market.

  The regulatory definition of default could still be improved by including the French "technical delinquency" notion as there is no deterioration of the borrower's solvency.

- **The characteristics of some activities must be more accurately recognized.**

  Securitisation should call for removing the security cushions hidden in several places of the calculation method considered by the Committee. They lead to an excessive increase of the regulatory capital requirements for this activity; a "clean SFA" for originators is requested. Operational requirements regarding securitisation are also unduly heavy and should be lightened.

  For *lease activity*, we recommend the Committee to reduce the risk-weights in the Standardized Approach and the LGD in the F-IRB Approach as the lessor's ownership gives a distinctive advantage over straight collateralization. Furthermore, the treatment of residual value must be amended in order to avoid an inconsistent and penalizing approach.

  Factoring is another activity, which requires further attention. It is a complex product and you will find attached an appendix reviewing its particular features: product types risk of dilution, mechanism of reserve funds, and including our proposals

  Equity investment is highly impacted by the new framework and should call for a particular attention from the Committee. The present risk weights will certainly cause the banking industry to retrench from this activity and probably need to be reviewed.

You will find attached our detailed comments and proposals.

We do think it is still possible to include the above improvements in the Accord. If you would like additional clarification on any of the points raised in this letter, the members of the FBF would be happy to provide you with further detailed views.

Yours sincerely.

Pierre de Lauzun

**FRENCH BANKING FEDERATION DETAILED COMMENTS AND PROPOSALS
ON THE THIRD CONSULTATIVE PAPER OF THE
BASEL COMMITTEE ON BANKING SUPERVISION**

I. <u>Implementation</u>

1.1. Eligibility criteria should be made more flexible

Most of our observations aim at avoiding that inappropriate requirements or formulations may lead some regulators to abrupt invalidation of an efficient rating system; we also wish that no specific kind of rating system be considered as the only acceptable one (for example model-based system). In some cases, this inappropriateness comes from the way that the Basel Committee's provisions have been written in the CP 3 and may thus be interpreted; in some others, it results from direct and explicit requirements.

1.1.1. Reduce the length of required historical data periods

We understand that, on an ongoing basis after the implementation of the new Accord, bank must ground their internal estimates of PD, LGD and EAD on sufficient historical data, ideally reaching a complete business cycle. Nevertheless we restate our continuous concern, already expressed in our answer to CP 2, that :

- required data observation periods should not be unworkably long at the time of inception of the Accord, at the end of 2006. 7 years is clearly unreasonable and will be a strong obstacle for many banks on their path towards A-IRB, and a disincentive for many others,
- there should not be such a distortion between portfolios: 2 years required at the outset of the Accord for the LGD and EAD of retail exposures and 7 years for corporate exposures (including sovereigns and banks),
- there should not be such a distortion either between loss characteristics inside the same asset class (2 years for corporate PD and 7 years for corporate LGD and EAD).

We have been expressing strong criticisms against this requirement for a long time; if data observation periods cannot be made identical for all asset classes and loss characteristics, we ask that at least a 3-year transition period be granted for LGD and EAD of corporate exposures, reducing the initial observation period to 4 years. Furthermore, the existing inequality between F-IRB and A-IRB on the topic of historical data length, at the disadvantage of the latter, runs counter the Basel Committee's stated objective of provided reasonable incentives to move towards the most advanced approaches of the new framework.

1.1.2. Remove exclusive references to mechanical quantification

We first consider that the Basel Accord should not contain implicit or explicit requirements of use of mechanical quantification for PD, LGD and EAD, based exclusively on historical data and calculation formulae. These requirements are particularly obvious in the sections referring to LGD and EAD quantification (§ 430 to 441) :

> *"This estimate must be based on the average economic loss of all observed defaults within the data source (referred to elsewhere in this section as the default weighted average) and should not, for example, be the average of average annual loss rates. Since defaults are likely to be clustered during times of economic distress and LGDs may be correlated with default rates, a time-weighted average may materially understate loss severity per occurrence. Thus, it is important that banks utilise default-weighted averages as defined above in computing loss severity estimates. "*

This wording seems to exclude LGD assessments that do not simply result from "the average economic loss of all observed defaults within the data source". The usual way to work out LGD estimates for corporate exposures rather lies on an analytic process in which all components of LGD are separately analysed and then aggregated to deliver a single figure. We consider that, if an incentive for one method or another should exist in the Accord, it should favour sound processes of analysis tracking separately all components of LGD; supervisors may usefully focus on the quality of the assessment of each component taken individually, and then on their overall aggregation to compute LGD.

We also feel that, especially in the field of corporate lending, sufficient human judgement should be allowed to play a critical role in the assessment of PD, LGD and EAD. For example, we believe that most of the impact of guarantees or liens on the borrower's strategic assets does not come from the activation of these guarantees of collateral, but also 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 is a useless and costly exercise that may even lead to wrong assessment of LGDs if mechanically used.

Human judgement is even essential in the fields where few comparable default and loss examples exist: Specialised Lending has been highlighted, but it is also the case for bank or sovereign lending, as well as for the financing of industries where defaults are rare. Complex structured lending is also obviously a field where mechanical quantification could 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 any other means that are not available for statistical models and that are likely to produce more adequate results than the average of historical data.

We thus favour a wording of the Basel Committee's proposals where the emphasis would be on the quality of the overall assessment process, making appropriate use of the data sources that are relevant and available, each sub-segment taking advantage from the global quality of the overall system as a whole.

Validation of PD, LGD and EAD estimates ("back-testing") is also a part of this framework and should be addressed by supervisors with the same flexibility. Particularly, default and loss estimates assigned to the exposures of a given sub-segment may be considered as validated in regard of realised losses, even when numerous default and loss observations are not available for this specific sub-segment, if the bank's assessment method for this 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. One technique that could be used jointly or alternatively with global validation for LGD estimates would also be separate testing of some or all components (collateral values, guarantee enforcement, unsecured recoveries...).

1.1.3. Data collection and storage

The Basel Committee's requirements regarding data collection and storage are clearly excessive (§ 391 to 395) :

- history of ratings since the start of the relationship with any borrower,
- key data used to assign a rating,
- people responsible for each rating assignment,
- more particularly, detailed components of loss and recovery given default:
- tracking the source of repayment, specifying the guarantee or collateral involved, is often impossible or useless
- administrative costs are generally assigned to each facility on a conventional basis,
- the period necessary for a complete recovery process is often longer than available in data sources, which makes the measurement of in fine recoveries difficult.

More generally, the utility of storing such detailed data is quite questionable. The Basel Committee indicates that one of the aims may be "to allow retrospective reallocation of obligors and facilities to grades, for example if increasing sophistication of the internal rating systems suggests that finer segregation of portfolios can be achieved". This retrospective rating is simply unworkable, especially in the context of human judgement-based rating assignment, and that the necessary consolidation of detailed data would entail disproportionate costs for uncertain benefits (detailed data widely vary from one activity to another, and a single format for all data across a banking group would reduce their appropriateness). These remarks do not mean banks should not assess the impact and efficiency of changes in their rating system. They will do it differently according to the rating system types (model or expert based) and generally on a sample basis.

1.1.4. The equilibrium between conservatism and accuracy / stress tests

Stress tests

The rationale for systematic stress testing is not obvious. If a general and homogeneous downgrade of ratings is assumed, the IRB function will delivered increased capital requirements that are the exact reflect of the initial assumption and will not bring any relevant information to the knowledge of the bank. Furthermore, the probability that all exposures experience simultaneous downgrades is quite low, especially for large and diversified banking groups; diversification should be an important criterion for asking capital surplus in Pillar 2 if necessary, as it is not taken into account in Pillar 1, which disadvantages large wholesale banks compared with smaller and more specialised institutions.

The Basel Committee should not consider either that banks must be able to assess the impact of macro-economic conditions on the credit quality of the portfolio ("two consecutive quarters of zero growth" for example, § 397). This is not feasible in the case of modelled exposures (as models generally use bottom up approaches that do not specifically address the impact of macro-economic factors), and still less in the case of human judgement-based rating assignments.

As a matter of fact, the main kind of stress tests that could be used in the analysis of potential losses consist in scenarios specific to a given sub-portfolio (country, industry...), based on expert economic analysis and individual study of exposures.

"Stressed" LGDs and EADs

It is stated in § 430 and 437 that banks must use LGD and EAD estimates that are "appropriate for an economic downturn if these are more conservative than the long-run average" when these estimates are volatile over the economic cycle. This requirement comes in addition to the understandable one that LGDs and EADs are default-weighted rather than time-weighted, and its utility is not obvious, except if we consider that the IRB model does not take into account LGD and EAD volatility; alterations in the assessment of average LGDs and EADs should not be seen as the remedy to shortfalls in regulatory capital models.

Treatment of seasoning for retail exposures

Another shortfall in the IRB model is that it lies on standardised transition matrixes and thus cannot take into account atypical default trajectories, such as the peak in the number of defaults experienced by mortgage loans after their third year. We consider that this phenomenon should exclusively be taken into account through the correlation levels that have been set for these exposures, except in the exceptional case of a rapid exposure growth, which should be addressed on a portfolio-by-portfolio basis, and not by increasing PDs (which would be inconsistent with realised default rates on those exposures), but rather by appropriately making use of Pillar 2.

Back-testing, conservatism and "through the cycle"

The results of back-testing will have to be very cautiously interpreted by supervisors as this process may meet two obstacles :

- many years of historical data will have to be collected before through the cycle ratings can be validated by through the cycle realised default and loss rates. At implementation date, the Accord project does not require any precise length of historical data used for back-testing, but only "as long as possible" and "ideally covering one or more complete business cycles" periods. Therefore, the first back-testing exercises may produce results that show apparent discrepancies between through the cycle ratings and more "point in time" realised rates;
- as uncertainties must lead to additional conservatism in rating assignments (§ 373), realised default rates may not apparently validate such ratings.

Furthermore, the results of back-testing should allow invalidating rating assignments only when they show consistent and sufficient data that disqualify the estimated PD of the assigned ratings.

1.1.5. Exposures with scarce loss data

The French banks are conscious that, in some cases, it will prove impossible to link loss characteristics with loss data, since no default may have occurred for some industries or types of counterparties that are so specific that the mapping of data may be hazardous or irrelevant. Examples include :

- LGDs for upper investment grade sovereigns,
- LGDs for banks that are considered as major players in developed countries,
- ...

In this case, the French banking industry fears that competitive biases may rise; the lack of data may indeed lead the different national regulators to divergent conclusions and authorisations. Some banks may exit from some markets and/or competitive pressures may lead to understate the risk of these particular sub-portfolios. The French banks therefore consider that banks should be free to opt for one of the three following options in a consistent manner :

- if the bank is under A-IRB for the rest of its exposures, it can remain in A-IRB for these particular exposures, provided that the PDs and LGDs it uses are controlled by its supervisors and have proved to be both reasonable and in the average of the practices of competitors,
- even if the bank is under A-IRB for the rest of its exposures, it can choose to return to F-IRB for these exposures (but LGDs around 45% may prove unsustainable),
- even if the bank is under IRB for the rest of its exposures, it can choose to return to Standardised for these exposures. It must satisfy its regulator that the portfolio to which it applies this exemption exhibits a low counterparty risk profile, which in turn explains the scarcity of past loss data.

1.1.6. Other topics

- The monitoring for possible inconsistencies between several rating systems must not be understood as compelling banks to systematically rate the same exposures in several rating systems across their departments or business lines in order to check that they produce identical results.

- As in the Advanced IRB approach banks must be free to determine their own EAD estimates provided that they are grounded in historical experience, we strongly oppose the compulsory use of a 100% CCF in the A-IRB when it is required in the F-IRB approach (§ 286).

1.2. More accurate guidelines should be provided in some fields

1.2.1. Definition and horizon of EAD

What is EAD?

The only definition of EAD in the A-IRB approach is provided in § 436 of CP 3: "Advanced approach banks must have established procedures in place for the estimation of EAD for off-balance sheet items. [...] Banks estimates should reflect the possibility of additional drawings by the borrower up to and after the time a default event is triggered."

This definition restricts the scope of EAD to a quantification of potential additional drawings for the undrawn part of a facility at the observation date. Thus the EAD estimate for a given exposure will not be equal to its observed drawn amount at or after the date of default, provided that phenomena such as contractual or voluntary amortisation cannot be taken into account; furthermore, the "floor" at 100% of the current drawn amount limits the possibility of fair assessment of the real exposure at default.

Consequently, PD × LGD × EAD will not be comparable with the actual recorded losses in one year, and will be systematically higher, thus overestimating capital requirements. The Basel Committee should think about the mean to reach a correct assessment of EAD and provide greater clarity about what should be measured (as has been done for the definition of default and loss).

In order to promote a realistic Advanced IRB approach, the Basel Committee should thus forget about the narrow concept of Credit Conversion Factor in use in the Cooke context and try to establish a sound framework for the assessment of exposure at default. As a matter of fact, we are not convinced that the best way to model EAD is to distinguish between a drawn part of the facility that would be taken for 100% and an undrawn part to which a CCF would be applied: EAD could certainly be modelled independently from the drawn/undrawn part at the time of observation.

The Basel Committee should also promote clear distinctions between loss characteristics: PD should only reflect the risk of default of the borrower or transaction, EAD should only reflect the anticipation of outstandings at the moment of default and LGD should only reflect the loss incurred on these outstandings at the end of the recovery process. Consequently, the French banks consider that the possibility to reflect the likelihood of additional drawings in LGD estimates must be removed from § 307, as this practice would blur the readability of loss characteristics and would open a way for competitive distortions.

What is the horizon of EAD?

We consider that, just like PD but conversely to LGD, EAD is a "pre-default" risk characteristic, as it measures the potential increase of exposure between the observation date and the time of default (eventually being corrected with additional drawings that would occur after default). As such, it must have an horizon consistent with the one of default, i.e. one year: EAD would be the exposure of a facility experiencing default at any random time between the observation date and the time of default.

The idea that EAD must be measured under the liquidity horizon of the model is strengthened by the fact that it is also submitted to migration risk beyond that liquidity horizon: for example, in the case of amortising loans, the remaining maturity used in the IRB approach will be reduced in comparison with bullet loans, showing that reductions in EAD after one year are taken into account through this mean.

1.2.2. What parameters should be used for LGD assessment?

The Basel Committee has been somewhat clearer for LGD, but critical information should be delivered on the following topics :

- it should be stated that the horizon of the default that entails the assessed loss is life of the credit: criteria for the assessment LGDs must take into account defaults occurring at any time of the life of the loan. In turn, the horizon of recovery is clearly set at the end of the recovery process;
- the Basel Committee should seek convergence with IAS when specifying the costs that should be taken into account (internal or external costs linked with recovery, discount rates...).

1.2.3. Remaining problems with the retail/corporate boundary: the € 1 Mn threshold

The Basel Committee restricts the perimeter of exposures on legal entities included in the retail asset class to :

- "small businesses", imprecise term which in our opinion must not imply any additional restriction to the type of counterpart that may be included in the retail portfolio,
- loans that are not part of a consolidated exposure of the banking group on the concerned counterpart that would exceed € 1 Mn.

This latter condition is mitigated by the end of § 199: "It is expected that supervisors will provide flexibility in the practical application of such thresholds such that banks are not forced to develop extensive new information systems simply for the purpose of ensuring perfect compliance. It will, however, be important for supervisors to ensure that such flexibility (and the implied acceptance of exposure amounts in excess of the thresholds that are not treated as violations) is not being abused."

The French banks fear that § 199 may be interpreted in too stringent a way, and that banks will nevertheless be compelled to develop extensive information systems so as to ensure broad (and not even "perfect") compliance with its requirements. We understand from the current provisions that a bank should check all consolidated existing amounts on a given counterpart before treating it as retail or as corporate, which implies very different processes (see § 200 of CP 3).

The French banks consider that such a need for a compulsory **pre-origination** consolidation would jeopardise the commercial reactivity of some business lines, especially in the case of transactional activities that are focused on one-off financing rather than on a long-term relationship with a client. Leasing, especially when originated through the seller of the financed asset, is typically the kind of transaction-oriented activity in which a small-amount financing ticket is concluded within a very short time, just leaving to the bank's agent the time to perform a score, but certainly not to consolidate all exposures on that client over the whole banking group. Of course, a deeper analysis is performed when the counterpart already benefits from material exposures by the concerned subsidiary of the banking group, and the whole exposure can be treated as corporate.

The French banks are thus convinced that the retail rating system should apply to any of those exposures of low individual amount, for practical reasons; but they would understand that a capital requirement be based on the corporate formula when the group's aggregated exposures on one counterpart appear to be material relatively to the size of the retail portfolio.

This simply requires, in such cases, that corporate capital requirements be allowed to be calculated on the basis of ratings assigned by a retail-oriented rating system. This improvement would require two modifications in the wording of § 199 and 200 :

- it should be clear that the main criterion for allowing PDs, LGDs and EADs to be assessed by **retail-style rating systems** is the consistency between the characteristics of the concerned exposures and their risk management ("large pool of exposures, managed by the bank on a pooled basis"),
- the € 1 Mn limit should only apply for the choice of the **regulatory capital calculation formula**. As such, should only be eligible to retail capital charges transactions that fulfil both conditions (i) to be assessed through retail-style rating systems and (ii) not to be a part of a global exposure by the banking group on the counterpart exceeding € 1 Mn.

Attention could also be paid to the possibility of replacing the € 1 Mn threshold with the granularity criterion (i.e. no aggregate exposure to one counterpart exceeding 0.2% of the regulatory retail portfolio) disclosed in § 44 for the Standardised approach.

II. Calibration

2.1. The 10% LGD floor for mortgage exposures

The French banks are strongly opposed to setting a LGD floor at 10% for the exposures contained in the "residential mortgage" portfolio :

- provided that many pools of retail mortgage exposures exhibit LGDs lower than 10% that are grounded on historical experience, this provision singles out residential real estate loans to individuals by imposing them capital requirements substantially higher than what is needed for other retail loans bearing the same risk level,
- the LGD floor provides a substantial advantage to banks that choose to assess the impact of unfunded guarantees on PDs rather than on LGDs, especially in countries like France where this kind of guarantees is current practice,
- the cyclicality of losses on mortgage exposures, which the floor is intended to prevent banks from ignoring, is not equivalent for all markets in the world. For example, markets characterised by the predominance of variable rate exposures tend to exhibit higher volatility of losses on mortgage exposures, whereas markets characterised by the predominance of fixed rate loans show more stability.

We recognise that very low LGDs based on the minimum historical data required for retail exposures at the outset of the Accord (2 years) would be somewhat questionable if the appropriate margin of conservatism was not included in the assessment of LGDs. We nevertheless consider that banks relying on more robust data and/or analytical processes should not be imposed any floor at all; furthermore, we think that the floor is too rigid a tool in this matter and that this topic should be addressed in Pillar 2 rather than by creating additional distortions in Pillar 1.

2.2. Weak incentives in favour of the advanced approaches – insufficient recognition of credit risk mitigation techniques

On the whole, the French banks have regretted since the start of the Basel II process that the Accord does not give sufficient recognition to advanced risk measurement (through A-IRB) and management (through credit risk mitigation techniques). This criticism still appears valid after the release of CP 3.

The F-IRB approach still unduly restricts the recognition or impact of some mitigation techniques :

- unfunded guarantees provided by guarantors rated less than A- (or equivalent in the internal rating systems) are not recognised, even when their creditworthiness is sharply better than the borrower's;
- physical collateral is still penalised by an overly conservative assessment of its value. The "collateralisation rate" method used in F-IRB embeds implicit haircuts on the value of the collateral that are displayed in the table below:

Collateral kind	Minimum collateralisation rate	Maximum collateralisation rate	Maximum LGD reduction	Implied haircut
Receivables	0%	125%	10%	84%
Real estate	30%	140%	10%	86%
Physical except real estate	30%	140%	5%	93%

The haircuts implied in this way are inconsistent with the practice of some activities: no aircraft financing would be made if a 93% haircut were applied to the value of collateralised aircraft.

Several aspects of this calculation method raise concerns in our opinion: for example, an exposure with 30% real estate collateral and 30% physical collateral will receive no LGD reduction, unlike an exposure with 60% real estate collateral.

The method for calculating the impact of non financial collateral on LGD should be revised in its principle; the haircut method should be applied to this kind of collateral, which would have the advantage of readability and of harmonisation with financial collateral.

If anyway the current method was to be kept, in order to ensure consistency between the observed LGD rates and the structure assumption in the current text, the modification requested would consist in setting LGD values to :

> 30% instead of 35% for CRE/RRE,
> 35% instead of 40% for other physical collateral.

One may observe that a 30% LGD value is obtained with assumptions which should normally be regarded as already very conservative: a loan to value ratio of 70% (equivalent to a ratio of over-collateralization of 140%), a haircut on the asset value of 50% (recall the considered assets comply with operational requirements of the draft accord, including the existence of a liquid market and frequent revaluations), and a 100% unsecured LGD rate, which by nature is excessively conservative. This value of 30% should therefore in our opinion be regarded as a maximum value, given the assumption of a 70% loan to value rate.

The key point on which we would like to raise the attention of the committee is that if loss rates of 35 or 40%, as are currently mentioned in the draft accord, may be observed in certain cases in the industry, they are not observed in transactions with a maximum 70% loan to value ratio and with collateral complying with the operational and legal requirements of the new accord. Maybe the Committee has considered separately these elements in its present reasoning, this could be why our feeling is that there may presently be a consistency issue between them.

Another point concerning collateral recognition: we do not understand why collateral without first lien should be recognised in the case of real-estate collateral (§ 472) and not in the case of other physical collateral (§ 485); we request that this distinction be withdrawn. For example, we have many transactions with other physical collateral where we have second liens with important and

unquestionable risk-mitigating effect, simply because the amount for which the first lien is registered is limited compared to the amount of the transaction.

2.3. "Slotting criteria" Foundation approach for Specialised Lending

The supervisory slotting criteria methodology defines four risk categories (strong, fair, satisfactory, weak), plus a default category, to which supervisory risk-weights are applied. On the following chart, we have represented two curves. The lower curve represents the risk-weights calculated with the corporate formula and a maturity of 2,5 years. The upper curve represents the risk weights proposed within the SL supervisory slotting methodology.

This chart illustrates that the risk weight of each category in the SL methodology roughly corresponds to the highest risk weight of this category in the general corporate methodology.
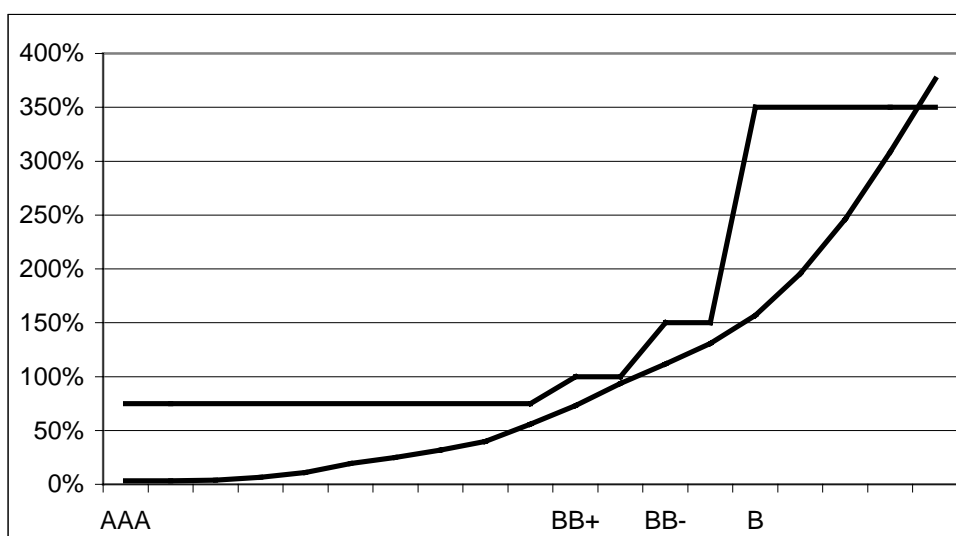
These material threshold effects stem from the small number (four) of categories in this methodology, which obviously does not allow a satisfactory differentiation of transactions and thus of risk weights. Those threshold effects and the resulting risk weights would jeopardise many SL transactions, and ultimately the whole SL activity.

Concerning the different issue of borrower ratings, § 366 of CP 3 indicates that to meet the objective of a meaningful distribution of exposures across grades with no excessive concentrations, banks must have a minimum of seven grades for non-defaulted borrowers, and one for defaulted. We consider that this principle should apply also to the facility-rating scale in the SL supervisory methodology.

Simply defining 7 categories instead of 4 would in our view improve the economic consistency of regulatory capital calculations, while avoiding economically baseless detrimental effects for SL activity, respecting the overarching principles of the Draft Accord, and complying with its general level of conservativeness.

In order to ease the implementation of the required modification, we would recommend that the requested three additional categories were defined as generic intermediary categories between the four existing categories that have already been documented by the Committee. If the additional categories are simply defined as intermediary categories between those, there should be no need to write additional documentation in order to define them specifically.

2.4. Maturity adjustment below 1 year

The possibility that the one-year floor may not apply to the maturity used in the calculation of capital requirements is explicitly limited to "financial market transactions and one-off short-term exposures that are transaction-oriented" (§ 291-292).

These provisions should have a critical impact on capital allocated to market and trade finance activities. Therefore we pay particular attention to building a fair comparative capital treatment to those activities. From this standpoint, two main comments should be made to the current proposals :

- the Basel Committee duly restricts the use of the one-day floor to transactions that "are not a part of the bank's ongoing financing of the obligor", even though this perimeter needs to be expanded,
- but the formula used in order to derive risk weights for less than one-year transactions is wrong and inconsistent with the underlying model assumptions.

1.2.1. Perimeter

We support on the whole the "steady state" hypothesis that underpins the IRB model under the liquidity horizon, i.e. that capital should be based on what average risk should be during the following year and that current portfolios are the best and most simple approximation of what future portfolios will look like. We also support the exemption that is targeted to market or trade transactions with short original maturity, as they are most likely not to be replaced if the counterpart's credit quality is perceived to have materially decreased within one year.

However, we believe this perimeter needs to be extended so as to include exposures with the same characteristics :

- the maximum original maturity for eligible assets should be set at 6 months instead of 3 months, as a maturity between those two bounds does not imply that the facility is part of the ongoing term financing of the obligor,
- all assets included in the "purchased receivables" regulatory portfolio should qualify for the one-year maturity floor exemption, as they represent trade receivables,
- we do not understand why OTC derivatives are not included among exposures benefiting from the maturity floor exemption, whereas interbank loans and deposits or securities lending operations qualify.

1.2.2. Calculation of the maturity adjustment below one year

Absent opposite mentions, we suppose that the maturity adjustment formula applying below one year is the same that applies beyond, i.e.:

$(1 - 1.5 \times (0.08451 - 0.05898 \times \log(PD))\wedge2)\wedge -1 \times (1 + (M - 2.5) \times (0.08451 - 0.05898 \times \log(PD))\wedge2)$

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 transactions expires.

By definition, migration risk only appears beyond the liquidity horizon; below, banks are exposed only to **default risk**, i.e. the predicted defaults happening or not. Thus applying the same formula on both sides of the liquidity horizon simply makes no sense and is theoretically inconsistent with the underlying assumptions of the IRB model.

Practically, this formula also appears to generate inconsistent capital adjustments. A formula measuring default risk under one year should smoothly lead from 0 capital charge for intraday transactions to the full one-year capital charge for one-year transactions, which is not the case.

The results of the current Basel formula are displayed in the following table :

PD	Current capital adjustment (1D)*	Current capital adjustment (1M)	Current capital adjustment (3M)	Current capital adjustment (6M)
0,03%	0,399	0,446	0,547	0,698
0,05%	0,508	0,547	0,629	0,753
0,10%	0,622	0,652	0,715	0,810
0,20%	0,709	0,732	0,780	0,854
0,40%	0,776	0,794	0,831	0,887
0,50%	0,795	0,811	0,845	0,897
0,70%	0,820	0,834	0,864	0,910
1,00%	0,844	0,856	0,883	0,922
2,00%	0,884	0,893	0,912	0,942
3,00%	0,903	0,911	0,927	0,951
5,00%	0,924	0,930	0,943	0,962
10,00%	0,948	0,952	0,961	0,974
15,00%	0,959	0,962	0,969	0,980
20,00%	0,966	0,969	0,975	0,983

* based on 220 business days

Those results show that even overnight transactions will receive weak capital relief from the current formula. **This excessively conservative calculation removes most substance from the exemption to the one-year maturity floor.**

Alternative proposal

Consistently with other industry participants and with the underlying IRB model, we propose an alternative way to adjust capital requirements for eligible transactions below one year. This proposal is based on the following assumptions :

- the reasons why market and trade transactions were singled out are that i) they are not part of the ongoing financing of the obligors and cannot be rolled over without motivation ii) such obligors and transactions are frequently monitored, and not reviewed only each year as is the case for the overall credit portfolio, and a review 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 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 able not 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 able not 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 1-year capital charge is therefore calculated as, for example, capital for twelve 1-month transactions with identical credit quality at origination. **In no case this amounts to a calculation of capital charges for a complete stop of business.**

The proposed 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 1 year corresponding to horizon n, and PD_1 is the one-year PD. In this framework, capital requirements would remain calculated by using a correlation based on the one-year PD (of course any other interpolation formula can be used).

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 strictly 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%.

The results of this alternative method are the following :

1-year PD	Proposed PD_n (1D)*	Proposed PD_n (1M)	Proposed PD_n (3M)	Proposed PD_n (6M)	Proposed capital adjustment (1D)*	Proposed capital adjustment (1M)	Proposed capital adjustment (3M)	Proposed capital adjustment (6M)
0,03%	0,000%	0,00%	0,01%	0,02%	0,136	0,401	0,602	0,774
0,05%	0,000%	0,00%	0,01%	0,03%	0,135	0,394	0,594	0,770
0,10%	0,000%	0,01%	0,03%	0,05%	0,131	0,386	0,586	0,765
0,20%	0,001%	0,02%	0,05%	0,10%	0,124	0,377	0,579	0,760
0,40%	0,002%	0,03%	0,10%	0,20%	0,117	0,367	0,570	0,754
0,50%	0,002%	0,04%	0,13%	0,25%	0,113	0,363	0,566	0,752
0,70%	0,003%	0,06%	0,18%	0,35%	0,108	0,356	0,560	0,748
1,00%	0,005%	0,08%	0,25%	0,50%	0,102	0,347	0,553	0,743
2,00%	0,009%	0,17%	0,50%	1,01%	0,088	0,325	0,534	0,731
3,00%	0,014%	0,25%	0,76%	1,51%	0,080	0,313	0,524	0,724
5,00%	0,023%	0,43%	1,27%	2,53%	0,073	0,303	0,516	0,720
10,00%	0,048%	0,87%	2,60%	5,13%	0,073	0,309	0,526	0,730
15,00%	0,074%	1,35%	3,98%	7,80%	0,078	0,323	0,544	0,745
20,00%	0,101%	1,84%	5,43%	10,56%	0,082	0,339	0,562	0,760
			Confidence interval:		99,9995%	99,992%	99,975%	99,95%

based on 220 business days

All other parameters being unchanged, the calculations displayed above show that this maturity adjustment would be stronger (i.e. more favourable) for the highest PD levels. This comes from the correlations used in the IRB formula, which decrease when PDs increase. We consider that the rationale for this relationship between PD and correlation is generally weak, and becomes especially unsustainable in the case of short-term transactions; thus we have performed other calculations with constant correlations and reached more consistent and acceptable results. For that purpose we have set the correlation level at 18%, which is the average of IRB corporate extreme values:

1-year PD	Proposed capital adjustment (1D)*	Proposed capital adjustment (1M)	Proposed capital adjustment (3M)	Proposed capital adjustment (6M)
0,03%	0,069	0,241	0,386	0,517
0,05%	0,070	0,241	0,386	0,521
0,10%	0,071	0,244	0,393	0,533
0,20%	0,072	0,252	0,408	0,554
0,40%	0,077	0,269	0,436	0,593
0,50%	0,078	0,277	0,449	0,610
0,70%	0,082	0,292	0,473	0,643
1,00%	0,089	0,313	0,507	0,688
2,00%	0,105	0,369	0,594	0,802
3,00%	0,117	0,407	0,651	0,876
5,00%	0,130	0,446	0,708	0,945
10,00%	0,141	0,472	0,735	0,963
15,00%	0,147	0,483	0,739	0,953
20,00%	0,154	0,493	0,744	0,945

based on 220 business days

This scheme preserves simplicity of calculation (whether asset correlation is constant or not), as no additional input is necessary and as it can be implemented in a single Excel cell.

2.5. Double default vs. substitution approach

FBF generally supports the principle that the risk mitigating effect of unfunded guarantees should be as accurately as possible reflected in the assessment of capital charges, as well for corporate as for retail exposures.

The Basel Committee's current substitution approach for guarantees has proved flawed, as it is based on the assumption that if the guarantor (the most creditworthy counterpart) defaults, the borrower (the less creditworthy counterpart) also automatically defaults, thus assimilating the risk on the guaranteed part of the exposure to the risk of a direct exposure on the guarantor. This assumption only makes sense when there is perfect correlation between the guarantor and the borrower, which cannot be supposed in most cases, and must therefore be replaced by a more adequate framework.

It is widely admitted throughout the industry that the most suitable counter-proposal as of today lies in the paper recently issued by the Board of Governors of the Federal Reserve System, *Treatment of Double-Default and Double-Recovery Effects for Hedged Exposures under Pillar I of the Proposed New Basel Capital Accord* ("the Federal Reserve's paper"). This paper is of particular interest as it establishes the theoretical basis of an assessment of "double default" effects that is consistent with the fundamental assumptions of the "asymptotic single risk factor model" that underpins the IRB function.

The Federal Reserve's paper supports the criticisms of the industry against the substitution approach :

- the substitution approach runs counter the Basel Committee's stated objective of aligning regulatory and economic capital requirements,
- it is a strong disincentive to obtain valid guarantees and treats in the same manner guarantees from a parent company and guarantees from an independent guarantor, which stands against the fair management of risks.

It must be added that, as some banks are not ready to weaken their internal rating systems in order to reflect substitution rather than double default (the latter being the best picture of reality), they will face the need to deliver two PD or LGD values for the same loan, one being used for regulatory purposes and the other for economic capital and internal management. That is both unfeasible and inconsistent with the objective of the "use test" (using the same measures in regulatory capital and in the life of the credit process).

The French banks thus strongly oppose the current requirement of substitution and consider that further Basel proposals should be based on the Federal Reserve's paper. The solutions we recommend are designed to fit in this framework:

- Questions about calibration raised by the Federal Reserve's paper :

  - the Federal Reserve asks whether the correlation of guarantors (ρ_G) to systemic risk should be set at a higher level than what is delivered by the standard calculation of correlation in the IRB formulae (ρ_{IRB}), arguing that guarantors are often major banks or institutions with higher correlation than average. For our part, we do not see any reason for setting correlation at different levels for the same counterpart, depending on whether it is a guarantor or a direct borrower. If regulators consider that correlation levels for bank or sovereign exposures have not been properly calibrated, they should revise them accordingly, based on the principle that one counterpart is assigned one single correlation ;
  - the Federal Reserve asks whether there is a need for an additional correlation parameter that would express the correlation between the assets of the guarantor and the obligor (ρ_{OG}), in excess of the correlation due to systemic risk; if $\rho_{OG} = \sqrt{\rho_O} \times \sqrt{\rho_G}$, it is assumed that there is no specific risk correlation atop systemic risk correlation. Internal practices of banks already assessing the impact of double default show that this parameter is considered of critical importance, as it allows to give preferential capital relief to guaranteed transactions with guarantor independent from the borrower. The French banks thus consider that at least two different levels of ρ_{OG} should be used in the IRB framework :

    - one for guarantors linked with the obligor (same group...), where $\rho_{OG} = 100\%$, which is equivalent to substitution ("wrong way risk"),

- one for guarantors independent from the obligor. In this case, a reasonable margin of conservatism could be set: $\rho_{OG} = (\sqrt{\rho_O} \times \sqrt{\rho_G}) + 20\%$ would lead to results close to those of the internal systems of banks managing cautiously double default effects.

- Questions about the concrete implementation of the "double default" framework :

  - how should it be implemented in the Foundation IRB approach? Two options :

    - either through the Federal Reserve's complete formula, with 4 inputs (obligor's PD, obligor's LGD, guarantor's PD, guarantor's LGD). Pros: accuracy. Cons: complexity of using different formulae for hedged loans on one side, and unsecured loans on the other;
    - or by simplifying this formula through a "haircut" approach, calibrated on the Federal Reserve's formula, with 2 inputs (obligor's PD, transaction's LGD) and a supervisory haircut ;

  - how should it be implemented in the Advanced IRB approach? The French banks are convinced that assessing the impact of guarantees on PD and/or LGD in the A-IRB approach is an inseparable part of the rating process, and that banks should be free to produce their own PDs and LGDs, whether the loan is hedged or not. Thus the "ordinary" IRB formula must always be used in the A-IRB approach; supervisors will make sure that the impact of double default is correctly assessed by A-IRB banks by requiring that they demonstrate the overall consistency between their own system and the framework used in the F-IRB approach.

Besides, the French banks remain cautious about the systematic inclusion of "double recovery" effects into the IRB framework. We would not totally follow the Federal Reserve's paper when it states that the double recovery effect can be measured with $LGD_O \times LGD_G$, which supposes a complete independence between the obligor's and the guarantor's assets in case of joint default and a full ability by the bank to recover on a defaulted guarantor the amounts that it has not been able to collect from a defaulted obligor, and conversely. We consider that, given the state of art in this matter, F-IRB banks should only be allowed to use the lowest LGD between obligor's and guarantor's (which will often be identical), and A-IRB banks should apply the existing provisions that require them to measure a conservative LGD based on historical loss data.

2.6. Counterparty risk treatment of OTC derivatives

As we understand it, the review of the counterparty risk treatment of OTC derivatives under the New Accord has so far focused on counterparty risk weightings and not on the credit conversion factors (CCF) assigned to these transactions. We strongly believe that the current CCF calculation rules for OTC derivatives lead to significant understatement or overstatement of capital requirements which in turn lead to incorrect incentives.

On the other hand, we feel that expected positive exposure (EPE), or closely related measures, are emerging among internationally active banks as standard measures of exposure at default for economic capital calculation purposes. As an illustration of our view, the recent ISDA-LIBA-TBMA counterparty risk survey points out that about two thirds of the respondents use EPE or conceptually consistent measures for allocating economic capital to OTC derivatives portfolios. Not only do we see an increasing convergence of industry practice towards an EPE based standard, but we also firmly believe that EPE based credit conversion factors would largely outperform current CCF in terms of assessing the adequate capital requirements for OTC derivatives. This would consequently provide the right incentives.

We are also aware of the ongoing discussions between the ISDA Counterparty Risk Working Group (CRWG) and the Model Task Force, as well as the main pending questions regarding the use of EPE based measures in a regulatory framework, these topics are the following:

- Wrong way exposures,
- The effect of granularity and exposure correlation on capital,
- Time horizon and maturity,
- Treatment of collateralised OTC derivatives and securities financing transactions,
- Validation of EPE-based measures of future exposures.

We believe a tremendous amount of research has been achieved on each of these topics within the CRWG and the MTF during the last few months. We therefore also believe that the participants have reached a sufficient degree of understanding of these issues to be able to come up with coherent answers in a timeframe compatible with the New Accord.

We are therefore strongly in favour of the inclusion of EPE based credit conversion factors for OTC derivatives (and most probably for securities financing transactions with similar risk profiles) in the scope of the New Capital Accord.

2.7. Definition of default

The regulatory definition of default has reached a globally satisfactory stage in CP 3. Nevertheless, it could still be improved by including the technical delinquency notion described in the French accounting regulation (CRC 2002-03) as the outstanding payments that are not due to a deterioration of the borrower's solvency. Loans and leasing operations with public administrations or large corporates often become past due simply because of the payment policy of the entity, without any doubt on their solvency. We therefore ask that § 414 be amended so as to include this notion.

Along with the implementation of these 3 additional categories, the risk-weight associated with the strongest category should be diminished down to 50% for example, otherwise by construction the scale effects will not be corrected.

2.8. Equity investment

Equity investment is highly impacted by the new framework and should call for a particular attention from the Committee. The present risk weights will certainly cause the banking industry to retire from this activity and probably need to be reviewed.

Choice of approach: The Basel Committee offers two methodologies to calculate risk weighted assets for Equity exposures not held in the trading book: a market-based approach and a PD/LGD approach. Supervisors , will decide which approach or approaches should be used by banks and in what circumstances. We consider that banks should be allowed to propose the application of either of the two methods regardless of whether the equity is quoted or not. At a minimum, banks should be allowed to use PD/LGD for unquoted securities and long-term strategic holdings and should be allowed to apply an internal model to any type of holdings. With regards to the internal model, we would welcome a less restrictive definition of the method used, so as to allow banks to use mixed credit & market models (instead of just volatility-based models), or earnings-based models (as opposed to pure asset-value-based models) in the future.

Undrawn commitments to private equity funds: In a FAQ document, it appeared that the Basel Committee recommended that banks convert private equity funds' undrawn commitments to a credit equivalent. In the case of LBO funds, banks have looked at their funds' history and concluded that the drawing of new funds by fund managers in the case of non-performing investments only represented 0.8% of the outstanding capital of the fund and 4.3% of the undrawn commitments. This indicates that the undrawn commitment should not be considered as a facility that would systematically be used by fund managers when holdings are in difficult situations. As a result, we would consider it very penalising to risk weight the undrawn commitment as a credit.

III. Specificities of some activities

3.1. Financial leasing

In France as in a number of other countries, financial leasing services are provided by firms which have a 'credit institution' status and thus are subject to the international solvency ratio. As this is not the case for all countries, this factor could distort competition; thus the French banking industry pays considerable attention to an equitable treatment of those transactions in the new Basel Accord, which should not be unduly penalised (i) compared with other banking transactions not based on the property of the collateral and (ii) compared with similar transactions provided by non-bank companies.

The French banks have identified the following drawbacks in the currently proposed treatment of financial leasing:

- The risk weights in the Standardised approach and LGDs in the Foundation IRB approach do not recognise the historically demonstrated advantage of transactions based on the property of the financed asset compared with simple collateralised loans. Appendix 1 presents the rationale for this revision and the recommended values.

- The corporate / retail boundary is inadequately set considering the way that most leasing companies structure their business (see the point dedicated to this topic).

- In both IRB approaches, § 487 of CP 3 requires that leases with residual value be treated as two separate exposures, the discounted lease payment stream on one side with associated PDs and LGDs, and the residual value on the other side with a fixed 100% risk weight. This method, whose rationale is already weak for the F-IRB approach, is especially inconsistent for the A-IRB approach.

  - We understand that the Basel Committee intends to capture both the risk of loss resulting from the default of the counterpart and the risk of loss stemming from the depreciation of the leased asset, even if the counterpart performs well until the end of its contract. We would like to stress that adding both risks by allocating each one to a distinct part of the exposure leads to mechanical overstatement of risks: **either** the counterpart performs well until the end of the contract and there is a market risk on the value of the asset, **or** the counterpart defaults during the contract and the LGD assigned to the transaction also includes the loss due to the depreciation of the asset (we recall that F-IRB LGDs for loans secured by physical collateral include overestimated haircuts that are supposed to represent the erosion of the asset value).

  - Thus, in the F-IRB approach, the capital requirement should be the **highest** of (i) 100% of the residual value and (ii) the risk weight stemming from the PD and LGD of the transaction, and not the **addition** of both figures.

  - In the A-IRB approach, market risk on the residual value and credit risk on unpaid instalments are assessed on the basis of an expert appraisal of the future value of the asset. We strongly oppose splitting all leasing transactions in two parts, whereas the LGDs produced by A-IRB banks include both risks. We rather ask that the eligibility requirements for A-IRB regarding leasing mention that the LGD of each transaction must notably take into account the risk on the residual value of the leased asset.

In addition, we have two limited requests intended to avoid a mis-interpretation of the text of the accord:

3.1.1. Interpretation issue concerning leasing vs loans

§ 486 of the CP3 Pillar 1 document, concerning recognition of leasing transactions, provides that "Leases other than those that expose the bank to residual value risk will be accorded the same treatment as exposures collateralised by the same type of collateral". Our concern is simply that this provision, under a literal interpretation, could be construed as requiring an identical treatment for these two situations, whereas they are similar, but not identical.

As partly mentioned above, they notably differ on the delay necessary to obtain the proceeds of the sale of a considered asset, as this delay is shorter for an owner than for, for example, a mortgage creditor. They also differ on the amount of these proceeds, as in certain jurisdictions (in France for example), creditors who owns the financed assets are not primed by certain privileges granted, for example, to the tax administration or to a part of wages due to the staff of the debtor.

Therefore, our request consists in inserting, after the first sentence of § 486, the following text: "This provision should however not be construed as requiring an identical treatment for both situations, where internal estimates of risk parameters validly reflect differences between them, because in principle they may be similar but in no case identical".

3.1.2. Interpretation issue concerning collateral value / borrower default correlation

Several sections of the CP3 Pillar 1 document address the issue of correlation between the risk of default of an obligor and the risk of depreciation of the related collateral.

We share the idea according to which, beyond a certain degree of such correlation, a collateral cannot be considered as providing a substantial level of credit protection, and thus should not be considered as eligible collateral. However, in our view, the notions of material positive correlation (§ 95), material dependence (§ 470) or undue correlation (§ 482) should be precised, in each of these sections or in a text applicable to all kinds of collateral under the three approaches:

"The level of material correlation between the risk of default of the obligor and the risk of depreciation of the collateral upon which collateral would cease to be eligible is defined qualitatively as the level upon which the collateral can be reasonably deemed as providing only little protection to the bank".

3.2. Purchased receivables – factoring, ABCP

The method for assessing capital requirements for purchased receivables, that first appeared in the instructions for QIS 3, has still considerably to be improved in order to fit the reality of risks for those operations. We are focusing on factoring (see appendix 2 for a detailed analysis) and ABCP conduits to elaborate our recommendations, but those remain valid for other kinds of receivable purchasing.

Our main criticisms are related to :

- the way that loss characteristics on short-term receivables will be used in a capital framework that usually requires "annualised" values,
- the definition and treatment of dilution risk,
- the absence of a real pool-level "top down" approach,
- the treatment of protections against first losses,
- the fixed 75% EAD rate for undrawn purchase commitments.

Taken together, those characteristics simply make capital requirements for purchased receivables unbearable and disconnected from actual risk.

3.2.1. Annualisation of loss characteristics

As purchased receivables usually are very short-term claims, observed PDs or ELs are related to much shorter horizons than the one-year horizon that is usually required for regulatory capital calculations (for example, the average initial maturity of receivables in an ABCP's asset pool is 3 months). Therefore the annualisation technique has a critical impact: for example, multiplying by 4 PDs observed on 3-months receivables in order to obtain one-year PDs and insert them into the usual IRB formula leads to excessive capital requirements.

We refer there to the previous argumentation on maturity: we are convinced that purchased receivables, especially in factoring operations and ABCP asset pools, are the typical kind of assets that should be eligible for a carve-out to the one-year maturity floor. The debtors are not clients of the bank and the bank is not participating to their "ongoing financing".

The effective maturity of the risk on the debtor is clearly the maturity of the receivables. The bank has a variety of means to react to global or specific negative evolutions, among which amortisation triggers: if losses exceed such trigger there will be no further purchase of receivables and the pool will start to amortise. The maturity of the deal will be therefore the maturity of the then outstanding receivables.

The treatment we recommend for eligible short-term exposures should thus apply to purchased receivables, considered as one-off transactions: use of a short-term PD, compensated by a proportional increase in the confidence interval of the IRB formula. Furthermore, receivables should be eligible with initial maturities up to 6 months (instead of 3).

3.2.2. Definition and treatment of dilution risk

Dilution risk should be more precisely defined: § 338 only refers to "ordinary" dilution (i.e. credit to the receivable obligor coming from discounts or disputes); but there also exists a dilution stemming from fraud or even directly from the default of the seller (invoice netting / "commingling") – see appendix 3 for more details about dilution risk. If these cases of "exceptional" dilution are not comprised in the definition of dilution risk, some banks may just measure the dilution on their usual non-defaulted seller contracts and infer that it is "immaterial", which allows them not to bear any capital requirement for dilution risk (§ 338).

The recourse to the seller is consubstantial to the dilution risk, as no financial institution is ready to assume the moral hazard risk associated to dilution. Dilution belongs to commercial relations area and the bank has no incentive to intervene in this domain. As a matter of fact, many "defaults" will result in some form of dilution, as it is a common way to solve commercial problems. Considering that inherent association between dilution risk and total recourse on the seller (full legal recourse as provided in the transaction documents), we propose to adapt the methodology and the way the corporate formula is used:

- The PD would be the one of the seller, as there would never be any dilution loss for the bank unless the seller defaults.

- The EAD would be :

    - either the average diluted amount assumed by the bank in case of default of the seller and which will generally be higher than the historic level. The dilution rate has to be stressed because the default of the seller will generate some forms of dilution that are invisible during the normal life of a deal ;
    - or the nominal amount of purchased receivables at the time of default.

- The LGD will be, these options being tied with those for EAD :

    - either the standard LGD associated to the seller in default / average diluted amount assumed by the bank, as the bank will be entitled to produce its remaining exposure in the procedures following the default of the seller;
    - or the seller's standard LGD times the part of the seller balance that is concerned by dilution at the time of default / the nominal amount of purchased receivables at the time of default.

    LGD may be reduced by the effects of first loss protections (see next point), if the bank is able to take into account loss volatility and the fact that losses may thus exceed the amount of first loss protections (except for exposures receiving the securitisation treatment, in which first losses are differently taken into account).

There is consequently no reason for requiring banks to directly express dilution risks in terms of EL with a compulsory and penalising LGD of 100%, thus refusing any A-IRB for dilution risk.

Besides, the French banks do not see how a bottom-up approach could be used to assess dilution risk for pools of receivables, as this risk is related to the seller's global invoicing process rather than to any particular receivable.

3.2.3. Treatment of protections against first losses

Mechanisms such as reserve funds, restricted funding (factoring) or overcollateralisation (ABCP) serve as protection against first losses, mitigating dilution risk in the case of factoring. In the case of ABCP programs, the overall treatment of securitisation allows these mechanisms to be considered as credit enhancements for more senior positions, which therefore benefit from this protection.

This is not the case for factoring; we understand that, at best, reserve funds can be considered as purchase discounts and offset the EL part of capital requirements. We ask that they be treated as real first loss positions, available to absorb expected as well as unexpected losses, and therefore also may offset a part of UL in the capital requirements; this could be achieved through an assessment of LGD

that would incorporate the effect of first loss protections and loss volatility. Moreover, the first loss protections are in most cases replenished every month so that the bank is totally protected against any level of loss up to any amortisation trigger.

3.2.4. Absence of a real pool-level "top down" approach

§ 334 (default risk) and 338 (dilution risk) refer to a "top-down" approach for assessing risks. § 455 gives further details: "the purchasing bank will be required to group the receivables into sufficiently homogeneous pools so that accurate and consistent estimates of PD and LGD (or EL) for default losses and EL estimates of dilution losses can be determined. [...] methods and data for estimating PD, LGD and EL must comply with the existing risk quantification standards for retail exposures."

The French banks consider that, on the whole, the retail IRB approach is a "bottom-up" approach: the individual characteristics of each exposure are used in order to determine the segment to which it belongs, and each exposure is individually assigned to a given pool. A real "top-down" approach would conversely lie only on pool-level information, such as granularity, industry/country concentration/diversification, underwriting practices of the seller, etc.

We believe it would not be practical or useful to split the pools of receivables by formal sub-categories of risk, beyond what is required by the rating agencies (in securitisation of receivables) and the risk management process of the originator.

The natural level of analysis would be :

- for highly granular pools of receivables such as ABCP, at the transaction level (i.e. most of the times, receivables generated by one seller). The distinction by seller is in itself discriminant in terms of risk, as there is a wide range of default rates among different sellers ;
- for less granular pools such as factoring contracts, at the level of the factor's whole business, possibly divided into several sub-categories, each containing several transactions with sellers.

In practice, the structures of the deals often define some subcategories that lead to a more accurate and pertinent apprehension of risk (delinquencies, ineligible receivables, individual ratings for big obligors…); nevertheless, banks must not be required to systematically do so in order to refine their risk estimates.

This top-down approach is the only one that would not require unnecessary and expensive changes in operational processes and systems for factoring and ABCP activities; therefore the French banks ask that the reference to "sufficiently homogeneous pools" and "risk quantification standards for retail exposures" be unambiguously removed from § 455.

3.2.5. Fixed 75% EAD rate for undrawn purchase commitments

There are two levels of undrawn purchase commitments :

- a global limit on the seller, that requires prior notice to be terminated; the 75% CCF (§ 336) is understandable when applied to that amount, even if questionable in its level (see below),
- limits on each receivable obligor, whose cumulated amount is (sometimes much) higher than the global limit on the seller. The factor is free to reduce or cancel the limit on any obligor without prior notice; therefore the 75% CCF must not be considered as applying to the sum of obligor limits.

Furthermore, we question the 75% CCF level imposed by the Basel Committee: in a Foundation approach, this level is much higher than experienced by banks; in an Advanced approach, we do not understand why banks should not be allowed to use own EAD estimates grounded on historical experience. It should be stressed that EAD usually models the drawing behaviour of counterparts at the approach of default; in the case of purchased receivables, the counterpart that defaults (obligors) and the counterpart that may draw the line (seller) are not connected with each other, and thus it is impossible to prove a positive relationship between obligors' defaults and seller's drawings.

IV. <u>Securitisation</u>

4.1. Calibration

We consider that, as drafted, the CP 3 acts as a disincentive for banks to use securitisation as a portfolio management tool. Given that credit portfolio management is of increasing importance to the banking industry as a way to optimise the risk reward profile of loan portfolios across credit cycles, by selling or buying risks on specific names or, more globally, by securitising segments of these portfolios, banks not only have more stable performance but also contribute to economic stability in making credit availability less cyclical. **We would then expect that regulators actually encourage banks to use the whole range of credit risk mitigation techniques, including securitisation.**

We are therefore extremely concerned that the current proposal does not adequately recognise the effective risk transfer embedded in securitisation transactions. Looking at new securitisation deals, rather than to seasoned ones (where the first loss piece has been partly reduced by recent defaults), we have seen that the mismatch and counterparty risk charges applied to these transactions means that from a capital perspective there is little deal recognition despite the fact that the securitisation is transferring credit risk. These points, which were not included in the QIS 3 study, means that the already optimistic views from participating banks, in fact, painted a picture that was over optimistic. The result of this further level of analysis is not only the reduction in regulatory recognition of securitisation but also to further increase the capital required by the banking system for that securitised pool.

By maintaining this highly conservative treatment of securitisation despite the many comments that the industry has voiced since WP2, the Basel Committee is taking the risk that **banks will have to stop securitising their assets, which will severely reduce the liquidity of their portfolios and their ability to disperse their risks.** Indeed, for a large universal bank, servicing its client base means originating and holding large portfolios of loans and securitisation is the only efficient way to globally manage industry or country concentration and transfer risks on illiquid credits, at least partially. These programs have visible costs that must be justified to shareholders and analysts by a corresponding regulatory capital relief. In the absence of any externally measurable capital relief, **securitisation transactions would actually appear to destroy shareholder value, whereas they actually add value through the risk transfer.** Therefore, we strongly disagree with comments that have been made that securitisation transactions do not need regulatory capital savings to be viable for banks, especially as regulatory capital aims at being a proxy for economic capital. On the contrary, we believe it is essential that the new framework appropriately takes into account the effective risk transfer achieved through securitisation. Without this recognition, the only option visible to the market, in order to shift large portions of risks out of the bank's balance sheet, would be to reduce the bank's appetite to grant new loans, thus damaging its franchise and increasing pro-cyclicality.

We therefore urge the Committee that **the effective risk transfer realised through securitisation be recognized by a commensurate capital relief.**

It has been an ongoing concern of the industry that **securitisation does not create risk** (apart from counterparty risk in synthetic transactions) but rather redistributes risks between originators and investors. Although a moderate increase between the capital charge of the pool before securitisation and the sum of the capital charges of all tranches could be accepted, we consider that the current level of increase (in the order of 50% considering that all tranches are kept within the banking system) clearly demonstrates that the proposed framework encompasses a double penalty to securitisation:

☛ once by not considering properly the risk transfer from the originator (deduction up to K_{IRB}),

☛ a second time in applying overly conservative risk weights to sold tranches.

The following points particularly stand out :

• The Supervisory Formula Approach would obviously be the best method for a fair assessment of regulatory capital requirements from an originator's point of view, as it is sensitive to the main risk drivers of these structures (granularity, thickness, seniority...). However it fails to achieve such objective because of the inclusion of two floors, one under K_{IRB} and one for senior tranches. These floors mean that over 95% of the notional amount of a typical securitisation would have risk

weights that are in excess of what a "clean SFA"[1] formula would generate. It is this **"clean SFA"** (i.e. excluding the K_{IRB} deduction floor and the senior floor) which has broad support from the industry which would deliver a much more accurate representation of risk.

- Supervisors should review the treatment of first loss positions below K_{IRB}. Requiring **deduction for all positions under K_{IRB}** makes little economic sense as it does not recognise any risk transfer to investors and lies on a misunderstanding of the way first loss pieces behave during the life of a securitisation operation. The regulatory community should accept that advanced IRB banks are, in many cases, able to model the risk characteristics for both the sold and retained tranches of securitisations. Therefore, subject to regulatory supervision and testing, banks should be able to use their own models either to demonstrate the risk reduction effect of securitisation at an asset level or to calculate the PD/LGD of retained tranches which can then be used to calculate **K_{IRB}** of those retained tranches. Failing this, various recommendations are articulated in appendix in order to overcome this situation.

Supervisors must thoughtfully decide if they wish to provide any incentive for selling or retaining any given tranche of securitisation programs. The current intent to promote selling tranches just below K_{IRB} shows that there is still a misunderstanding in the regulatory community as to what securitisation achieves. **Securitisation transactions are not a way to manage expected losses, these should by definition be covered by revenue.** If banks have specific credit concerns on names or industries, they manage these risks by reducing the exposure, selling the asset, or hedging on a single name basis. By definition, large securitisation transactions are not a way to manage such specific risks, banks **rather use them to shift to the market the unexpected loss component of portfolios** which at inception have acceptable credit quality, but where banks want to "buy an insurance" against potential downturns. The recent credit cycle has demonstrated the efficiency of such strategies, and the pro-cyclical aspect of Basel II will make the management of unexpected losses and migration risk increasingly vital for large commercial banks and for the health of the financial system. **Indeed, as the capital requirement is defined as the amount of capital to cover both expected <u>and</u> unexpected losses, shifting only the unexpected loss while keeping the expected loss by definition should deserve a legitimate regulatory capital relief**, even though in most cases the actual losses will be in the order of magnitude of the expected losses, therefore second loss would not materialise.

- Supervisors must pay more attention to the treatment of **senior tranches** (which can be defined as tranches that would experience losses only under a confidence interval higher than the regulatory 99.9%), which indiscriminately receive a 7% risk weight. Analyses show that, if any floor was deemed necessary (which we think it is not), a 1% value would be adequate. We underscore that a 7% risk weight for those tranches is an unnecessary and costly incentive to sell them, without any value from a risk management perspective.

- Synthetic securitisations are unduly penalised by the "substitution" rule applied to guarantees and CDS, like other guaranteed transactions, and even much more in the case of super senior tranches of CLOs (which on the average represent more than 90% of the nominal amount of those securitisations). The 7% risk weight will apply to those tranches, be they sold or retained since it will prove almost impossible to find any guarantor with a risk weight lower than 7% (with a 0.03% PD, a 21% unsecured LGD would be necessary), leading automatically almost all synthetic securitisations to the use of the cap at K_{IRB} and depriving them from any capital saving at all. This undeserved situation can only be solved by the removal of the floors (see above) and the use of a framework that recognises **"double default"** effects (refer to the "credit risk" section).

From the industry point of view, it is clear that a significant amount of work still has to be carried out. With this in mind and considering the complexity of securitisation issues, we suggest that the final decisions on securitisation be deferred until completion of a longer consultation process than the present one. Securitisation may be handled as a separate matter, which could eventually amend the final Accord, without jeopardising the implementation timeframe.

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[1] This "Clean SFA" was discussed and put forward in the combined ESF/ASF/ISDA response to QIS3/WP2 in January of this year.

4.2. Operational requirements

We believe that operational requirements regarding securitisation are unduly heavy :

- For traditional securitisations, § 516 (b) seems to confuse efficiency of the risks transfer from a prudential point of view and absence of control over the transferred exposures from an accounting point of view. We believe that risks may have been efficiently transferred even if the transferor maintains effective or direct control over the exposures. Moreover, if the transferee (a SPE) is consolidated from an accounting point of view, we think that the debt issued should be considered as credit linked notes, with maturity mismatches treated as usual.

- For synthetic securitisations, the operational requirements should not be stronger than those required for ordinary credit risk mitigation techniques.

- Concerning operational requirements for clean-up calls, we do not understand the 10 % limit under which a call may be exercisable without capital requirement. From our point of view, there is no need of explicit limit: each national supervisor is relevant to judge if a call is considered a form of implicit support provided by the bank; this point comes under the supervisory review process described in Pillar 2.

4.3. Tranched covers

We worry about the content of § 169, that states that all exposures with tranched covers must be treated accordingly to the securitisation treatment, even when they consist in guarantees on one or a few exposures :

- this is uselessly complex (the securitisation treatment is justified as long as there are enough underlying exposures so that the assessment of portfolio effects in the vehicle would pertain to internal modelling – which is not the case for single name covers),
- this prevents A-IRB banks from using the internal PDs and LGDs that they assign to those loans, whereas a single name tranched cover does not require any complex internal modelling as for securitisation programs.

Nevertheless, F-IRB banks at least should be given the option either to treat tranched covers as ordinary guarantees or to use the treatment for securitisation, as the latter is the only way to give adequate recognition to first loss covers in the F-IRB approach.

V. <u>Pillar II</u>

At the international level, co-ordination of supervision is an absolute need in order to avoid home/host regulators' concurrence and inconsistency and should be placed under the home regulator responsibility. Pillar II should only be applied at top consolidated level by the home supervisor.

The maintenance of a level playing field and avoidance of undue implementation costs are two primary objectives of the banking Industry, which, we believe, are also shared by the Basel Committee. Regulatory convergence and coordination are key factors to achieve such goals and must therefore be part of the Accord through an adequate statement of principles.

- Regulatory convergence

Convergence of rules and application of rules are clearly a request of the industry. National discretion may undermine the objective of a unique set of regulations and implementation interpretations, which are the other side of the necessary flexibility, should not distort the level playing field. In that regard, we support the objectives of the Accord Implementation Group to minimize divergence in the interpretation of the international rules and would suggest giving it a more prominent and permanent role. We would also welcome any effort to reduce further national discretion through phasing out or eliminating as many provisions as possible.

- Regulatory coordination

Whatever the convergence level is achieved, difference of interpretation and choice of options will remain. Besides, local markets have characteristics that cannot be ignored and each supervisor has its own legal framework, which it has to abide by. On the other hand, the banking businesses are increasingly global and some features of the Accord, like Pillar 2 and Pillar 3, can only be rightly assessed at the consolidated level.

Such a situation could lead to conflicting rules and multiple reporting which are a source of confusion and undue cost for the industry. Regulatory coordination will therefore play a major role in the success of the Accord and should be based on the recognition of the leading role of the home regulator. The home regulator should have the responsibility to set up implementation plans and conflict resolving procedures in order to fulfill the following objectives:

1. No bank should have to go through validation processes twice in order to satisfy the competing demand of the home and host regulators. This requirement does not mean the exclusion of the host regulator but rather the definition of its contribution to the decision. Assessment of the validity of the risk parameters for the host country is an example of the possible allocation of responsibilities among regulators.

2. No bank should be forced to operate two different sets of rules or interpretations of the Basel Accord in the same jurisdiction;

3. Capital requirements at sub-consolidated level should be set in a proportionate and consistent manner with the consolidated approach. Accordingly, the Operational Risk capital charges at sub-consolidated level may result from an allocation when the measurement of risk can only be established at the consolidated level.

4. No Bank should be compelled to provide for additional capital requirements under Pillar 2 provisions at sub-consolidated level except for exceptional cases.

This prominent role of the home regulator should not preclude the host regulator from exercising its basic responsibilities, which are :

- verify that the characteristics of the local market are rightly taking into account and avoid competitive distortions audit the local implementation of the Accord

At the national level, we understand the capital add-ons as exceptional, only driven by specific circumstances, and not an ordinary practice, which then should have been included in the calibration of the Accord. Furthermore, banks' specific measures must remain an undisclosed request of the regulator for obvious stability reasons.

Stress tests should be considered with care as already mentioned and cannot but be bank's specific. Country, industry, activity diversification may offset the possible add-ons whatever their origin.

VI. <u>Pillar III</u>

We are satisfied that the new draft paper requires less information on some subjects. However, the Transparency Group's proposals still contain too many information requirements on thinly, complex and sensitive data about credit quality and defaults (PD, LGD, EAD), even if the text authorize, in some exceptional cases, not to disclosure this information (eg paragraphs about general disclosures for all banks or quantitative disclosures for PD/LGD approaches). That might lead to erroneous judgments by non-informed market participants and provide sensitive disclosures and commercial data to competitors. The draft paper contains also much sensitive information about equities in the banking book, in particularly concerning qualitative disclosures.

Disclosure requirements for securitisation seem too detailed and will have to be considered in accordance with IAS. This position is also valid for interest rate risk.

The fact of not being allowed to apply the lower weighting or the specific methodology if disclosures are insufficient is excessive. We propose to require a complementary information for the next disclosure.

APPENDIXES

Appendix 1 – Financial leasing – Risk weights and LGDs in the Standardised and Foundation IRB approaches

Financial leasing enables customers to finance the purchase of equipment (plant, vehicles and agricultural machinery) or property, while enabling the bank to maintain ownership of the asset throughout the term of the transaction.

This latter characteristic guarantees absolute security for the lessor, which incurs the risk of the transaction but can recover the asset in the event of a default by the lessee. The lessor can subsequently resell this asset to cover any losses incurred as no other creditor has preferential rights over the asset's value.

Financial leasing transactions are arranged in such a way that the lease payments and purchase option price enable the lessor to recover the total principal value of the asset plus a sufficient margin to cover its own refinancing costs, the cost of the risk, its overheads and its profit.

There is no need to assign a risk weighting of 100% to financial leasing transactions when calculating minimum capital requirements if: (i) the useful life of the asset is greater than or equal to the duration of the contract; (ii) the asset can potentially be resold; (iii) the asset is located in a country whose legislation enables it to be recovered within a reasonable timeframe.

Experience in France shows that a much smaller risk-weighting is perfectly acceptable.

Property leasing

A survey covering the period 1996-2000, and conducted on a sample representing 47-60% of the industry's outstanding lease payments, reveals that the recovery rates after selling properties ranged from 65% to 79% (based on the ratio *selling price/residual financial value plus charges*).

Financial leasing companies obviously favour transactions involving conveniently-located properties. As well as enabling them to recover their initial investment if the lessee defaults, this policy also makes it easier to relet a property if the customer does not take up the purchase option (given that the lessor maintains ownership of the property).

Under these circumstances, in the Standardised approach, the risk weight of 50% described in footnote 21 of § 47 seems totally justified and should apply to any financial leasing of commercial real estate, with a set of conditions less complex and stringent than those exposed in footnote 21. Furthermore, this weighting was adopted by the EU for the European solvency ratio in 1991 and was maintained in 1998.

Similarly, under the Foundation IRB approach, the potential gain in LGD for transactions secured by CRE/RRE should be increased (e.g. from 10% to 20%) and/or the required collateralisation rates should be decreased (e.g. from 140% to 110%). This recalibration would therefore appropriately recognise the additional protection provided by the direct property of the object of the leasing.

Equipment leasing

Experience shows that a risk weighting of less than 100% should be used.

Recovery rates (i.e. *resale price/residual financial value and outstanding lease payments*) range between 50% and 90% for asset categories representing 87% of total leased assets.

In addition, recovery and resale times tend to be short. As a general rule, the typical recovery time for mass-market goods (with a buoyant second-hand market) tends to be under one month. The recovery time for less common capital goods, such as large plant and machinery and heavy-duty printing and construction equipment, can be as long as six months.

Given that leased equipment is crucial for the running of their business, lessees tend to prioritise payments to financial leasing companies in order to avoid losing this equipment. This incentive is reinforced by the fact that assets can be recovered very quickly (sometimes within a matter of days, especially in the case of aircraft, for example).

For all these reasons, equipment-leasing transactions, like property leasing transactions, should be assigned a risk weighting of 50% under the Standardised approach. Similarly, under the Foundation IRB approach, the potential gain in LGD for transactions secured by "other physical collateral" should be increased (e.g. from 5% to 10%) and/or the required collateralisation rates should be decreased (e.g. from 140% to 110%). This recalibration would therefore appropriately recognise the additional protection provided by the direct property of the object of the leasing.

Appendix 2 – <u>Factoring</u>

I. Notions of factoring risk.

1.1. General description of factoring operations

Factoring consists in an assignment of receivables which, in its most complete form, includes:

- The funding of the assigned receivables (= amounts at seller's disposal) ;
- The guarantee on the assigned receivables (= credit insurance on obligors) ;
- The management of the assigned receivables (=collection of overdue invoices and payment allocation).

From this general framework, several product categories can be identified according to the elements below:

- The agreement includes the 3 above mentioned services or only a part of them ;
- The assignment is notified to obligors (who thus pay the factor directly) or remains confidential ;
- The factor manages the client risk by allocating payments to invoices, conducting audits or invoice soundings on a regular basis etc… or fully trusts the seller.

Hence 8 different products can be identified under the term « factoring »:

	DISCLOSED		UNDISCLOSED	
	With Obligor Account Management	**Without Obligor Account Management**	**With Obligor Account Management**	**Without Obligor Account Management**
With recourse	Classical recourse factoring	Classical recourse factoring without Obligor Account Management	Simple Invoice discounting	Simple funding by balance purchase
Without recourse	Classical factoring without recourse.	Classical factoring without recourse and without Obligor Account Management	Invoice discounting With optional guarantee	Deconsolidating factoring

1.2. Description of the risks connected to those different products.

Factoring is a complex product that needs to be divided into 2 basic products whose risks are largely independent from one another :

- The funding to the seller, guaranteed by receivables ;
- A guarantee in favour of the seller covering him against obligor insolvency.

a) The seller (client) risk: the risk of not being able to recover payments from obligors in case of seller's default.

A loss related to seller's risk may be recorded only under 2 compulsory conditions :

- Seller's definitive default (insolvency procedure) ;
- A dilution of receivables.

There are 4 types of dilution :

- The ordinary dilution which can occur during the life of the agreement (credit notes, ordinary disputes) ;
- The default-related dilution which stays unnoticed until default occurs (non-payment of instalments, subcontractor's direct recovery, netting generating payments by compensation of receivables) ;
- Fraud (anticipated invoices, multiple assignment, forgery, invoices on counterfeit or fraudulent goods, embezzlement);
- For undisclosed agreements only: «commingling » (direct payments that will not reach the factor in case of seller's default between the notification of obligors and the time when they actually forward their payments to the factor).

This risk of dilution is covered by 2 kinds of guarantees :

- The Manager's guarantee (uncertain value).
- Mechanisms of reserve funds or restricted funding (overcollateralisation) that enable to absorb the first loss on the dilution (the amount of those guarantees is decided for each contract according to the risk assessment prior to the signature of the agreement).

In these circumstances, the level of the final loss in case of seller's default will depend on the following parameters :

- Was the cover of the first loss adequately sized?
- Was there a regular follow-up of the current dilution, of the default-related dilution and were invoices audited to detect potential fraud?
- Do we get paid directly by the obligor? If not, what steps were taken to cover the risk of commingling?
- Is the agreement with or without recourse? If with recourse, were the obligors selected before granting funding to them to avoid joint default?

The level of seller's risk thus depends on the type of products. **The average loss on a classical factoring agreement** in case of seller's default was valued by several factors at about 7 % of the receivables funded at the time of the default, whereas it is supposedly around 30 % in undisclosed factoring without obligor account management.

Statistical behaviour of seller risk: low likeliness to occur (few agreements end up in a loss related to seller risk) but high potential loss upon occurrence (the amounts funded to the sellers are high and, in case of forgery, for example, the full amount can be definitively lost).

b) Obligor risk : risk of having to indemnify the seller in case of obligor's default (agreements without recourse) or risk of joint default of obligor and seller (agreements with recourse).

For agreements without recourse, this is a « plain vanilla » credit risk, directly related to the rating of the obligor in question. It occurs automatically in case of :

- Actual obligor's default (insolvency or official receivership) ;
- Presumed obligor's default (invoice unpaid more than a fixed number of days after due date without any actual dispute).

This risk is covered in two ways :

- The reinsurance of obligor risk with a credit insurer (SFAC-Crédit, Gerling, Coface…)
- For some agreements without or with partial reinsurance: a fixed level of indemnity leaving small losses to the seller's charge and making the resort to the factor unlikely.

For agreements with recourse, this is a « plain vanilla » risk covered by the seller. It thus depends on the obligor's and the seller's rating and the probability for obligor and seller to default exactly at the same time (joint and simultaneous default).

II. Application for the new Basel Accord

1.1. Proposed principle.

Since seller (dilution) and obligor (default) risk are totally different both in nature and profile, it seems illusory to us to try and approach them the same way. We therefore suggest to consider a factoring agreement as the combination of 2 distinctive products :

- A funding to a client, guaranteed by receivables ;
- A credit insurance on obligors (amounting to 0 for agreements with full recourse).

Therefore, the capital requirement can be measured as follows :

- Top down for agreements with obligor account management: capital requirement of obligor risk pool + capital requirement of client risk pool.
- Bottom up for agreements without obligor account management: capital requirement related to seller risk + capital requirement for each obligor in the agreement.

2.2. Proposed method

1) Assess default risk (=obligor risk) based on pooled or stand-alone obligor characteristics

* For agreements with obligor account management: top-down approach – Build a pool of obligor accounts (Total amount of purchased receivables).

We believe the notion of homogeneity must be regarded according to the regularity of the risk profile. Since factors handle a great number of obligors (more than 50.000), it is possible to build extremely diversified pools showing a very stable risk profile over time even if the companies that make up this pool are individually heterogeneous.

For this reason, it appears to us more efficient to use a small number of pools of large size rather than splitting the portfolio into a great number of pools built according to more or less relevant criteria: we believe diversification is a much more powerful homogeneity factor than an individual selection of the elements of the pool. Thus we believe that, conversely to what is written in § 455 of CP 3 (which asks that PD, LGD and EL be determined following retail risk quantification standards), a true "top-down" must be used for the assessment of risks on obligor pools, with pool-level criteria (diversification, granularity, industries, seller's underwriting practices...) rather than obligor-level criteria as would be necessary for allocating retail exposures to segments as asked besides.

A loss history could be calculated on each pool, which could allow for the calculation of EL:

Obligor EL = [obligor pool PD x obligor pool LGD x obligor pool EAD]

With :

- PD = historically noticed balance on defaulted obligors / average pool balance, eventually mitigated by guarantees ;
- LGD= average loss in case of obligor default (usually above 90 %), eventually mitigated by guarantees ;
- EAD= pool balance ;
- Obligor default : insolvency procedure on obligor or invoice unpaid over a fixed number of days after due date without any dispute raised by obligor (this aspect may vary according to the contractual conditions of each factor);

Received guarantees (for agreements without recourse: credit insurance; for agreements with recourse: a guarantee provided by the seller when it is better than the obligor) are taken into account through the bank's usual methods, in PD and/or LGD estimates.

* For agreements without obligor account management: bottom-up approach.

Each obligor's PD and LGD is calculated on the basis of its own characteristics:

Obligor EL = [obligor individual PD x obligor individual LGD x obligor EAD]

2) **Assess dilution risk (=seller risk): build one pool of seller balances for each internal rating and agreement type (the seller balance is the total amount of receivables purchased from the seller in question, be those receivables guaranteed or not).**

The seller balances would be split according to the seller's internal rating and other criteria such as the agreement type (disclosed or not, with or without recourse) or the "factorability" of the seller's customer balance (quality of the invoicing process, controls, dispute rates...).

It would thus be possible to allocate a PD to each pool (the seller's PD) and a statistically calculated LGD (example: 7% for disclosed agreements with obligor account management and average factorability of the seller's customer balance).

For each pool, we will get the following equation:

Seller EL = [seller individual PD x concerned pool LGD x seller balance]

With :

- PD = historically noticed balance on defaulted sellers / average pool balance ;
- LGD= (i) net losses on diluted receivables in case of default / average seller balance at the time of default or (ii) net losses on diluted receivables in case of default / amount of diluted receivables at the time of default. Can be refined through an analysis of the "factorability" of each seller's customer balance.
- EAD= (i) seller balance at the time of default or (ii) amount of diluted receivables at the time of seller's default (linked with the option chosen for LGD) ;

When the bank receives guarantee on seller risk, it may be specific insurance, reserve funds or restricted funding. It should be noted that reserve funds are protections against first losses and not just general collateral; the current provisions of CP 3 state that they can be assimilated to discounts and thus be treated accordingly to § 344, which assimilates purchase discounts to provisions. We are convinced that, as for third-party asset securitisations, this first loss provided by the seller should be able to offset not only the EL part but also the UL part of regulatory capital requirements.

This could be achieved through an assessment of LGD that would incorporate the effect of first loss protections, taking into account the volatility of average losses and therefore the (usually low) possibility that they may exceed the amount of first loss protections.

As dilution is typically a seller-related risk, we think that no bottom-up approach is feasible for dilution risk.

3) **Specific focus on the unused part of limits.**

The factor traditionally grants credit and/or purchasing limits on each obligor. Those limits may be cancelled on a contractual basis without notice. The unused amount of these limits must thus not generate any capital requirement and EAD must be set to 0% as for any immediately and unconditionally cancellable commitment.

However, the agreement with the client, which materialises the commitment to purchase receivables (on certain conditions) may be terminated with a notice (usually 2 or 3 months). It is thus legitimate to take into consideration the unused part of the maximum potential risk in case of seller default when evaluating capital requirements. Some factors do not state any formal purchasing limit and are thus exposed to an infinite theoretic risk (practically, the purchasing is limited by the client's activity). In the spirit of texts, this practice could prove extremely damaging and the contractual level of the purchasing limit will have to be generalised.

In the bottom-up approach, the contribution of each obligor limit to the overall seller limit must be measured. This contribution will be assessed according to a criterion to be defined (for example in proportion to obligor limits).

Example:

Client funding limit: 100
Limit on obligor A: 50 (33% of total obligor limits)
Limit on obligor B: 75 (50% of total obligor limits)
Limit on obligor C: 25 (17% of total obligor limits)
Sum of limits on individual obligors: 150

Portfolio of receivables as of 31/12: 75
Unused part of the limit: 25 (8.3 on A ; 12.5 on B ; 4.2 on C)

The evaluation of capital requirements made on this unused part (according to the same method as the used part) will then receive a non-zero EAD in conformity with the Basel Committee's proposals. Nevertheless we question the 75% CCF level imposed by the Basel Committee: in a Foundation approach, this level is much higher than experienced by banks; in an Advanced approach, we do not understand why banks should not be allowed to use own EAD estimates grounded on historical experience.

Appendix 3 – <u>Calibration of securitisation exposures</u>

1. Risk transfer from the originator

1.1. Should banks sell the first loss?

The current framework applies a prohibitive capital charge to first loss pieces through the full deduction approach up to K_{IRB}. This seems to be considered by the Committee as **an incentive for banks to sell these first loss pieces.** We believe that this objective is not realistic, at least in the current development of the markets in Europe. Indeed, our recent experience is rather that investors will rightly require more and more alignment of interest between the originator and the investors. Some opportunities, including CLOs of CLOs may develop, but we doubt there can ever be the capacity to absorb the volumes of first loss pieces that will be generated by large banks actively managing their portfolios.

More importantly, in our risk management strategies, **we do not see securitisation transactions as a way to manage expected losses.** If banks have specific credit concerns on names or industries, they manage these risks by reducing the exposure, selling the asset, or hedging on a single name basis. By definition, large securitisation transactions are not a way to manage such specific risks, banks **rather use them to shift to the market the unexpected loss component of portfolios** which at inception have acceptable credit quality, but where banks want to "buy an insurance" against potential downturns. The recent credit cycle has demonstrated the efficiency of such strategies, and the pro-cyclical aspect of Basel II will make the management of unexpected losses and migration risk increasingly vital for large commercial banks and for the health of the financial system.

Indeed, as the capital requirement is defined as the amount of capital to cover both expected <u>and</u> unexpected losses, shifting only the unexpected loss while keeping the expected loss by definition should deserve a legitimate regulatory capital relief, even though in most cases the actual losses will be in the order of magnitude of the Expected losses, therefore second loss would not materialise.

1.2. Comparing K_{IRB} and first loss

The underpinning paradigm of the current framework is that risk transfer only occurs if and when the first loss kept by the originator is smaller than K_{IRB}. The risk transfer would simply be measured by the difference between K_{IRB} and the first loss. Although this principle can seem sound from an intuitive point of view, we believe it is in itself largely flawed.

It would actually be right only if the calibration of K_{IRB} and the calibration of the first loss would be based on similar frameworks, which is far from being the case. In the real world, the calibration of the first loss (by rating agencies or securitisation models) leads to results that by definition should be expected to exceed K_{IRB} :

- PDs and LGDs are stressed compared to internal data (especially when securitising illiquid assets based on internal ratings),
- The granularity of the securitisation pool (in the corporate world) is much less than the one of the overall bank portfolio. This translates into a loss distribution for the CLO portfolio which has a much fatter tail than the banks loss distribution,
- The first loss is sized to cover potential losses up to the confidence interval of the next rated tranche at an horizon equal to the maturity of the structure whereas K_{IRB} is calibrated at a 1 year horizon[2],
- In most transactions, the originator has substitution rights, therefore the first loss is calibrated to cover future losses on a bullet portfolio, whereas K_{IRB} only measures the capital charge of the assets currently securitised, for which the average maturity is generally significantly smaller than the maturity of the structure.

For all those reasons, the likelihood that we can structure a transaction where the first loss is smaller than K_{IRB} is very remote unless :

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[2] Our research show that if the first loss would be sized to cover losses at a 1 year rather than 5 year horizon, it would be reduced by a factor of 35 to 60% depending on the underlying portfolio. This implies that there would be more chances that the first loss be smaller than K_{IRB}, therefore generating some capital relief.

- We concentrate on portfolios where K_{IRB} would be unduly overstated, as is currently the case under the current Accord for corporate credits. However this would result in regulatory arbitrage rather than sound risk transfer,
- We concentrate on short-term securitisations which will offer positive capital benefit but do not offer the same protection against future downturns.

However, this result should not be interpreted as a lack of effective risk transfer, but as a lack of robustness in the comparison between K_{IRB} and the first loss.

1.3. Potential improvements within the current framework

We believe that Advanced IRB banks should be encouraged by their regulators to develop internal models for the assessment of securitisation as a sound risk management practice to assess the risk of first loss retained or bought. However, as an alternative to adopt a full IRB approach for securitisation, **we strongly support the industry's proposal for a "clean SFA"** in which the various floors would have been removed. This "clean SFA" has been widely tested by the industry and it appears that its results are sensitive to the main drivers of losses for securitisation tranches (granularity of the underlying asset portfolio, thickness and position of the tranches) and on the whole consistent with banks' internal models.

If an alternative to this "clean SFA" nevertheless had to be found, we believe some amendments to the current framework could at least mitigate the current biases:

1. We suggest that some allowance is at least taken of a lifetime expected losses of the securitised credit portfolio when looking at the retained first loss position. This can be represented by the following formula:

   First loss amount retained against K_{IRB} = First Loss Position – (EL to maturity – EL 1 year)

   This option would be more realistic as it would fit the fact that, when no mechanism for trapping excess spread exists, first loss positions are reduced by the amount of realised losses during the lifetime of the securitisation operation (this option would thus not apply to securitisations retaining excess spread) and more risk is transferred to investors. It would still have a conservative bias insofar that the volatility of losses embedded in the first loss position also is sized to maturity, but it would be an important step in the right direction.

2. In the case that the originating bank is able to have the retained tranches rated by an ECAI, the originating bank should at least be able to treat these positions under RBA without regard to whether it is above or below K_{IRB}. As ratings are based on potential losses to maturity, this approach would also at least partially address the bias of the comparison of the first loss sized to maturity and the K_{IRB} sized at 1-year horizon. Indeed this approach would also be consistent with the broadly shared view that the capital charge for credit risk should be independent of the status of the owner of that credit risk. We would nevertheless regret to have to use the RBA as a mean to escape the effects of the miscalibration of the SFA, as our global view is still that SFA should adequately reflect the risk balance of a securitisation originator.

3. Other mechanisms could be studied so as not to lead to compulsory deduction of all positions below K_{IRB}. One example could be based on the recognition that securitised portfolios are not as granular as the overall portfolio of the originating bank, and thus more volatile losses lead to more risk transfer to investors and less risk retained by the originator. We therefore suggest that the N parameter be used to make the deductible amount fall below K_{IRB} as N decreases.

2. Assessing the risk weights for senior tranches

The risk weight floor at 7% (56 bps of capital requirement) is also one of our major concerns. Although the whole community agrees there is very little benefit for banks to shift these tranches, the floor creates a significant incentive to indeed sell those tranches outside the banking industry, which only increases the cost of securitisation without bringing real risk relief.

The risk profile of the most senior tranches is actually completely different than the one of a mezzanine tranche, as the most senior tranches cover the tail of the loss distribution. It is also quite

different from the risk profile of a AAA corporate as the default of a AAA corporate, also being a small probability of occurrence, is a more digital event, and may translate into a significant LGD, which is not the case for a senior securitisation tranche.

Banks' model as well as the "clean SFA" concur to show that, even in the remote event that this tranche would be hit by some losses, the losses as a percentage of notional would in all scenarios be minimal. Therefore, we believe that the parameters used to set the floor at 56 bps are not realistic.

In all simulated transactions, the LGD of the most senior tranche ranges between 0% and 3%. Therefore, we suggest to use a 5% LGD as a conservative assumption, instead of the implicit 50% LGD used in the current formula. This would allow banks to either retain these senior tranches at a reasonable capital charge, rather than sell them at an unnecessary cost.

We would also like to raise the Basel Committee's attention on the fact that the recognition of "double default" is also very important for synthetic securitisation, where huge nominal amounts are usually sold to investors in CDS form. The substitution method does not reflect the fact that a bank's exposure to the counterparty is conditional to the fact that losses on the underlying portfolio would reach the level of the tranche, which makes it a very small probability.