

Institute of
International
Finance, Inc.



**IIF RESPONSE TO THE THIRD CONSULTATIVE PAPER OF THE BASEL
COMMITTEE ON BANKING SUPERVISION**

Reports of the

STEERING COMMITTEE ON REGULATORY CAPITAL

WORKING GROUP ON CAPITAL ADEQUACY

WORKING GROUP ON OPERATIONAL RISK

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PREFACE

The Institute of International Finance, its Steering Committee on Regulatory Capital, and its Working Groups on Capital Adequacy and Operational Risk welcome the opportunity to continue participating in the dialogue concerning the reform of the regulatory capital framework. During the past four years, the Institute has been engaged in an intense process of analysis and discussion of the reform proposals, a process that has benefited from a transparent, frank, and informal exchange of views with the Basel Committee and its subgroups.

The Institute appreciates the efforts of the Basel Committee to craft a new regulatory capital framework that is more risk sensitive and better aligned with banking practices. Furthermore, the Institute supports the goal of establishing an adequate system of incentives for banks to improve their risk management capabilities. The third consultative paper released by the Basel Committee represents an important step toward those goals. However, the Institute, its Steering Committee, and its Working Groups believe that certain aspects of the proposals require further revision before the new framework can be finalized. This report highlights these issues and suggests ways in which they can be addressed. We hope that the Basel Committee finds these suggestions useful, and we look forward to continuing the dialogue with the Basel Committee as it moves forward to finalize and implement the new regulatory capital framework.

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IIF Steering Committee on Regulatory Capital

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BACKGROUND

In April of this year, the Basel Committee on Banking Supervision (the “Basel Committee”) released a third consultative paper (“CP3”) proposing to establish a new regulatory capital framework for commercial banks. The CP3 proposals reflect nearly four years of work by banking supervisors and banks to craft an updated regulatory capital framework that is more risk sensitive and better able to protect financial system soundness.

The Institute of International Finance, Inc. (“IIF”) has been actively involved in representing the views of international commercial banks on the regulatory capital reform process and has actively supported dialogue with supervisors on these proposals over the years.¹ When the Basel Committee initiated the reform process in 1999, the IIF Board of Directors established a Steering Committee on Regulatory Capital (the “Steering Committee”) of chief executive officers and chief risk officers to guide the IIF’s work in this area. The Steering Committee guides the work of the IIF’s Working Group on Capital Adequacy (WGCA) and the IIF’s Working Group on Operational Risk (WGOR).

The Steering Committee and the technical Working Groups have been actively involved in dialogue with the Basel Committee concerning its proposals.² A transparent, frank, and informal exchange of views with the Basel Committee and its subgroups has occurred throughout the reform process, and the IIF appreciates the Basel Committee’s openness to feedback and suggestions for change.

The Working Groups consist of senior credit risk managers at leading global banks throughout the world, including emerging markets. The WGCA focuses on the credit risk aspects of the Basel Committee’s reform proposals for regulatory minimum capital requirements (“Pillar One”), supervisory review (“Pillar Two”), and transparency (“Pillar Three”). The WGOR focuses on operational risk. In addition to these groups, the Institute maintains four regional emerging market working groups: Asia, Central Europe, Latin America, and the Middle East/North Africa. Each of these working groups met by teleconference in late June and early July of this year, and the views of the senior risk management officers in those banks are included in this report. Finally, the Institute’s Middle East/North Africa Chief Risk Officer Forum provided views on the CP3, and their views also are included in this report.

Chapter 1 of the report presents the consensus views of the Steering Committee. Chapters 2 and 3 present the consensus views of the WGCA and the WGOR, respectively, concerning Pillar One. Chapter 4 addresses Pillar Two supervision issues, and Chapter 5 addresses Pillar Three transparency matters.

¹ The Institute’s involvement in this work began in 1998, with the report by the Working Group on Capital Adequacy responding to the Basel Committee’s paper *Credit Risk Modeling: Current Practices and Applications*.

² *Report of the Steering Committee on Regulatory Capital*, March 2000
Report of the Steering Committee on Regulatory Capital, May 2001
Report of the Working Group on Capital Adequacy, March 2000
Report of the Working Group on Capital Adequacy, May 2001
Report of the Working Group on Operational Risk, May 2001

This report does not seek to represent the complete set of views of each participating bank regarding the Basel Committee proposals. Rather, the report represents the consensus views of these banks, which all broadly agree on the thrust and main recommendations of the IIF reports. A number of IIF members will, in addition to this consensus-based report, submit their own corporate views to the Basel Committee and/or their national supervisors.

This report has also been reviewed and approved for release by the IIF Board of Directors, a list of which appears as Appendix A to this report.

EXECUTIVE SUMMARY

The Institute's Steering Committee on Regulatory Capital supports the Basel Committee's efforts to increase the risk sensitivity and relevance of the regulatory capital framework for internationally active banks. This support has not wavered throughout the reform process, begun in 1999. Through the Steering Committee, as well as various technical working group activities, the global banking community has sought to provide meaningful and constructive feedback to regulators in their efforts to improve the regulatory capital treatment of credit and operational risks. The Steering Committee appreciates the Basel Committee's openness to dialogue and its work with banks on a wide range of policy, technical, and data-related issues. The result over the years has been a refinement of the supervisory proposals and many improvements.

However, a number of changes are needed before the new regulatory capital framework can be viewed as final and consistent with the Basel Committee's goals of enhancing risk sensitivity and promoting financial stability. Steering Committee members would like to raise a number of serious issues for consideration during this commentary period including procyclicality, recognizing provisioning, diversification, and credit risk models; streamlining and simplification; calibration and incentives; and regulatory coordination, all of which are critically important issues to resolve and are highlighted in this Executive Summary. In addition to these items, the body of this report provides a number of detailed recommendations and the rationales supporting their adoption. A full list of all recommendations appears after this Executive Summary.

Procyclicality: Provisioning, Diversification, and Credit Risk Models: A certain amount of procyclicality is inherent in any risk-sensitive approach to credit risk. However, because the new regulatory capital framework would restrict recognition of the key tools banks use to manage procyclicality (in particular, diversification and prudent provisioning), the regulatory capital requirements generated by the new framework may be excessive. To date, no clear and comparable measure of the potential procyclicality effects at individual banks has been developed. However, overstating regulatory capital requirements could have the effect over time of diverting capital from other productive uses. *Therefore, the Steering Committee recommends that the levels of potential procyclicality be assessed throughout the implementation period and that recalibration be undertaken, taking into account the results of any subsequent research.*

The failure of the new capital framework to recognize the diversification benefits associated with operating multiple different global businesses, and the failure to recognize the credit risk models that can quantify that diversification benefit, demonstrates the likely areas in which improvements could be made. Increasing the regulatory capital framework's risk sensitivity without also enhancing the recognition of banks' methods for managing and mitigating risks is highly problematic and inappropriate. *The Steering Committee therefore recommends that the Basel Committee and banks begin working now on developing an appropriate approach to recognizing diversification and banks' credit risk models within the regulatory capital framework.*

Streamlining and Simplification: Steering Committee members remain concerned by the cost of creating compliance systems to accommodate the new regulatory standards and the complexity of the proposed new framework. Steering Committee members accept the need for a more granular regulatory capital framework than the existing one, but they believe that the proposal continues to be excessively detailed. This detail can increase opportunities for regulatory arbitrage while imposing unnecessary and unproductive costs on banks.

Of particular concern are the sharp distinctions created within the Internal Ratings-Based (IRB) Approach. Steering Committee members support the use of regulatory-determined loss given default

(LGD) and exposure at default (EAD) parameters as a foundation for moving toward regulatory recognition of internal estimates for these parameters. Steering Committee members believe, however, that the proposal creates unnecessary cliff effects and complicates compliance considerably by creating too many special rules and distinctions between the Foundation and Advanced IRB Approaches. *Therefore, this report recommends a series of refinements designed to streamline compliance efforts and enhance banks' ability to qualify to use internal LGD estimates on a portfolio-by-portfolio basis within the IRB umbrella as soon as data and cost considerations make such a transition along the IRB system feasible. Chief among these are the elimination of multiple approaches to assessing maturity effects and to recognizing nonfinancial collateral.*

The Steering Committee would like to underscore the importance of this recommendation. If the new framework is to encourage banks to enhance their risk management capabilities, it is critically important that the framework establish a smoother continuum within the IRB system that encourages banks to use internal parameter estimates as much as possible (subject, of course, to validation and supervisory oversight). A better balance between supervisory and internal parameters and methodologies can and should be established so that banks do not become mired in the Foundation IRB Approach to the detriment of their risk management, shareholder, and regulator's priorities for enhancing internal systems.

Calibration and Incentives (Credit Risk and Operational Risk): Steering Committee members reiterate the need for the new framework to provide regulatory capital incentives for banks to move along the spectrum of sophistication. In the credit risk area, the Basel Committee's third Quantitative Impact Survey ("QIS 3.0") demonstrates clearly that this has not occurred. Regulatory capital charges are likely to increase significantly in some portfolios despite the existence of enhanced risk management approaches and despite market evidence. This is especially true regarding the treatment of sovereign and interbank exposures, for which few actual defaults exist and for which the proposal would impose an excessively conservative treatment of LGD relative to market experience. The regulatory treatment of LGDs is particularly important given that the lack of default data is likely to limit significantly any bank's ability to validate its internal LGD assumptions under the proposed Advanced Internal Ratings-Based Approach.

The calibration across portfolios remains a critically important task, especially for those portfolios that are so important to the conduct of international finance. Calibration issues also exist in the operational risk context, in which it is far from clear that regulatory capital incentives will exist to encourage banks to move along the spectrum and invest in systems to qualify for the more advanced approaches to measuring regulatory capital. It is critically important in this context that both the risk weighting and insurance recognition standards reward prudent and enhanced risk management practices rather than penalize them. *Therefore, the Steering Committee recommends that the Basel Committee ensure that regulatory capital incentives exist for banks to enhance their risk management capabilities across all portfolios rather than merely in the aggregate.*

Regulatory Coordination/College of Supervisors: The new regulatory capital framework will be implemented on a cross-border basis, especially for large, globally active banks. Given the complexity of modern banking and the regulatory capital framework, this means that banking supervisors will need to communicate and coordinate among each other to a greater degree than in the past. *Therefore, the Steering Committee recommends that the Basel Committee explore the establishment of a College of Supervisors to serve as a forum for supervisors to share information concerning oversight plans and compliance concerns.* For example, for each global banking group, a college consisting of the group's four to six largest supervisors could exist.

The Steering Committee seeks to encourage regulatory coordination to minimize the implementation burden for internationally active banks and to increase the clarity and certainty regarding

which supervisory entity will be responsible for various tasks, especially validation. *Therefore, Steering Committee members strongly encourage the Basel Committee to focus on establishing frameworks for supervisory coordination that do not dilute the authority of the consolidated home country supervisor.*

For example, one role of the College of Supervisors could be to attribute a coordination responsibility to the home regulator to eliminate duplicative and contradictory standards being applied to a banking group. *The Steering Committee believes that a feedback mechanism to the Accord Implementation Group (AIG) may also need to be established so that conflicts could be identified and, if possible, avoided.* The Steering Committee recognizes that this concept requires refinement. It looks forward to engaging the Basel Committee and the AIG in dialogue concerning how the concept could be implemented to address both supervisory and banking concerns.

Pillars Two (Supervision) and Three (Transparency): Finally, the Steering Committee supports the Basel Committee's efforts to create a three-pillar approach in which supervisory and market disciplines reinforce the quantitative capital standards. This report illustrates some areas in which additional clarity is needed to avoid unnecessary confusion as the financial system moves toward this new paradigm. In particular, concern exists that the actual minimum standard may not be clear, given the statements in the Pillar Two proposal regarding various "top-up" provisions. *The Steering Committee recommends that the text be clarified considerably to ensure that all parties (regulators, rating agencies, and shareholders) understand and evaluate banks using the same interpretation of the new capital framework.* Steering Committee members support and appreciate the refinements in the Pillar Three proposals over the years and the establishment of increased transparency in the banking markets. *Steering Committee members continue to believe, however, that the banking community would be better served by a less prescriptive standard and recommend that the Basel Committee consider how that can best be achieved.*

Related to the transparency recommendations is the Steering Committee's concern regarding the apparent lack of coordination between the Basel Committee and the International Accounting Standards Board (IASB). *The Steering Committee therefore recommends that the Basel Committee work closely with the IASB to foster convergence between the international regulatory capital and accounting framework for banks, especially regarding loan provisioning.*

Steering Committee members hope that their views may be helpful to the Basel Committee as it seeks to refine and finalize the regulatory capital proposals. Steering Committee members look forward to continued dialogue and exchanges of views with Basel Committee members.

LIST OF RECOMMENDATIONS

Framework Issues

1. Procyclicality
 - 1.1 The Basel Committee should work with banks and other experts during the transition period to determine the nature and scope of the potential procyclical effects of the new framework. The format of such work could include a variety of mechanisms, including specialized projects and additional QIS exercises.
 - 1.2 The Basel Committee should re-evaluate the calibration of the regulatory capital framework during 2006 (before the final framework is implemented) and fine-tune the calibration in light of additional information and data.
2. Provisioning: The Basel Committee should work closely with the International Accounting Standards Board (IASB) to foster convergence between the international regulatory capital and accounting framework for banks, especially regarding loan provisioning.
3. Diversification: Pillar Two should encourage national supervisors to undertake the best possible diversification analysis and provide some capital benefits to banks with robust assessments as an offset to capital add-ons within Pillar Two.
4. Credit Risk Models: The Basel Committee and the banking community should begin work promptly on how best to recognize banks' internal credit risk models within the regulatory capital framework.
5. National Discretion: The Basel Committee and the Accord Implementation Group (AIG) should monitor carefully the use of national discretion to minimize opportunities for uneven playing fields to emerge.
6. Streamlining and Simplification: The regulatory capital framework should be simplified as follows:
 - 6.1 Maturity: Create one single maturity adjustment methodology in the IRB Approaches. The 2.5-year fixed-maturity assumption in the Foundation IRB Approach would remain available as a fallback option only for banks without internal methodologies for assessing maturity effects (subject to supervisory approval).
 - 6.2 Collateral Recognition: Eliminate the different approaches for recognizing collateral and apply only the approach available to "Advanced" IRB banks.
 - 6.3 Validation: Expressly recognize that validation processes need not be limited to quantitative tools.
7. Calibration and Incentives: The incentive structure within the new capital framework should be adjusted as follows:
 - 7.1 Incentives Across Credit Risk Portfolios: The Basel Committee should ensure that regulatory capital incentives exist for banks to proceed along the sophistication spectrum from Standardized to Advanced IRB Approaches in *each* portfolio.

- 7.2 Incentives/Market Dynamics: The Basel Committee needs to undertake a coordinated and comprehensive communications effort regarding the new framework to ensure that the market and nonparticipating regulators do not misinterpret the actual minimum regulatory standard, which should be measured in relation to Pillar One alone. Increasing the amount of training and joint programs with the Financial Stability Institute, as well as bilateral exchanges among staff, could accomplish this task.
- 7.3 Incentives/Operational Risk: The operational risk capital calibration across the different approaches should be reviewed soon after the implementation of the new Accord to ensure that incentives exist to move across the spectrum.
- 7.4 Incentives/Interbank and Sovereign Lending: The new definition of “short-term” for interbank exposures should be set at six months (especially in the Standardized Approach), and the regulatory LGD for interbank and sovereign exposures should be lowered to 30%.
- 7.5 Incentives/Emerging Markets: The Basel Committee should encourage local regulators to take the necessary preparatory steps to establish frameworks that would allow banks, when technically and operationally ready, to adopt the IRB Approach in their jurisdictions, as local market conditions warrant.

8 Regulatory Coordination/College of Supervisors

- 8.1 College of Supervisors: The Basel Committee should explore the establishment of a College of Supervisors. For example, for each global banking group, a college consisting of the group’s four to six largest supervisors should exist. The college would serve as a forum for supervisors to share information concerning oversight plans and compliance concerns.
- 8.2 Home Country Supervision: The Basel Committee should establish frameworks for supervisory coordination that do not dilute the authority of the consolidated home country supervisor. For example, one role of the College of Supervisors could be to attribute a coordination responsibility to the home regulator to eliminate duplicative and contradictory standards being applied to a banking group.
- 8.3 Operational Risk: Regulatory capital will be calculated on a bank-wide consolidated basis under the proposal. Therefore, an appropriate mechanism for allocating regulatory capital to separate business entities must exist. In addition, any allocation mechanism must be as simple as possible to avoid generating increasing compliance costs.
- 8.4 AIG Feedback Mechanism: A feedback mechanism to the AIG should be established so that conflicts between home and host supervisors can be identified and, if possible, avoided.

Pillar One

9. Standardized Approach

- 9.1 Collateral/Standardized Approach: Additional forms of collateral should be available under the Standardized Approach. In particular, collateral on commercial property as well as receivables should be recognized in the Standardized Approach.
- 9.2 Risk Weights/Standardized Approach: Bankers from emerging markets strongly recommend that granularity in the proposed risk weight buckets be increased by introducing an additional

risk bucket of 75%. The lower risk weights provided for sovereign exposures funded in local currency (Paragraph 28) should be extended to corporate exposures.

10. IRB Approach

- 10.1 Probability of Default (PD) Estimation: Paragraph 409 should be revised by establishing a neutral principle for PD estimation, which would allow banks to use PD estimates consistent with their internal risk management policies.
- 10.2 PD/Transitional Arrangements: The WGCA strongly recommends that the Basel Committee make mandatory the availability of a transitional regime for PD validation rather than make it subject to national discretion.
- 10.3 PD/Validation: WGCA members believe that the Basel Committee should eliminate from the proposals all text that seems to infer that PDs have an exact predictive value. The new framework should make clear that PD is a forward-looking estimate of the probability that each obligor may default over the coming year. The framework should also recognize, however, that actual defaults in reality are random across the PD distribution and may differ from the expected PDs.
- 10.4 Retail/Definition of Default: The Basel Committee should rely on prevailing market practices for the definition of default. For example, when market practice in retail portfolios does not use “days past due” as a trigger for default and, instead, uses an alternative but equally rigorous approach (e.g., behavioral scoring models), the regulatory capital framework should not require banks to track the days past due.
- 10.5 Definition of Default/Nonaccrual: Bankers from the Middle East and North Africa region suggest that the Basel Committee provide clear guidance to regional supervisors to avoid the perverse incentives that could arise if the regulatory definition establishes nonaccrual status as the equivalent of default (which is not the standard in some jurisdictions).
- 10.6 LGD/Transitional Arrangements: A transitional arrangement should be created so that banks have a real chance of validating LGD estimates when the new framework is implemented in 2007. The Accord should permit a wide range of validation methodologies consistent with internal risk management practice, including, for example, developmental evidence, internal consistency checks, external data, and, of course, statistical testing. Also, the temporary LGD floor established for mortgage exposures in Paragraph 235 should be eliminated.
- 10.7 Credit Risk Mitigation (CRM): The WGCA recommends that the CRM recognition systems currently proposed for the Advanced IRB Approach be available in the Foundation IRB Approach. In addition, the WGCA believes that the artificial restrictions on the type of guarantors recognized under the Standardized Approach should be eliminated.
- 10.8 Confidence Intervals: The Basel Committee should be transparent in its calibration efforts and should avoid using the term “confidence interval” in this context. Therefore, the new regulatory capital framework should remain silent with respect to the target confidence interval pending further research on how best to incorporate risk models into the regulatory capital framework.
- 10.9 Credit Conversion Factors (CCF): The 75% CCF currently established for commitments in Paragraph 281 should be adjusted based on maturity.

11. Operational Risk

- 11.1 Frequently Asked Questions: The Basel Committee or its Risk Management Group (RMG) should compile some frequently asked questions (FAQs) and supervisory answers to those questions to foster consistency in mapping losses and gross income.
- 11.2 Operational Risk/Clarification of the Scope of the Alternative Standardized Approach (ASA): The Basel Committee should clarify the scope of application for the ASA and its place in the spectrum of approaches available to banks.
- 11.3 Operational Risk/Insurance Recognition: Banks using the Basic Indicator and Standardized Approach in Pillar One should not be penalized on insurance grounds under Pillar Two. The WGOR further recommends that Pillar Two assessments be permitted to recognize benefits related to insurance cover for operational risk.
- 11.4 Operational Risk/Captive Insurers: The WGOR considers it excessively onerous to require banks to deduct capital investments in insurance captives and then prohibit recognition of the protection provided by those captives on an arms-length third-party basis. The WGOR would be pleased to work with the RMG on how best to resolve these issues.
- 11.5 Operational Risk/Overlaps with Credit Risk: Concern exists that Paragraph 633 could be interpreted incorrectly to create duplicative and costly data collection burdens. The WGOR recommends two corrections: The paragraph should refer to operational risk “management” instead of “databases,” and the last sentence of Paragraph 633 (fifth bullet point) should be deleted.
- 11.6 Operational Risk/Advanced Measurement Approach (AMA) Correlation: Concern exists that the CP3 proposal may establish an impossible standard to meet regarding the treatment of correlations.
- 11.7 Threshold for Losses: The WGOR recommends eliminating the example contained in Paragraph 633 and replacing it with a standard requiring thresholds to be set in relation to business line and model characteristics.

Pillar Two

12. Pillar Two and Minimum Capital: Proposed Principle 3 under Pillar Two (which establishes that supervisors should expect banks to operate above *minimum* regulatory capital ratios) should be revised to clarify the real minimum required capital for banks. In addition, Pillar Two should provide a framework for making judgments on an individual, bank-by-bank basis and should provide supervisors with the tools necessary for taking bank-specific measures.
13. National Discretion: The Basel Committee and the AIG should monitor carefully the use of national discretion to minimize opportunities for uneven playing fields to emerge.
14. Strategic and Reputational Risks: The Basel Committee should avoid adopting a quantitative approach for dealing with strategic and reputational risks. The WGCA, therefore, suggests avoiding capital rules for these types of risks.

Pillar Three

15. Transparency: Pillar Three should provide a more principles-based approach to disclosure with qualitative guidelines, complemented by illustrative examples and recommended practices.

IIF STEERING COMMITTEE ON REGULATORY CAPITAL

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CHAPTER 1: REPORT OF THE IIF STEERING COMMITTEE ON REGULATORY CAPITAL

The Steering Committee supports the Basel Committee's efforts to create a more risk-sensitive regulatory capital framework for banks. Steering Committee members believe that increased alignment between regulatory and economic capital measures can create real incentives for all banks to improve their internal risk management systems while contributing to the development of more resilient financial systems. The combination of more risk-sensitive quantitative capital requirements (Pillar One), more robust supervisory approaches tailored to focus on risk characteristics within individual institutions (Pillar Two), and increased transparency (Pillar Three) can accomplish these goals if the new framework is adequately designed and implemented in a pragmatic and commercially sensible manner.

The reform of the regulatory capital framework for banks has been under way for almost four years. During that time, the Basel Committee has significantly adjusted its proposals. Many of these adjustments reflect the needs of the financial community for a capital framework better attuned to the realities of modern risk management. The Steering Committee greatly appreciates the Basel Committee's commitment to an open and intensive dialogue with the financial community during the reform process and believes that many of the changes represent significant improvements. Chief among these is the development of the Internal Ratings-Based (IRB) Approach, a continuous risk-weighting function for credit risk, and the Advanced Measurement Approaches (AMAs) for operational risk.

Nonetheless, much work remains before the framework can achieve its stated objectives. For example, the reformed regulatory capital framework will still neither reflect the benefits associated with diversified earnings nor account for specific diversification benefits within individual portfolios. In other words, the correlation factors are set at levels that seem to be inappropriate for large, well-diversified banks. Failure to reflect these benefits raises questions concerning the regulatory capital incentives for banks to conduct globally and sectorially diversified financial activities. Moreover, the Basel Committee's Third Quantitative Impact Study (QIS 3) demonstrates the increased risk sensitivity of the new regulatory capital framework; it also shows that more incentives are needed to fulfill the framework's stated objectives.

Concern also exists that the interaction of the three pillars in the Basel Committee proposal could increase required regulatory capital within the banking system rather than maintain parity, especially after the charges for operational risk are added. Finally, some members observe that changes in the regulatory framework by definition will change bank behavior. They caution the Basel Committee to avoid inadvertently creating incentives for banks to exit market sectors, particularly if the unintended result could be to encourage weaker credits to migrate to Standardized Approach banks. Steering Committee members also register concern for possible inadvertent effects caused by the combination of increased procyclicality in regulatory minimum capital and the inability to recognize the relative benefits of portfolio diversification.

This Steering Committee report highlights the key areas in which additional work is needed before the new regulatory capital framework can be finalized. Four main issues have been identified as requiring significant refinement and/or additional work during the implementation period. These are as follows:

1. Procyclicality: provisioning, diversification, and credit risk models
2. Streamlining /Simplification
3. Calibration and incentives
4. Regulatory coordination/College of Supervisors

The Steering Committee's views on these issues are guided by one overriding principle: The new framework should create real business benefits for both banks and supervisors. The best way to accomplish this is to simplify the framework and incorporate additional flexibility so that advances in risk management and changes in the financial landscape do not require major amendments to the capital framework.

1. Procyclicality: Provisioning, Diversification, and Credit Risk Models

A risk-sensitive capital framework necessarily will contain a certain amount of procyclicality as a natural consequence of being responsive to deteriorations and improvements in risk profiles. Numerous academic, supervisory, and internal bank studies support this view. Even the current regulatory capital framework seems to contain a certain amount of procyclicality. The issue is not whether capital should fluctuate with risk and economic cycles. The issue is how those fluctuations should be managed.

Commercial banks use a number of tools to manage the potential procyclicality of their economic capital assessments. The goal is to manage effectively the risks to which bank depositors and shareholders are exposed while generating a positive return for these stakeholders. The two main tools are diversifying portfolios across geographic, product, and business activities (so that cyclical movements in each area can counterbalance each other) and adopting prudent provisioning policies based on rigorous assessment of unexpected losses. Diversification strategies also serve other purposes, including business model and strategy execution, revenue enhancement, and prudent risk management. Prudent provisioning practices, including dynamic provisioning (where it is permissible), based on a rigorous assessment of general expected losses, also help banks build cushions to absorb losses due to economic cycle movements. In addition, some banks use stress testing on a stand-alone basis (i.e., not linked to their credit rating systems) to assess the potential procyclicality of their portfolios. However, no clear and comparable measure of the potential procyclical effects at individual banks has yet been developed.

The Basel Committee has attempted to reflect some of these tools within the regulatory capital framework. However, the Steering Committee believes that the proposed solutions are insufficient. For example, although the credit risk weighting function recognizes a limited form of diversification, this recognition takes the form of a standard regulatory assumption. It only discounts small and medium enterprises (SMEs) versus corporate portfolios and credit cards versus residential mortgage lending. It does not recognize the specific levels of diversification present in each bank's portfolio. This is because the Basel Committee has indicated that it will not recognize banks' internal credit risk models that measure diversification effects within this round of reform.

Consequently, the new framework will create regulatory capital incentives for banks to focus on specific business areas and will create disincentives for banks to operate in a globally diversified manner. These effects are counterproductive for a global regulatory capital framework that seeks to encourage banks to enhance their risk management capabilities. The related policy choices within the framework then generate questions concerning whether the capital framework has been calibrated to a true minimum regulatory standard.

The regulatory reform efforts also do not address the definition of capital and, therefore, do not update the treatment of provisions. Increasing the risk sensitivity of capital requirements for assets without simultaneously updating the risk sensitivity of bank contra-assets (e.g., provisions) creates imbalances in the framework and generates a regulatory capital requirement that overstates potential procyclical effects. The Basel Committee's efforts to recognize at least some offsets to expected losses in regulatory capital calculation (by recognizing future margin income and specific reserves) and to flatten the risk-weighting curve, while welcome, result in at best an incomplete solution. This is because the role that reserves can play to offset those expected losses is limited. In other words, the denominator in the

capital ratio calculation has changed without any corresponding adjustment to the numerator. Failure to incorporate some flexibility in the implementation of the twin objectives for reforming the regulatory capital framework—increasing risk sensitivity and maintaining system-wide capital—could introduce some unwarranted rigidities in the regulatory capital framework over time.

Most Steering Committee and WGCA members accept the Basel Committee’s decision to delay crafting a framework for recognizing banks’ internal credit risk models. However, many also note that this choice is conceptually incompatible with the existing market risk regime and the emerging operational risk regime. Steering Committee members also recognize that updating the regulatory capital treatment of bank provisions will require not only recognition of banks’ credit risk models, but also more dialogue and agreement between banking supervisors and accounting standard-setters on the treatment of bank provisions. Additional work is needed here to ensure consistency between evolving accounting standards and the new regulatory capital framework. Such a dialogue would have the additional benefits of increasing transparency and the effectiveness of Pillar Three. Finally, Steering Committee members are concerned that the full extent of potential procyclical effects cannot be well understood yet, given that most banks have not fully implemented the new regulatory capital framework.

In an effort to be pragmatic, the Steering Committee therefore recommends the following steps be taken to address procyclicality within the new framework and during the transition period:

- **First, the Basel Committee should work with banks and other experts during the transition period to determine the nature and scope of the potential procyclical effects.** The format of such work remains open for discussion. **It could include a variety of mechanisms, including specialized projects and QIS exercises. Any such work should be paired with a commitment to re-evaluate the calibration of the regulatory capital framework during 2006, before the final framework is implemented.** This should provide policymakers with flexibility to adjust the framework in a manner that avoids the more extreme outcomes implied by the QIS 3 results. Such recalibration should not be viewed as an opportunity to revisit the entire framework. **Instead, it should be used as an opportunity to fine-tune the calibration in light of additional information and data that may come to light as banks proceed through the implementation process.**
- Second, although the Steering Committee continues to believe that diversification should be better recognized under Pillar One, it also believes that **Pillar Two should expressly encourage national supervisors to undertake the best possible diversification analysis when exercising their oversight of individual banks and provide some capital benefits to banks with robust assessments as an offset to some of the anticipated regulatory capital add-ons within Pillar Two.**
- Third, **the Basel Committee and the Accord Implementation Group (AIG) should monitor carefully the use of national discretion to minimize opportunities for uneven playing fields to emerge.**
- Fourth, **work should begin promptly between the Basel Committee and banks on how best to recognize banks’ internal credit risk models within the regulatory capital framework.**
- Fifth, **the Basel Committee should work closely with the IASB to foster convergence between the international regulatory capital and accounting frameworks for banks, especially regarding loan provisioning.**

2. Streamlining/Simplification

The measurement and management of risk within globally diversified banks is a complex task. Designing a regulatory capital framework that reflects modern risk management approaches necessarily requires some amount of detail. At the same time, excessive detail can create (rather than limit) arbitrage opportunities. Steering Committee members believe that the amount of detail contained within the CP3 proposals for credit risk remains excessive and will generate inappropriate compliance burdens and costs for commercial banks, whereas nonbank competitors have no such requirements.

At the same time, the different treatments of the same items (especially maturity and collateral) within the IRB Approach create serious cliff effects that could deter banks at the margin from developing internal LGD and EAD estimates to qualify for the proposed Advanced IRB Approach. Furthermore, although the expanded recognition of nonfinancial collateral and the recognition of maturity effects are important steps, the complexity and the costs for achieving recognition under the proposal may be significantly higher than the benefits received.

The Steering Committee believes that compliance burdens could be eased if the Basel Committee adopted the following simplification/streamlining suggestions:

- **Maturity: Create one single maturity adjustment methodology for banks using the IRB Approach. The 2.5-year fixed-maturity assumption in the Foundation IRB would remain available as a fallback option only for banks without internal methodologies for assessing maturity effects (subject to supervisory approval).** Implementation of this recommendation may require the development of a single approach for maturities less than one year to ensure they are not inappropriately penalized.
- **Collateral Recognition: Eliminate the different approaches for recognizing collateral and apply only the approach available to “Advanced” IRB banks.** The Steering Committee here observes that most globally active banks currently have robust collateral management practices, and the proposed different approaches to collateral recognition would impose unnecessary and costly compliance burdens on banks. When paired with the limited benefit associated with successfully recognizing collateral in the proposed capital framework, the investment in compliance systems could outweigh the benefits, creating disincentives for banks to use more advanced approaches.
- **Definition of Default—Retail Portfolio: Increase reliance on existing robust market practices.** The Steering Committee notes, for example, that in retail portfolios some banks use scoring or behavioral models that do not track the term “days past due.” Requiring banks to track this element as a condition of default within the retail portfolio would be inconsistent with market practice for these models and would impose unwarranted compliance burdens on banks.
- **Validation: Provide express recognition that validation processes need not be limited to quantitative tools.** For example, statistical methodologies to validate parameters may be inappropriate in portfolios or sections of portfolios in which defaults are rare. Examples of such situations include sovereign and interbank portfolios as well as lending to highly-rated obligors.

These streamlining recommendations would help establish a more cost-effective continuum within the IRB system in which banks could transition more smoothly toward using internal LGD estimates on a portfolio-by-portfolio basis when data and cost–benefit considerations warranted. It would also preserve the availability of regulatory-determined parameters for which lack of data or insufficiency of internal controls at a bank so warranted.

3. Calibration and Incentives

The Steering Committee believes it is critically important for the new framework to provide regulatory capital incentives for banks to move across the sophistication spectrum in both the operational and credit risk areas. A number of participants in the IIF process believe that a proper alignment of incentives across regulatory approaches has not yet been achieved within either the credit risk or operational risk frameworks. In addition, Steering Committee members doubt that the framework as proposed will achieve its goal of maintaining roughly the same amount of regulatory capital in the system as a whole because many believe the net result over time will be to increase regulatory capital requirements. In this area, the bankers' interpretation of the QIS 3 results differs from the supervisory community's interpretation.

Incentives Across Credit Risk Portfolios: The QIS 3 results show that the cumulative effect of conservative assumptions in the risk-weighting function and strict rules on credit risk mitigation (CRM) recognition and securitization may fail to deliver roughly equivalent capital. The Basel Committee analysis supporting an equivalent outcome was based in part on the assumption that the CRM benefits in the QIS 3 were understated, given that most banks would likely be able to recognize more collateral after the transition period, when Basel-compliant systems were in place. Banks disagree. They doubt much benefit will accrue from the CRM framework, especially given the modest reduction in LGD values permitted within the framework and the likelihood that many instruments will not qualify for recognition. Furthermore, the QIS 3 results show that gains achieved in the credit risk area are outweighed by substantial charges for operational risk, especially for Standardized Approach banks.

The CRM issues are of concern not only for emerging market regions, but also for banks in the G-10 countries, which in many instances will adopt the Standardized Approach and at least some part of the IRB system. Furthermore, the QIS 3 results showed a wide dispersion of individual results, with several banks experiencing significant capital increases associated with specific business lines (e.g., interbank lending, sovereign lending). This is largely due to the conservative regulatory treatment of LGD for these portfolios in the Foundation IRB Approach, which is inconsistent with bank experience. At the same time, it is unlikely that most banks in either G-10 or emerging markets will be able to validate their internal LGD assumptions given the paucity of default data in these portfolios. Because it is unrealistic to assume that validated LGD estimates will be available for these portfolios, substantial increases in regulatory capital could result from implementing the new framework as proposed. This is an inappropriate result.

Failure to ensure that regulatory capital incentives exist for banks to proceed along the sophistication spectrum from Standardized to Advanced IRB in *each* portfolio could generate incentives for banks to exit particular business lines. Concern exists in some emerging markets that this issue could arise particularly with respect to short-term interbank lending. A comparable concern exists within G-10 markets regarding the proposed excessively conservative treatment of securitization. Over time, some Steering Committee members believe that key intermediation activities could migrate to financial firms not subject to banking supervision, although it is recognized that such decisions would be driven by economic, rather than regulatory capital, considerations.

Incentives/Market Dynamics: Concern exists that the Pillar Two–proposed Principle 3 might generate problematic market dynamics that could increase regulatory capital over time. This proposed principle states that regulators expect all banks to operate above regulatory minimums. Leading commercial banks currently operate at capital levels well in excess of the regulatory minimum requirements, and this capital strength is a key component to their high external ratings. To the extent that proposed Principle 3 operates solely to codify existing market practice, concern exists that the convergence between economic and regulatory capital will not be well understood by external rating agencies and that these agencies may require banks to hold capital well in excess of that which would already be required under Pillar One and proposed Pillar Two Principle 3. This is because the proposed Principle 3 is unclear. It does not indicate whether the goal is to codify existing practice or whether it seeks to establish a new regulatory minimum standard consisting of the sum of capital required under Pillars One and Two.

The Steering Committee therefore recommends that the Basel Committee clearly indicate that minimum regulatory capital is to be measured in relation to Pillar One alone. It also strongly urges the Basel Committee to undertake a coordinated and comprehensive communication effort regarding the new framework to ensure that the market and nonparticipating regulators do not misinterpret the actual minimum regulatory standard. Increasing the amount of training and joint programs with the Financial Stability Institute, as well as bilateral exchanges among staff, could accomplish this task. More innovative means may be needed to reach other market participants (e.g., rating agencies). Steering Committee and Working Group members would be pleased to provide assistance in this effort if the Basel Committee believes it would be useful.

Incentives/Operational Risk: It is critically important that appropriate incentives also exist for banks to implement successively more advanced operational risk management systems. The current framework proposals do not create such incentives. In fact, even with the proposed Alternative Standardized Approach (ASA) taken into consideration, the QIS 3 results seem to indicate that regulatory capital requirements would increase even as a bank moves from the Basic Indicator to the Standardized Approach. Moreover, it is not yet clear what level of capital will be required under the Advanced Measurement Approaches (AMAs). **To ensure that appropriate incentives will exist, such that regulatory capital is a declining function of enhanced risk management, the calibration of operational risk capital requirements across the different approaches should be reviewed soon after implementation.** Without the guarantee of such a review, many banks may be reluctant to implement an AMA. These calibration issues must be addressed if the new framework is to be implemented in an appropriate manner.

Two other items in the operational risk proposals require some revision to ensure that appropriate regulatory capital incentives exist. First, reservations exist concerning the Alternative Standardized Approach (ASA). Most members believe the ASA should only be available under exceptional circumstances to avoid regulatory arbitrage. Level playing field issues also could arise, especially if not all jurisdictions would offer the ASA and if some jurisdictions permitted partial use with respect to the ASA. In addition, it is possible that the ASA could decrease the credibility of the Standardized Approach unless low-volume non-OECD banking activities were the intended scope of application. For these reasons, **the Basel Committee should clarify the scope of application for the ASA and its place in the spectrum of approaches available to banks.**

Second, although the Basel Committee’s willingness to recognize the risk mitigation effects of insurance in the operational risk regulatory capital framework is welcomed, some modifications are needed here. Recognition of insurance cover for operational risk is critically important for establishing incentives for banks to expand their risk mitigation efforts regarding operational risk and for the markets to develop a wider range of tools to mitigate operational risk. Ideally, risk mitigation would be recognized

in all approaches. At the same time, it is important to be pragmatic and ensure that the framework adequately measures the insurance benefit. **Therefore, banks using the Basic Indicator and Standardized Approach in Pillar One should not be penalized on insurance grounds under Pillar Two. Moreover, Pillar Two assessments should recognize benefits related to insurance cover for operational risk.**

Incentives/Interbank and Sovereign Lending: The QIS 3 results demonstrate discontinuities and disincentives in the treatment of interbank exposures. The Steering Committee continues to express serious concerns with the shortening of the definition of “short-term” down to three months. The 2001 Steering Committee report highlighted in detail the potentially adverse consequences for interbank market liquidity and velocity of money associated with this proposal.³ These views have not changed. Steering Committee members continue to believe that this approach seeks to address macroeconomic issues inappropriately through the regulatory capital framework. This treatment diverges with the Basel Committee’s stated objective of increasing the capital framework’s risk sensitivity because it does not reflect the lower loss levels within this portfolio. **The Steering Committee reiterates its recommendation that, at a minimum, the new definition of “short-term” be set at six months, especially in the Standardized Approach.**

The QIS 3 results for interbank and sovereign exposures also illustrate a sharp increase in regulatory capital for these portfolios. This would create inappropriate incentives for banks to withdraw from or decline participation in interbank markets. Steering Committee members further note that it is highly unlikely that banks will develop statistically significant data sets to validate internal LGD and EAD estimates, given the lack of default events within this class of obligors. Consequently, even “Advanced” IRB banks are likely to need to use regulatory parameters for these portfolios for a long time. The Steering Committee finally notes that the QIS 3 results show a cluster of LGD data points significantly below the regulatory assumed LGD value of 45%. **Therefore, the Steering Committee recommends that the regulatory LGD for interbank exposures be lowered to 30%. The same rationale and recommendation applies to sovereign portfolios, for which the loss experience within the global banking community is not consistent with the supervisory LGD assumptions in this portfolio.**

Incentives/Emerging Markets: Finally, IIF members in the emerging markets indicate that supervisors in their regions may not be encouraged to adopt the IRB Approach. This would seriously undermine efforts to enhance risk management capabilities within banks and supervisory agencies outside the G-10. It could also complicate compliance efforts for internationally active banks from both emerging and G-10 markets. Therefore, **the IIF’s emerging market members suggest that the Basel Committee encourage local regulators to take the necessary preparatory steps to establish frameworks that would allow banks, when technically and operationally ready, to adopt the IRB Approach in their jurisdictions, as local market conditions warrant.** Banks in these regions are concerned that competitive disadvantages may emerge if only the Standardized Approach is made available, whereas foreign banks may use the IRB Approach as approved by their home regulators.

4. Regulatory Coordination/College of Supervisors

The new regulatory capital framework will be implemented on a globally consolidated basis, as is the norm within the bank supervisory arena. This is consistent with modern risk management, which emphasizes global evaluation of risks and allocation of economic capital to cover those risks. However, banking regulation remains a profoundly national activity. No supervisor can relinquish its legislative mandate to protect the domestic banking system. The Basel Committee, throughout its 30-year history,

³ *Report of the Steering Committee on Regulatory Capital, May 2001*

has developed a set of standards clarifying the relative oversight responsibilities between “home” and “host” regulators. These standards do not, however, address how regulatory capital should be allocated, nor do they clarify the relative responsibilities among supervisors that are each technically responsible for model validation.

Consequently, the Basel Committee has established an Accord Implementation Group (AIG) to articulate guiding principles for implementing the new regulatory capital framework. The Steering Committee strongly supports this development, hoping that it will eliminate *ex ante* potential overlaps and conflicts in compliance obligations on a cross-border basis. The Steering Committee has formed a Task Force on Home/Host Issues to address the range of difficult implementation and capital allocation issues that arise within this context. In addition, the Steering Committee notes with approval that the Working Group on Operational Risk (WGOR) and the Basel Committee’s Risk Management Group (RMG) are working collaboratively to explore various possible solutions for addressing regulatory capital allocation issues for operational risk in particular. The challenge here is to ensure that some fair, appropriate, and simple mechanism exists for distributing regulatory capital to cover operational risks, when the regulatory capital assessment process will be undertaken at the consolidated, home country/portfolio level.

College of Supervisors: The Steering Committee and its Task Force underscore the importance of ensuring that the best possible collaboration, coordination, and communication should occur among supervisors jointly responsible for overseeing global banking groups’ activities. Failure to establish a coherent and efficient implementation mechanism for the new capital framework would be fatal to its effectiveness and could impose on banks crippling global compliance costs.

Therefore, **the Steering Committee recommends that the Basel Committee explore the establishment of a College of Supervisors.** For example, for each global banking group, a college consisting of the group’s four to six largest supervisors should exist. The college would serve as a forum for supervisors to share information concerning oversight plans and compliance concerns.

The Steering Committee encourages regulators to coordinate in order to minimize the implementation burden for internationally active banks and to increase the clarity and certainty regarding which supervisory entity will be responsible for various tasks, especially validation. In general, it will be important for the Basel Committee to reduce substantially national discretion options that could undermine efforts to establish a level playing field and could create regulatory arbitrage opportunities. Therefore, **Steering Committee members also strongly encourage the Basel Committee to focus on establishing frameworks for supervisory coordination that do not dilute the authority of the consolidated home country supervisor.** For example, one role of the College of Supervisors could be to attribute a coordination responsibility to the home regulator to eliminate duplicative and contradictory standards being applied to a banking group. A feedback mechanism to the AIG would also be needed so that conflicts could be identified and, if possible, avoided.

The Steering Committee recognizes that this concept requires refinement. It looks forward to engaging the AIG in dialogue concerning how the concept could be implemented to address both supervisory and banking concerns.

Conclusion

The Steering Committee reiterates its continued support for the creation of a risk-sensitive capital framework and its support of the Basel Committee’s efforts in this area. Steering Committee members hope that the recommendations contained in this report will help supervisors refine the new regulatory capital framework and create a set of regulatory capital standards that will benefit both banking regulators and banks. The Steering Committee appreciates the Basel Committee’s commitment to a dynamic and

active dialogue process with the private sector and looks forward to continued dialogue on the framework and throughout the implementation period.

IIF WORKING GROUP ON CAPITAL ADEQUACY

Abbey National plc
ABN AMRO Bank N.V.
Arab Banking Corporation
Arab National Bank
Banca Monte dei Paschi di Siena S.p.A.
Banca Nazionale del Lavoro S.p.A.
Banco Bradesco SA
Banco Itaú S.A.
Banco Mercantil
Bank of America
Bank of China (Hong Kong)
Bank of Montreal
Bank of Nova Scotia
BBVA
BNP Paribas Group
Byblos Bank
CIBC
Citigroup
Commerzbank AG
Crédit Agricole Indosuez
Credit Suisse First Boston
Deutsche Bank AG
Dresdner Bank AG
Fortis Bank
Gulf International Bank
HSBC Holdings plc
ING Group
J.P. Morgan Chase & Co.
KBC Bank N.V.
Lloyds TSB Group plc
MCC S.p.A. – Capitalia Group
Mizuho Financial Group
PKO BP SA
Rabobank Group
RBC Financial Group
Riyad Bank
Royal Bank of Scotland Group
Sanpaolo IMI S.p.A.
Skandinaviska Enskilda Banken
Société Générale
Standard Chartered Bank
Sumitomo Mitsui Financial Group
TD Bank Financial Group
UBS AG
UFJ Holdings, Inc.
Unibanco
UniCredito Italiano S.p.A.
Wachovia Corporation

CHAPTER 2: PILLAR ONE—CREDIT RISK (REPORT OF THE IIF WORKING GROUP ON CAPITAL ADEQUACY)

A. The Standardized Approach

WGCA members generally support the proposals regarding the Standardized Approach, although concern exists regarding the likely increase in required regulatory capital under this approach, particularly for nonretail portfolios. WGCA members therefore propose the following improvements to the proposed Standardized Approach:

Treatment of Maturity: The WGCA reiterates its concerns regarding the creation of a “below three months” definition of “short-term” lending, particularly in relation to interbank and trade finance markets. An excessively short-term definition could seriously undermine liquidity in interbank markets, which should be avoided. WGCA members observe that the proposed definition is contrary to widespread industry practice around the world. At the same time, the WGCA recognizes that retaining the current 364-day definitions is not politically feasible. **Therefore, the WGCA recommends that, at a minimum, the definition of *short-term* be extended from “below three months” to “below six months.”**

Collateral: The WGCA appreciates the modifications introduced by the Basel Committee to its original proposals, which expand recognition to a wider range of collateral instruments. However, further improvement is still needed, especially in light of the types of lending practices that are common among the group of banks that most likely will adopt the Standardized Approach. **WGCA members, as well as their colleagues from the emerging markets, believe that additional forms of collateral should be available under the Standardized Approach.** They also encourage increased parity of treatment for collateral instruments across the Standardized and IRB Approaches so that all banks receive regulatory capital recognition for prudent risk mitigation activities, albeit with an appropriately designed incentive structure to encourage progress toward more advanced approaches. **In particular, collateral on commercial property as well as receivables should be recognized in the Standardized Approach.**

To a certain extent, implementation of this recommendation might have limited effect on actual required regulatory capital since the Basel Committee has indicated that the entire framework will be calibrated to generate roughly the same amount of capital as the current standards. This effectively creates a floor for regulatory capital at the existing 8% level. However, it is important that the framework not create disincentives for banks to engage in traditional good risk management practices such as taking physical collateral. Full implementation of this incentive could ultimately require a reconsideration of the calibration given that it is equally important to ensure that appropriate incentives exist for banks to move along the spectrum and qualify for the IRB Approach.

Increase Number of Risk Weights—Corporate Exposures: **Bankers from emerging markets also strongly recommend increasing the granularity of the proposed risk weight buckets.** These banks believe that a steep cliff effect between Single A and Triple B ratings within the Standardized Approach is both inappropriate and problematic given the large range of credit quality within this band. They therefore **recommend introducing an additional risk bucket of 75% and the modification of this band of ratings** to reflect more appropriately the risk characteristics associated with these grades of credit quality and to enhance risk sensitivity in the framework. Emerging market banks believe increased risk sensitivity in the Standardized Approach will improve the regulatory framework’s effectiveness in aligning market and regulatory incentives, especially for those banks unable to use the IRB Approach either due to the scope of their businesses or due to the readiness of local markets and regulators to implement the IRB umbrella.

Local Currency Exposures—Corporate Portfolio: **Bankers from emerging market regions also recommend that the lower risk weights provided for sovereign exposures funded in local currency (Paragraph 28) be extended to corporate exposures.** These bankers note that in riskier jurisdictions exposures in local currency are significantly less risky and that this lower risk profile should be recognized in the new regulatory capital framework.

B. The IRB Approach

Most WGCA banks will be subject to the IRB Approach, and they currently are preparing their internal compliance systems for implementation. The WGCA remains committed to the development of a regulatory capital framework that progressively relies on banks' internal credit risk measurement systems.

When the Basel Committee announced in 1999 its proposals for a new capital framework, the WGCA proposed the spectrum approach, in which regulators would use bank internal systems to set regulatory capital requirements, using as many internal estimates as possible and subject to strict regulatory standards and requirements.⁴ In 2001 the Basel Committee proposed the IRB Approach, in which a bank's internal assessments of risk drivers serve as inputs to the capital calculation. However, the Basel Committee created two versions of the IRB Approach (Foundation and Advanced), differentiated primarily by which quantitative inputs would be specified by supervisors. The Basel Committee has also decided that the hurdle should be set at the PD estimation level, permitting banks to use internal LGD and EAD estimates only in the Advanced IRB Approach.

The WGCA has strong reservations regarding the proposed Foundation IRB Approach because it creates discontinuities between internal PD estimates and LGD estimates. These two parameters are linked. A bank operating a high-PD business can still run a relatively low-risk credit risk book if its collections processes and other policies make it possible for the bank to have correspondingly low LGDs. Conversely, a low-PD bank could actually be more risky than its PD structure implies if its LGDs are consistently high. Discontinuities between internal PDs and LGDs send a signal to bank management and supervisors that mistakes and incorrect assumptions are being made. The proposed two-stage IRB Approach establishes unnecessary hurdles and differences between these two parameters, which lack clear risk management justification.

The WGCA believes that most of the problems associated with the IRB Approach are derived from an overly prescriptive approach used to set the regulatory standards for the PD, LGD, and EAD parameters. In addition, problems arise due to unnecessary differences between the Foundation and Advanced IRB Approaches. Chief among these are the treatment of maturity and the recognition of collateral. Resolving these issues is complicated by the WGCA's parallel concern that if the Foundation IRB Approach becomes too attractive or inconsistent with real market practice, the incentives for banks to invest in costly systems to generate internal LGD and EAD estimates will be undermined. These bankers believe that regulatory capital incentives will drive risk management decisions.

WGCA members also worry that the Foundation IRB Approach's emphasis on only one credit risk measurement parameter over all others (PD estimation) could create myopic analysis within banks seeking to exit the Standardized Approach and within market participants. Finally, the creation of separate approaches not only for parameter validation but also for the treatment of maturity and the recognition of collateral will impose on banks excessive implementation costs. Foundation IRB banks would need to create compliance systems that are inconsistent with existing robust internal risk management approaches, only to dismantle these systems when the bank achieves Advanced IRB status. Conversely, the creation of these compliance systems could generate disincentives for banks to invest in additional technical

⁴ *Steering Committee and WGCA Reports, May 2001*

improvements to qualify for the Advanced IRB Approach because the short-term capital investment costs associated with Foundation IRB compliance would subsequently be lost.

Although the WGCA supports the use of supervisory-determined LGD parameters, members also believe a smoother transition should be available for those banks enhancing their risk management capabilities. In particular, the WGCA believes it will be important for the capital framework to encourage banks to use internal LGD estimates on a portfolio-by-portfolio basis as warranted by data availability and cost–benefit considerations. This recommendation is distinct from a partial use approach for individual portfolios because it seeks to ensure that a smoother and more effective transition exists for the entire bank within the IRB umbrella.

In addition, WGCA members note that the QIS 3 results show that for several portfolios the proposed framework fails to provide incentives for banks to move from the Standardized Approach toward the IRB Approach. In fact, it would seem that in many circumstances it would be exceedingly costly and burdensome for banks to move from the Standardized to the IRB Approach and that the benefits for making such a move would be minimal.

Specific Recommendations

Portfolio-Specific Incentives Needed: The WGCA recommends several modifications to the CP3 proposals, based on the reasoning presented above. In general, **WGCA banks observe that the QIS 3 results demonstrate the need to revise further the treatment of sovereign, bank, qualifying revolving exposures, specialized lending, and securitized assets to prevent regulatory capital requirements under the IRB Approach from exceeding those under the Standardized Approach and to ensure that adequate capital incentives exist for banks to move along the IRB continuum, replacing supervisory parameters with internal parameters as data and cost–benefit considerations warrant.**

Treatment of Maturity: In the WGCA’s view, maturity is the highest priority area in which unnecessary differences between the Foundation IRB and the Advanced IRB should be eliminated. **The WGCA recommends that Paragraph 288 be modified by eliminating the mandatory implicit maturity of 2.5 years for corporate, bank, and sovereign exposures. This assumption should be used only as a fallback alternative for those banks without internal methodologies for assessing maturity effects, subject of course to supervisory approval. Therefore, the treatment under Foundation and Advanced IRB should be the same, without the need for national discretion in this area. Specifically, a continuous maturity function should be available for both the Foundation and Advanced IRB Approaches, including exposures less than one year (although a separate function for exposures under one year may be needed).** WGCA members further recommend that the limitations contained in Paragraph 290 be eliminated so that the sharp cliff effects and excessive complexity associated with the current proposal can be reduced. Paragraphs 291 and 294 should be modified accordingly. The WGCA believes that these modifications could help to calibrate the risk-weighting function by increasing sensitivity to the relationship between credit risk profiles and maturity.

Probability of Default (PD): The WGCA believes that additional clarity and consistency are needed regarding the treatment of PD. **Member banks continue to suggest that the best approach should be based on each bank’s internal risk management policies and practices.** WGCA members are concerned that an explicit regulatory preference (e.g., the use of long-run averages) would create unnecessary conflicts between internal risk management and supervisory requirements. **The WGCA therefore recommends that Paragraph 409 be revised by establishing a neutral principle for PD estimation, which would allow banks to use PD estimates consistent with their internal risk management policies,** which, under the proposals, are subject to supervisory oversight under Pillar 2.

WGCA members recognize that the use of long-run averages in the regulatory capital framework serves multiple purposes, chief among these being to generate a conservative and prudent capital framework and address at least in part potential procyclicality. Finding better ways to address procyclicality could decrease the need to address this issue through this validation process. WGCA members also would like to underscore that they do not oppose the use of long-run averages per se. They only seek to increase the alignment of supervisory and risk management methodologies in a manner that would permit banks to use point-in-time ratings when circumstances warrant, subject of course to supervisory approval and oversight.

Validation of Default Probabilities: The WGCA strongly believes that the current proposals present an overly restrictive approach to PD validation. Moreover, various textual references to PD validation seem to confuse the role of PDs. **WGCA members believe that the Basel Committee should eliminate from the proposals all text that seems to infer that PDs have an exact predictive value. The new framework should make clear that PD is a forward-looking estimate of the probability that each obligor may default over the coming year. The framework should also recognize, however, that actual defaults experienced across the PD distribution may in practice differ from the expected PDs.** In addition, Paragraph 425 establishes a five-year data requirement. Concern exists that the flexibility to use a transitional arrangement to validate PDs, as provided by Paragraph 233, will not be available in all jurisdictions. **Therefore, the WGCA strongly recommends that availability of a transitional regime for PD validation be mandatory rather than subject to national discretion.**

Definition of Default: The proposed definition of default has improved significantly since 2001. However, despite the greater flexibility introduced, concern continues to exist regarding the proposed standard definition of default, which by its nature will not converge either with banks' internal definitions or with market practice. **The WGCA therefore urges the Committee to rely on prevailing market practices, at least in particular portfolios. For example, when market practice in retail portfolios does not use "days past due" as a trigger for default and, instead, uses an alternative but equally rigorous approach (e.g., behavioral scoring models), the regulatory capital framework should not require banks to track the days past due. In this area, national discretion would clearly allow regulatory requirements to be more aligned to local market structure.**

In addition, a number of bankers from the Middle East and North Africa region suggest that perverse incentives could arise if the standard regulatory definition establishes nonaccrual status as the equivalent of default. Concern exists that the regulatory definition could be interpreted as requiring banks to use nonaccrual status as an event of default (which is not the standard in some jurisdictions). The result could be that banks might be incentivized to place assets in nonaccrual status only after default has occurred, which would be contrary to good risk management practices. Banks in the region therefore request that the Basel Committee provide clear guidance to regional supervisors to avoid this situation.

Loss-Given Default (LGD) Validation: The proposed LGD time series requirements are considered unrealistic and excessively strict. **The WGCA strongly recommends that a transitional arrangement be created so that banks have a real chance of validating internal LGD estimates when the new framework is implemented in 2007.** As currently drafted, the proposal virtually ensures that most banks will not be able to qualify to use their internal LGD estimates when the framework takes effect because the final regulatory definition of default will only have been set in 2004.

In addition, certain requirements established for particular portfolios are considered excessively prescriptive. LGD validation cannot and should not be performed as a pure statistical exercise. **WGCA members recommend that the Accord be redrafted to explicitly permit a wide range of validation methodologies and rigorous procedures consistent with internal risk management practice,**

including, for example, developmental evidence, internal consistency checks, external data, and, of course, statistical testing.

Finally, the WGCA recommends the elimination of the temporary LGD floor established for mortgage exposures in Paragraph 235. This standard is considered too conservative and not based in real loss experience. The WGCA notes that substantially different market structures and historical experiences generate legitimate differences in LGDs across mortgage portfolios and that those differences should be recognized in the regulatory capital framework.

Credit Risk Mitigation (CRM): The WGCA recognizes and appreciates the Basel Committee's efforts to expand the recognition of CRM techniques and their impact on capital requirements. However, WGCA members are concerned by the conservative approach established for CRM treatment under the Foundation IRB Approach. WGCA members indicate that the proposed qualification standards for recognizing internal CRM techniques often are not compatible with existing systems. The additional costs of achieving compliant CRM will far outweigh the modest LGD reduction contemplated in CP3. This not only is counterintuitive but also could create perverse incentives for banks not to use CRM. Streamlining the CRM framework would have the additional benefit of significantly reducing the complexity of the framework. **Specifically, the WGCA recommends that the CRM recognition system currently proposed for the Advanced IRB be available in the Foundation IRB. In addition, the WGCA believes that the artificial restrictions on the type of guarantors recognized under the Standardized Approach (Paragraph 165) should be eliminated as no justification is found for requiring a specific A- or better rating. The WGCA believes it would be simpler to use only one recognition standard, namely the one currently proposed for use only in the Advanced IRB.**

Confidence Interval: WGCA members note that the use of the term "confidence interval" in the context of the regulatory capital proposals is misplaced. WGCA members believe that the standard confidence interval within the proposal refers to a calibration activity setting the capital framework outcome to the 8% target based on the current Accord. This is an inappropriate use of the term.

WGCA members believe that the Basel Committee should be transparent in its calibration efforts and should avoid using the term "confidence interval" in this context. WGCA members underscore that a discussion of confidence intervals would be more appropriate in the context of full regulatory capital recognition of banks' internal credit risk models. The Basel Committee has stated that the new Accord will not yet establish such recognition, and, therefore, the WGCA believes that references to confidence intervals in the regulatory capital framework at this stage are misplaced. In addition, the WGCA doubts that a 99.9% (or higher) confidence interval is an appropriate *minimum* industry standard, especially given the paucity of default data for highly rated obligors. Clarity in this respect is necessary so that the framework avoids creating theoretical expectations that cannot be fulfilled in the future when standards for recognizing credit risk models are created.

WGCA members also underscore that acceptance of internal risk models for regulatory capital purposes will ultimately require some standard confidence interval to be used in those models, as is currently the case for market risk. However, insufficient data exist at present to determine what that confidence interval should be either for credit or for operational risk. Additional research will also be needed to determine whether the confidence interval for these two risk silos necessarily needs to be equivalent to generate appropriately prudent supervisory results. **Therefore, the WGCA recommends that the new regulatory capital framework remain silent with respect to the target confidence interval pending further research on how best to incorporate risk models into the regulatory capital framework.**

Credit Conversion Factors (CCFs): Concern continues to exist regarding the inconsistent treatment of CCFs. The treatment of off-balance-sheet items, in particular commitments, differs between the Standardized and the Foundation IRB Approaches without any clear justification. This WGCA report does not address the full range of derivatives-related issues present in the Basel proposals. However, WGCA members note that the proposed treatment of CCFs is inconsistent with risk sensitivity and the objective of providing capital incentives for more sophisticated risk approaches. **Therefore, WGCA members recommend the 75% CCF currently established for commitments in Paragraph 281 be adjusted based on maturity.**

The WGCA reiterates that the streamlining recommendations presented in this report follow the overarching principle that substance should always take precedence over form. In particular, the achievement of supervisory objectives should take precedence over the sometimes overly detailed standards established by regulators. The Basel Committee should consider emphasizing in the Accord the flexible approach that will be necessary for its successful implementation, in particular during the early stages of the implementation process.

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CHAPTER 3: PILLAR ONE—OPERATIONAL RISK (REPORT OF THE WORKING GROUP ON OPERATIONAL RISK)

The Institute's WGOR notes that significant advances in the understanding and management of operational risk have occurred throughout the development of the new regulatory capital framework for operational risk. These advances have been captured in an increasingly dynamic and flexible proposed regulatory capital framework, largely as a result of robust dialogue between banks and the Basel Committee over the past four years. The WGOR largely supports the proposals presented in CP3. In particular, the WGOR strongly supports the creation of Advanced Measurement Approaches (AMAs), given that the Basic Indicator and Standardized Approaches rely on a flawed driver (gross income) and generate incentives for unproved operational risk management systems. This is because banks using these approaches could operate using poor internal control systems while potentially being subject to more lenient regulatory capital requirements than under the AMA.

Consequently, a number of important refinements are needed before the framework can achieve its stated goals of developing a risk-sensitive standard that encourages banks to enhance their internal risk management practices. This chapter highlights the key issues that remain to be resolved, from the WGOR's perspective.

Calibration: The calibration and regulatory capital incentives between the Standardized and Basic Indicator Approaches require refinement to generate sufficient incentives for banks to enhance their operational risk management capabilities. The current proposal could, in certain circumstances, create incentives for banks with the highest inherent operational risks to stay within the Basic Indicator. This result is inappropriate and should be avoided. **In the past, the WGOR had recommended that the beta values in the Standardized Approach should not exceed the alpha set in the Basic Indicator. The WGOR would like to reiterate that message.** The WGOR would also like to explore with the Basel Committee's Risk Management Group (RMG) whether they have any plans to recalibrate the operational risk framework either before 2006 or after implementation.

Concern also exists that the combination of the three pillars (including market discipline) effectively could establish a minimum capital requirement exceeding the Pillar One standards. In particular, concern exists that Pillars Two and Three will be used frequently to increase regulatory capital required in addition to the amount required under Pillar One. In addition, it would be problematic to hardwire calibrations, particularly for a 2007 framework based on 2001 data. Consequently, the WGOR recommends that the operational risk calibration be revisited in 2006 so that changes can be made based on more up-to-date data sets.

Gross Income: The WGOR generally supports the proposed gross income definition. Concerns in this area relate toward promoting consistency in its implementation. In particular, **WGOR members would like to foster consistency in mapping losses and gross income. This could be achieved during the implementation period if the Basel Committee or its RMG could compile some frequently asked questions and supervisory answers to those questions on this issue. The goal here is not to limit flexibility but, rather, to avoid significant disparities in implementation standards.**

Loss Classifications: **The WGOR generally also supports the proposed loss classifications for use in the operational risk regulatory framework.** However, it would like to underscore that the classifications and related decision tree for determining how to use the classifications were designed at a rather early stage in the evolution of the regulatory capital framework. It is highly likely that additional data and experiences will require the framework to adapt. Therefore, **the WGOR recommends that the Basel Committee incorporate flexibility into the standards and expressly indicate that the classifications are likely to evolve with industry practice over time.**

The proposed framework has a number of shortcomings. For example, events and effects are mixed. In addition, different interpretations exist regarding how to use the classifications. The classifications themselves are outdated. They do not provide categories for SARS-type events and September 11th-type events to fit into the hierarchy. Some of the difficulties relate simply to taxonomy. Proposed loss event 5 (damage to physical assets) is particularly problematic as currently crafted. Incorrect classifications will undermine the design of insurance products to fit this category. WGOR members also recognize that complete renovation of the classifications at this stage is unrealistic, because no such redesign can be undertaken before better data are collected. **Therefore, the WGOR recommends that the Basel Committee issue the classification with a significant health warning to set the stage for changes as the data environment improves.**

Alternative Standardized Approach (ASA): The WGOR has a number of reservations concerning the ASA. At best, most WGOR members believe the ASA should only be used under exceptional circumstances to avoid regulatory arbitrage. Level playing field issues also could arise if only some jurisdictions offer the ASA in whole or in part. For example, in business lines in which spreads exceed 3.5%, the ASA could look very attractive. In addition, it is possible that the ASA could decrease the credibility of the Standardized Approach unless low-volume non-OECD banking activities were the intended sole scope of application. For these reasons, **the WGOR strongly recommends that the Basel Committee clarify the scope of application for the ASA and its place in the spectrum of approaches available to banks. In addition, the WGOR recommends that the establishment of any approach for calculating regulatory capital should not be relegated to a footnote, in which additional confusion could be created regarding the credibility and availability of the approach.**

AMA Quantitative Requirements/Confidence Interval: The operational risk proposal suggests that a 99.9% confidence interval be established for any model seeking recognition within the Advanced Measurement Approaches (AMAs). The proposal further states that this requirement seeks to establish equivalence between the operational risk and credit risk frameworks. The WGOR strongly opposes the establishment of a specific confidence interval for operational risk models at this stage given that it is unclear exactly how operational risk models will function. WGOR members also note that the proposed confidence interval would likely be inconsistent with a minimum standard, especially because in the operational risk context it is possible that the error rate at this confidence interval would be excessively high and could erode the value of such a parameter. Finally, it is unclear whether equivalence with the credit risk framework is appropriate, especially given that banks' internal credit risk models will not be recognized in the regulatory capital framework at this time. Consequently, the WGOR recommends that references to a specific confidence interval for operational risk models be dropped at this time. **The WGOR notes that prior versions of the proposal have referred to the confidence interval as an example ("e.g.") rather than a requirement ("i.e."). This would be a preferred approach, especially if the Basel Committee seeks to use a confidence interval to refer to a bank's total minimum capital or solvency target, not just for the credit or operational risk components.**

AMA Quantitative Requirements/Correlations: The WGOR also is concerned that the CP3 proposal may establish an impossible standard to meet regarding the treatment of correlations. WGOR members note that different ranges of diversification exist at different banks. If the assumed correlation is 100% across 56 cells used to calculate operational risk exposures, the framework would generate an inappropriate capital requirement. Most WGOR members believe that the term "correlations" as used in CP3 actually refers to dependency and comovement rather than "correlation" as that term is understood within the strict mathematical sense. Accuracy in the use of terms here is critically important because banks should be encouraged to use internal categorizations and business lines for regulatory capital purposes, and the confidence interval should vary based on the number of internal business lines the bank used. Banks should not be penalized for calculating capital in a granular manner, yet that is the likely consequence of using the term "correlation" in this context.

AMA Quantitative Requirements/Flexible Application: The implementation and interpretation of the “use test” regarding the four AMA elements (internal data, external data, scenario analyses, and business environment/control factors) should be flexible, permitting banks to use different methodologies and emphasizing different elements based on compatibility with internal risk management. In addition, it should be noted that the same logic recommended in the IIF documents for validating credit risk internal ratings should apply to validating operational risk measurement approaches. Namely, validation mechanisms should not be limited to purely statistical approaches, and the validation mechanisms should be compatible with a bank’s internal risk management methodologies.

Insurance: The WGOR welcomes the Basel Committee’s willingness to recognize the risk mitigation that insurance can provide within the operational risk regulatory capital framework. This recognition is critically important for establishing incentives for banks to expand their risk mitigation efforts regarding operational risk and for the markets to develop a wider range of tools to mitigate operational risk. Ideally, risk mitigation would be recognized in all approaches. At the same time, the WGOR recognizes the importance of pragmatism and the need to ensure that the framework adequately measures the insurance benefit. **Therefore, the WGOR recommends that banks using the Basic Indicator and Standardized Approaches in Pillar One not be penalized on insurance grounds under Pillar Two. The WGOR further recommends that Pillar Two assessments can recognize benefits related to insurance cover for operational risk.**

Within the AMA, the WGOR is concerned that the proposed 20% limit on insurance recognition is inappropriately small and the standards for recognizing insurance are exceedingly prescriptive. For example, if the 20% limit is taken into consideration after the adjustment for credit risk, regulatory capital incentives to purchase insurance may not exist. The explicit mapping requirement between insurance and specific categories also would be very difficult to achieve, especially given exclusion clauses. Both banks and insurance companies expect new insurance products to be coming to the markets in the next decade. Therefore, **the WGOR recommends that the new capital framework should be flexible regarding insurance recognition in the AMA to foster innovation and encourage banks to achieve coverage and hedge risks.**

Concern also exists regarding the treatment of captive insurers. WGOR members believe it is excessively onerous to require banks to deduct capital investments in insurance captives and then prohibit recognition of the protection provided by those captives on an arms-length third-party basis. The WGOR would be pleased to work with the RMG on how best to resolve these issues during the implementation period so that an appropriate framework for recognizing operational risk mitigation instruments can be crafted.

Home/Host Issues: As noted, the Steering Committee is addressing a wide range of home/host issues through its Task Force on Home/Host Issues. The Steering Committee has also asked the WGOR to proceed in its dialogue with the Basel Committee’s RMG concerning the operational risk aspects of the home/host issue. This work is currently under way, and it is guided by two principles. First, regulatory capital will be calculated on a bank-wide consolidated basis under the proposal. **Therefore, an appropriate mechanism for allocating regulatory capital to the separate business entities must exist. Second, any allocation mechanism must be as simple as possible to avoid generating increasing compliance costs.**

Overlaps with Credit Risk: The WGOR notes that the Basel Committee makes specific proposals regarding the disaggregation and amalgamation of credit and operational risk data under Paragraph 633. Concern exists that this paragraph could be interpreted incorrectly to create duplicative and costly data collection burdens because it would require flagging credit risk losses in the operational risk database even though such losses would not affect regulatory capital for operational risk. **This issue could be**

resolved fairly easily. **The WGOR recommends two corrections: the paragraph should refer to “operational risk management” instead of “operational risk databases,” and the last sentence of Paragraph 633 should be deleted.**

Threshold for Losses: The proposed threshold for collecting losses established in bullet point 2 of Paragraph 633 has also generated concerns within the WGOR. That bullet point establishes as an example a *de minimis* gross loss threshold for internal loss data collection, at 10,000 euro. This threshold might be too low for high-volume businesses. In addition, as a gross loss threshold, the data capture burden could be significant as it could include near misses. The appropriate loss threshold should be set in relation to the AMA methodology used by a bank and the nature of the business line. **The WGOR therefore recommends eliminating the example and replacing it with a standard requiring thresholds to be set in relation to business line and model characteristics.**

Conclusion: The WGOR hopes the Basel Committee finds these views helpful as it finalizes the operational risk regulatory capital framework. Bankers within the WGOR remain committed to working with regulators on this project going forward and welcome the Basel Committee’s efforts to craft a meaningful and flexible framework that can evolve with market practices.

CHAPTER 4: PILLAR TWO—SUPERVISORY REVIEW

The Steering Committee, WGCA, and WGOR support the development of a supervisory review process under Pillar Two. WGCA members believe that a transparent and organized relationship between banks and their supervisors will contribute effectively to promote and ensure adequate internal risk management, measurement, and control practices as well as compliance with the specific requirements established for qualification for the IRB Approach. However, concern exists that the current draft creates uncertainty regarding how Pillar Two will be applied. In particular, the IIF recommends that the **Basel Committee should avoid duplication and revise the Pillar Two text to ensure transparency regarding the actual minimum requirement for banks operating under the new framework.**

The Basel Committee proposes four principles to guide the supervisory review process. Although the development of a regulatory capital framework structured on mutually reinforcing pillars is welcomed, concern exists that insufficient differentiation exists between Pillar One (minimum capital requirements) and Pillar Two (supervisory review process). In particular, concern exists that the current draft will create confusion concerning the actual minimum capital standards applied both within a banking system and to an individual bank. Proposed Principle 3 could be highly problematic, because it states that supervisors should expect banks to operate above *minimum* regulatory capital ratios.

Although in practice most leading international banks as well as several banks in emerging markets operate above regulatory minimums, it is unclear whether this will continue to be the case. A large spread between economic and regulatory capital currently exists due to flaws within the existing framework. Increased risk sensitivity and efforts to align the regulatory capital framework with internal practices could diminish this spread substantially. In this context, then, it is difficult to determine how much additional capital may be expected of banks pursuant to proposed Principle 3 either by regulators or by market participants. **WGCA members question the appropriateness of establishing additional system-wide regulatory capital buffers for all banks different than the ones already included under Pillar One.**

The WGCA believes Pillar Two should provide a framework for making judgments on an individual, bank-by-bank basis and should provide supervisors with the tools necessary for taking bank-specific measures. However, the proposed Principle 3 instead recommends that supervisors expect all banks in their jurisdictions to operate above the Pillar One minimum requirements.

The WGCA believes that Pillar One already establishes adequate conservative prudential buffers. WGCA members believe that establishing a general principle that supervisors “will typically require (or encourage) banks to operate with a buffer, over and above the Pillar One standard” unnecessarily introduces uncertainty as to what the real capital requirements for banks might be, blurring the line that should separate system-wide regulatory minimum requirements (Pillar One) from bank-specific regulatory requirements that are a product of supervisory activity (Pillar Two). The proposed principle also is inconsistent with the Basel Committee’s stated goal of keeping regulatory capital roughly constant within the financial system. Specifically, the initial goal of preserving the existing minimum 8% capital level is incompatible with a specific regulatory requirement that all banks must operate above that minimum. The net result could be that banks would be required to operate at higher regulatory capital requirements, with the effective minimum regulatory capital for each bank being substantially higher than the existing 8%. Furthermore, the proposals would also create excessive burdens in jurisdictions where capital requirements are well in excess of 8%, as the proposed text fails to make clear what the real minimum regulatory requirement is.

WGCA members further note that minimum required capital (estimated using the Basel Committee's QIS 3 results) would increase once operational risk is taken into account. If all regulators (and rating agencies) would require banks to operate at more than that minimum requirement, there would be a *de facto* increase in regulatory capital. In practical terms, the effect of the proposed Principle 3 could be to require all banks to operate at an investment grade capitalization level (BBB). No participating IIF bank seeks to operate at subinvestment-grade levels. However, concern exists that raising required regulatory capital to require investment-grade cushions could have significant systemic implications, especially if the target capital levels are not transparent. The WGCA, in its response to the earlier consultative paper, noted that the new framework could be interpreted as a shift away from an explicit capital framework based on minimum requirements toward one based on "adequate" levels of capital and an "appropriate margin above the minimum regulatory capital requirement." In the WGCA's view, transparency in banking markets could actually decrease if Pillar Two established a dynamic in which Pillar One only initiated the basis on which regulators set regulatory capital cushions for banks. The lack of transparency as to what the minimum requirements are, or the establishment of system-wide requirements, could have negative effects on the perception that markets have regarding the solvency of a particular bank and the banking system as a whole.

In addition, WGCA members note that most global financial institutions do not manage themselves in relation to regulatory capital but, instead, to economic capital. The combination of a supervisory principle in Pillar Two requiring banks to operate above minimum regulatory capital and a disclosure requirement in Pillar Three could generate inappropriate market pressures for banks to operate in relation to regulatory capital. Such an outcome would be fully inconsistent with proposed Principle 2, which relies on banks' internal capital adequacy processes and systems. In this context, concern exists that some regulators could interpret proposed Principle 2 as a duty to compare internal and external (regulatory) model results, requiring banks to hold capital according to the highest figure. This dynamic would introduce unnecessary uncertainty regarding the actual minimum standard and undermine the transparency of regulatory capital requirements. Finally, WGCA members note that Pillar Two requirements apply to the bank as a whole and that the most meaningful review of a bank's internal process is best undertaken at a consolidated level. Qualitative standards applied pursuant to Pillar Two can only be assessed at the consolidated level given existing consolidation requirements in most countries; **therefore, the WGCA recommends that the Basel Committee clarify the text of Pillar Two in a manner that explicitly indicates that only qualitative reviews can and should be conducted at the subconsolidated level.**

For these reasons, **the WGCA suggests that proposed Principle Three be revised to clarify the real components of the minimum required regulatory capital for all banks.**

Banks in emerging markets also note a particular concern in those jurisdictions where the minimum regulatory capital requirement is well in excess of 8% (e.g., 12%), which is usually prompted by the need to cope with riskier environments. Concern exists that as those jurisdictions transition into the new Accord the higher capital target (e.g., 12%) would create severe difficulties for the implementation of IRB approaches. In this situation, banks would be penalized by double-counting the higher risk of the economy, first by higher PDs and second by a higher capital target (e.g., 12%). **Supervisors in these regions, therefore, need to be aware of this issue and address it properly when implementing the new Accord.**

Finally, the WGCA would like to express its concern for the link established under Pillar Two between the capital framework and strategic and reputational risks. The WGCA notes that it is problematic to assign responsibilities to regulators and supervisors over the strategic decisions of their supervised banks. Furthermore, the WGCA cautions against adopting a quantitative approach for dealing with reputational risk. The responsibility for protecting a bank's reputation should not be reduced to a

compliance function. More important, it is far from clear whether regulatory capital is an appropriate tool for addressing reputation and strategic risks. **The WGCA, therefore, suggests avoiding capital rules for these types of risks.**

CHAPTER 5: PILLAR THREE—TRANSPARENCY AND MARKET DISCIPLINE

The IIF underscores its strong support for increased transparency in banking markets. It supports the Basel Committee's efforts to develop disclosure standards that will provide meaningful, timely, and relevant information to the market in a manner that enhances market discipline. The IIF appreciates the Basel Committee's commitment to developing a modern framework that responds to and reflects market needs. The Transparency Group has sought to decrease excessive prescriptiveness in the disclosure framework. In particular, the WGCA appreciates the increased flexibility IRB banks would have regarding disclosure of PD bands. This flexibility will allow banks to align better their internal risk management practices with their disclosure requirements.

Bankers in the WGCA also support the revised treatment of proprietary and confidential information. The new proposal should facilitate meaningful disclosure without jeopardizing sensitive customer and competitive information. WGCA members believe, however, that effective coordination mechanisms will need to be developed among supervisors in different jurisdictions so that this principle is applied uniformly across borders.

These aspects of the new proposals are considered significant improvements. However, **WGCA banks continue to believe that further improvements should be introduced to the disclosure proposals to eliminate remaining excessive prescriptiveness. In particular, a more principles-based approach to disclosure would permit banks and markets to develop appropriate practices that can respond to risk management innovations without revising the text of the Accord. Hardwiring into the Accord prescriptive disclosure requirements could constrain the framework's ability to adapt to evolving banking and risk management practices.**

In addition, concern exists that analysts and other third parties could misconstrue PD information as providing a meaningful insight into a bank's risk profile, without taking into account the other parameters. This could increase market volatility related to misunderstanding the frequency and volume of rating changes without reference to actual risk exposures. This could be a disincentive for third parties from conducting a meaningful analysis of a bank's risk mitigation and risk management activities.

The proposed comparison between estimates and actual figures may also generate more confusion rather than more transparency. Back-testing and validation are complex functions, and interpretation of the results requires more nuance than a simple numerical comparison. Deviations from expectations can occur for a variety of reasons, not all of which indicate that problems exist in a bank's internal rating system. For example, mergers will generate significant discontinuities between estimates and actuals. WGCA members are concerned that a nuanced understanding of these data points may not be achievable in environments in which analysts, pressed for time, may not fully understand the issues underlying the numbers.

Experience in financial markets indicates that market participants seek and value more meaningful qualitative information that can place quantitative data into context. The international accounting framework seems to be responding to this demand, converging into a principles-based approach that gives higher relevance to qualitative disclosures. WGCA members believe that excessively prescriptive disclosure requirements could flood the market with a large amount of meaningless data. They also question whether increased quantitative disclosure would be used appropriately and efficiently by the analyst community. Furthermore, WGCA members do not believe that requiring banks to disclose the parameters and other data used under Pillar One to validate a bank's minimum regulatory capital requirements using the IRB Approach provides the right mechanism for achieving comparability among banks.

The WGCA therefore continues to prefer the establishment of a Pillar Three framework based on mandatory general principles, with qualitative guidelines, complemented by illustrative examples and recommended practices. Such architecture would preserve flexibility for banks to provide more targeted disclosures consistent with their internal structure (and applicable accounting standards) while also ensuring that some specific quantitative items were part of the overall framework.

The WGCA appreciates the increasing efforts of the Basel Committee to coordinate and work collaboratively with international accounting authorities. Bankers believe that banking regulators and accounting standard setters should work closely so that the accounting framework and the Pillar Three framework do not conflict. Because both frameworks are currently being revised, it is critically important that increased collaboration generates a consistent disclosure framework. Bankers are concerned that with the level of prescriptiveness still present in the Pillar Three proposals the burden of reconciliation between accounting and supervisory requirements would be overwhelming. Furthermore, both G-10 and emerging market banks have noted how additional disclosure requirements are placed on banks by local stock exchanges and securities regulators. These multiple compliance burdens could be very difficult for banks to meet. Qualitative guidelines under Pillar Three would allow harmonization of the requirements more easily than would strict prescriptive rules. Therefore, **the WGCA continues to recommend that a flexible approach be adopted for Pillar Three requirements in close collaboration with international accounting standard setters so that the consistency and meaningfulness of bank disclosures can be significantly improved.**

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