The Basel Committee on Banking Supervision

The New Basel Capital Accord

Response to Consultative Documents dated

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KPMG International

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1 Introduction

1.1 Why is KPMG responding?

1.1.1 KPMG* is one of the leading global professional service organisations, whose member firms offer a range of audit, tax and advisory services. Our member firms' banking audit clients collectively represent approximately 25 percent of the world's largest banks, and range from the largest international banks and financial services groups to some of the smallest regional banks.

External professional advisors are playing an increasingly significant role in advising and assisting firms to achieve compliance with regulatory requirements and standards. This complements the significant role such audit and advisory firms play in the bank supervisory framework in many countries by providing a source of independent verification from which regulators are able to take comfort. In this way, they support and strengthen the supervisory process and help regulators facilitate a greater degree of consistency of standards across banks.

As the Committee's proposed approach will place greater reliance on banks' own internal processes and systems, we believe that there will be an even greater need for independent validation by external professional advisors, not to mention the need for advice and assistance in implementing the new requirements. We are prepared to continue helping banks and regulators to introduce and supervise the revised capital adequacy framework.

We also note that the implementation of the Committee's proposals will pose significant challenges for regulators around the world. From our discussions with regulators in a number of countries, it is clear that many regulatory bodies do not yet have enough staff with the types of specialised skills needed. Firms such as KPMG are prepared to provide support and assistance to regulators in this important area.

We are aware that the Committee has indicated that there are a number of matters relating to the detail of Basel II that remain unresolved. We anticipate that banks and industry bodies will focus on these detailed matters that have not yet been finalised. In this response, we have tried to focus only on matters that are relevant to KPMG's anticipated role in the implementation, validation, compliance and audit process. In preparing our response, we have, of course, consulted many of our member firms' internationally active banking clients. However, the views expressed in this response are those of KPMG alone and may not in all instances accord with the views of these clients.

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* As used herein, unless otherwise indicated, "KPMG" refers collectively to KPMG International, a non-operating association, and/or its member firms, which provide professional services to their clients.

2 Executive Summary

2.1 The overall proposals

KPMG is supportive of the Basel Committee's New Basel Capital Accord (Basel II). We consider the Committee has set itself ambitious goals, has developed a set of proposals that go a long way towards delivering those goals and has been open and constructive in its consultation with the industry. We consider that the success of the proposals is dependent on the consistent, efficient and practical implementation of Basel II primarily by the licensed institutions themselves but facilitated and supervised by global regulators. Successful implementation can undoubtedly deliver a more effective and transparent regulatory capital allocation process within the industry.

2.2 Our comments on CP3

KPMG supports the Committee's implicit objective to finalise Basel II with as few amendments to CP3 as possible in order to facilitate the implementation timetable. As a result, we have focussed our response on matters that we consider are most relevant to our role within the financial services industry. We make some limited comments on the detail of the proposals in areas where we consider further consideration is required. In every case, we recognise that some issues are indeed difficult to solve because they involve matters and decisions that country regulators, and perhaps legislative bodies, will make and that the Committee has driven this process as far as it can.

Our comments on the current proposals include:

- Consideration of the continuing efforts that the Committee and regulators can take to address the problem of home v host regulation. We consider this is of fundamental importance to the success of Basel II.
- Suggestions on how the industry can address the increased complexity of Basel II when compared to Basel I. Interpreting the final Accord efficiently and consistently will be a significant challenge.

Our thoughts on how to limit the risks of unintended consequences from the introduction of Basel II. Whilst the committee has drafted the proposals for internationally active banks, there will undoubtedly be consequences for the wider financial services industry (particularly where the scope of application is comprehensive in the EU) that cannot be currently anticipated.

- Suggestions that, in relation to Pillar 3, the Committee should consider further:
    - the overlap between the disclosures required under Pillar 3 and those required under International Financial Reporting Standards. We consider the proposed situation of separate Pillar 3 disclosure is not efficient in the long term.
    - the minimum standards for the validation of any separate disclosures made under Pillar 3 (and how firms can demonstrate that they have complied with the standards).

- the impact of the likely extension of fair value accounting particularly to assets in the banking book. We consider that the committee should consider publishing its thoughts in this area.

- the possibilities for future alignment of the basis of consolidation for Pillar 3 and financial statement disclosures.

- Suggestions that, in relation to encouraging the industry to continue the development of operational risk management techniques, the Committee should further consider:
  - the incentive to move along the spectrum of approaches. We consider existing incentives to move from basic indicator to standardised approach and from standardised approach to AMA (advanced measurement approach) insufficient;
  - the AMA soundness standard. We consider a 99.9 percent confidence level on a one-year horizon inappropriate, as the means of validation are almost impossible to achieve; and
  - the planning risk for AMA. Future plans of the Committee present a planning risk to the industry as requirements might change before the implementation date of Basel II.

2.3 Developments in Basel II since our response to Consultative Documents dated January 2001 (CP2)

2.3.1 We commend the Committee for its open and constructive dialogue with the industry that has lead to many amendments to the original proposals. In our response to CP2 in May 2001, we raised a number of matters that we consider have broadly been addressed by the Committee in its latest draft, including:

- easing the roll-out requirements for the IRB (internal ratings-based) approach that would have presented many firms with insurmountable hurdles in adopting IRB;
- recognising a wider range of collateral in the recognition of credit risk mitigation;
- permitting a wider range of possible maturities in the IRB approach;
- giving consideration to the treatment of counter-party risk in the trading book; and
- proposing a relaxation of the disclosure frequency for Pillar 3.

However, we consider that the Committee should give further thought to a number of matters that we raised in our response to CP2 that have not been incorporated in the proposals to date, including:

- explicit recognition of country risk within Pillar 1;
- recognition of a firm's strong control environment in reducing the capital requirement for operational risk in the basic indicator and standardised approaches;
- giving consideration to the extension of fair value accounting under international financial reporting standards (see section 3.5.3);
- the overlap between disclosures required by existing and future IFRS and those proposed under Pillar 3 of Basel II (section 3.5.1);

- differences in consolidated grouping for disclosure purposes (section 3.5.4); and
- the need for consistent application of the proposals and effective solutions to the 'home v host' regulator issue.

3 Our comments on CP3

3.1 Dealing with the problem of 'home' v 'host' country regulation

We fully recognise the authority of banking regulators from different jurisdictions to make decisions they deem best for their country and their banking system. However, inconsistent application of Basel II within and between countries may seriously weaken the Committee's intended goals. We encourage the Committee to continue its work in trying to achieve consistent adoption in the different jurisdictions where Basel II will apply.

When Basel II is eventually adopted, it is certain that there will be areas of explicit inconsistency (for example, where national discretions are permitted) and less obvious inconsistencies where national interpretations differ. This situation will no doubt present some international firms with significant problems, both in preparing policies, procedures and systems for global use and also in dealing with the complex problems presented by home v host regulation. The latter problem, if not addressed effectively, could add significantly to the costs of compliance with Basel II, for example if dual reporting is required.

Possible examples include situations where

- a firm seeks to adopt the IRB and/or AMA approach globally; its home regulator is satisfied about the processes in place; a host regulator of a major subsidiary is unable to offer the IRB and/or AMA approach due to a lack of resources or legislative timing differences; and
- a firm agrees with its home regulator that it will adopt the standardised approach globally; an overseas subsidiary with a host regulator is required (or has chosen) to adopt the IRB/AMA approach.

In both circumstances, there is a risk that the firms involved could incur significant costs in reporting under two approaches. These costs could include direct systems and process costs as well as management time and resources.

We consider that, for internationally active banks, home regulators should have the primary responsibility for establishing the standards it intends to apply to its international banks. We encourage the Committee to consider producing guidance on the circumstances in which host regulators can be expected to require local bank subsidiaries to produce information in addition to that produced for their home regulators. Many of the banks likely to be impacted by the home v host regulator problem are KPMG's member firms' clients. We are prepared to play a role (perhaps by preparing independent external reviews scoped to mutual agreement) in facilitating solutions to this problem.

It is worth remembering that a firm that complies effectively with all three pillars of Basel II could have the same amount of total required capital regardless of the approaches to Pillar I that it has adopted. Adoption of the most advanced approaches to Pillar I includes the incentive to reduce minimum capital requirements and the business incentive to enhance risk management and related internal processes.

Therefore regulators should be encouraged to focus on the combination of Pillars 1 and 2 (as well as the impact of Pillar 3) and not solely on the calculations required by Pillar 1. Increased sharing of information between home and host regulator will also help to reduce this problem.

3.2 Tackling the complexity of Basel II

Many industry commentators have criticised the complexity of the drafted Basel II accord. Basel II will place enormous burdens on regulators due to the sheer scale of the proposals and the requirement for judgement to be exercised in many areas. In the period before implementation and bedding down of Basel II, regulators will be asked by the banking community to interpret Basel II prior to seeking approval to use the approaches selected. Without careful management of the specific guidance and assistance provided to firms prior to the approval process starting, there is a risk that different firms will be advised to interpret aspects of Basel II in different ways. This could undermine the credibility of Basel II when it is implemented.

We acknowledge that certain regulators and the Accord Implementation Group are reducing the risk of inconsistent application by producing papers on implementation issues. However, we consider that more could be done in this area. We suggest that external firms such as KPMG member firms can assist with the consistent interpretation of Basel II by undertaking focussed reviews across different banks in particular areas that are causing concern. A better understanding of acceptable practice across the industry and the ways that complex issues have been tackled will improve the efficient introduction of Basel II. In turn, the challenge of validating both models and processes for credit and operational risk management will be easier.

3.3 Dealing with the risk of unintended consequences

As with the introduction of the original Basel Accord in 1988, Basel II is certain to lead to consequences that the Committee may not have anticipated and may not regard as desirable. Basel I accelerated the development of securitisation transactions designed to remove low risk (but high regulatory capital cost) assets from a bank's balance sheet, and commentators have suggested that Basel II may lead to consequences such as:

- pro-cyclicality of the economic cycle;
- the transfer of credit risks to entities specifically to 'game' the likely different interpretations of Basel II (i.e., where national discretions have been introduced differently);
- capital arbitrage between the bank and non bank sectors; and
- increased use of outsourcing to avoid charges on operational risk

Whilst Pillar 2 is designed to counter the first two activities, we are concerned that the application of Pillar 2 may take a number of years to bed down during which time there could be other as yet unforeseen consequences with negative implications for the industry. We would support any effective methods devised by the international regulatory community (an example, the development of the Solvency II requirements for EU insurance firms) that could enhance consistency both within the banking sector and the wider financial services industry.

Our proposed solution to this possible problem is to suggest further disclosure of the scale and nature of credit risk mitigation firms have undertaken and more extensive disclosure of the Pillar 2 conclusions firms and regulators reach.

3.4 Undertaking stress testing in the advanced approaches

In a number of areas of Basel II, firms are required to design, undertake and interpret stress tests in order to support the risk estimates and overall calculations of capital adequacy requirements laid down by Basel II.

An example is the requirement for an IRB bank to have in place sound stress testing processes for use in the assessment of capital adequacy. The testing must involve identifying possible events or future changes in economic conditions that could have unfavourable effects on a bank's credit exposures and assessment of the bank's ability to withstand such changes.

By virtue of our member firms' work advising firms, we know that many firms are unsure about the approach they should adopt to satisfy the requirements for adequate stress testing.

We understand that it is not possible to prescribe the stress tests that could be undertaken by all banks, as the business circumstances within every firm are likely to be different. However, we suggest that national regulators or the Committee should build up examples of the tools, techniques and assumptions supporting successful stress tests undertaken by banks and publish these as guidance. In addition, local regulators should consider publishing, on an anonymous basis, the observed results of stress tests undertaken by banks to enable market participants to benchmark themselves against comparable institutions.

3.5 Ensuring market discipline through Pillar 3 disclosures

In relation to the proposed disclosures set out in Pillar 3 of Basel II, we have comments in four areas:

- the overlap with disclosures required by international financial reporting standards;
- validation of the disclosures;
- the extension of fair value accounting under IFRS (International Financial Reporting Standards); and
- inconsistent consolidation bases between financial and Pillar 3 reporting.

3.5.1 Dealing with the overlap between Pillar 3 and disclosures required under IFRS

We continue to be concerned that the industry will be required to produce disclosures to comply with both relevant financial reporting standards (subject to audit) and also the Pillar 3 disclosure requirements (not subject to audit). We understand that the timetable for the development of IFRS is such that it has not been possible to combine the proposed Basel II disclosures with IFRS but we continue to regard this as the best long-term solution for those banks that will be reporting under IFRS. We urge the Committee to continue to work with the IASB (International Accounting Standards Board) with the goal

of a mutually acceptable disclosure standard and that for an interim, transitional period only separate Pillar 3 disclosures will be required. We acknowledge that this may be a solution that is contradictory to the three pillar concept designed by the Committee, but we consider the alignment of public reporting to be an appropriate longer-term objective.

3.5.2 Validating the Pillar 3 disclosures

We acknowledge that the Committee has indicated that Pillar 3 disclosures will not fall within the remit of an external audit unless required by other external bodies. We are concerned that until the overlap with IFRS is resolved, there is a risk that inconsistent approaches to the validation of the Pillar 3 disclosures will be adopted. In certain countries (for example, Germany, where the German Banking Act requires submissions prepared for the national regulator to be audited) we anticipate Pillar 3 disclosures will be externally audited, whereas in other countries the Pillar 3 disclosures will not be externally audited. This inconsistent approach risks undermining the credibility of the disclosures required.

In order to ensure the disclosures retain the highest levels of credibility, we suggest that:

- the Committee provides some clearer guidance on its expectations for the validation of Pillar 3 disclosures;
- firms should be required to outline explicitly within their Pillar 3 disclosures the process they have undertaken to ensure the completeness and accuracy of the disclosures; and
- national regulators should provide guidance on the minimum levels of verification that they consider necessary in relation to the Pillar 3 disclosures.

3.5.3 Dealing with the introduction of IFRS

Basel II has not addressed the impact of the introduction of IFRS on capital adequacy calculations. Key issues include the impact of the extension of fair value accounting under IAS 39 and possible future standards. The impact of extending fair value accounting to some of the financial instruments held in the banking book is likely to be wide ranging and will have an impact on asset valuations and reported capital, as well as on disclosures in the financial statements, and will therefore need to be considered in relation to Pillars 1 and 2 as well as Pillar 3.

We set out below some of the effects of adopting IFRS that will need specific consideration:

- The change in the basis of valuation of some banking book financial instruments (e.g. securities available for sale, loans and receivables not originated by the bank and hedging derivatives) will have direct impact on capital requirements and the disclosure of any such amounts. For example, the ability to distinguish and disclose the components of any movements between periods may in some cases be restricted.
- It is not clear how the amounts that are directly taken to reserves (rather than being credited/charged to the income statements) in respect of available for sale securities and cash flow hedges under IAS 39 should be treated for qualifying capital purposes.

- The increased use of fair values is likely to lead to an increase in the volatility of reported qualifying capital – how will this be reflected in determining capital requirements?
- IFRS requires specific provisions to be raised when there is an identified shortfall between book value of an asset and the present value of the anticipated future cash flows from the asset. Basel II requires firms to estimate the expected loss (driven primarily from historic data) on all assets and this drives the capital requirement. Closer alignment between the expectations of the Committee and the IASB would reduce systems development requirements for many firms.

We suggest that the Committee should continue to work closely with IASB. We see a fundamental alignment between the objectives of both bodies and we believe that the issue of accounting measurement and disclosure, which naturally fall within the remit of the accounting standard setters, can be made to serve the Committee's purposes as well. For example:

- Asset valuations and reported capital reserves in the financial statements would reflect adjustments in respect of the level of expected losses, given that this element of such adjustments will also be reflected in capital requirements when using credit risk models, there is a danger that capital will in effect be provided twice (once as a reductions in retained earnings and once through capital requirements in respect of the asset)
- Would disclosures and capital requirements under Pillar 2 in respect of interest rate risk in the banking book be relevant, when the impact of any interest rate mismatches may be reflected in the valuation of banking book assets and liabilities?
- Many components of regulatory capital, for example, subordinated debt, most preference shares and innovative tier 1 capital may be subject to fair valuation which together with the impact of retained earnings of the change in valuation basis would lead to an increase in the volatility of reported qualifying capital as well as the split of its components between Tier 1 and Tier 2 capital.

3.5.4 Reporting under inconsistent consolidation bases

Basel II will continue to require firms to make consolidated disclosures, prepared under different bases of consolidation, for both Pillar 3 and financial reporting purposes.

If disclosures are to be made in the context of the financial statements then consideration needs to be given to how the financial and regulatory consolidated basses can be better aligned so that information given is inherently consistent – otherwise it will be costly for the preparer and overly complex for the reader. We also consider that, since the entities included in the consolidation for determining regulatory capital may be different to those controlled by the group, disclosures about regulatory capital should not undermine the basis of the preparation of the consolidated financial statements.

3.6 Encouraging the development of operational risk management techniques

With respect to the proposed treatment of operational risk, we have comments in the following areas:

- The incentive to move along the spectrum of approaches
- The existing AMA soundness standard
- Planning risk presented by the AMA approach

3.6.1 Developing an incentive scheme to move along the spectrum of approaches

The Committee wishes to encourage banks to move along the spectrum of approaches. We support this goal and consider that achieving it will lead to the continuation of the development and improvement of operational risk management practices that the industry has seen in the last few years. However, we consider that the Committee should consider further whether the existing incentives are adequate and effective.

Certain beta factors in the standardised approach are higher than the alpha factor in the basic indicator approach, resulting in lower capital charges under the basic indicator approach. On the other hand, the qualifying criteria for the standardised approach are stricter than those for the basic indicators approach. Hence in certain circumstances, any incentive to move from basic indicator to standardised approach may be minimal.

Furthermore, in contrast to CP2, the floor for the advanced approaches (AMA, IRB) is now jointly applicable on credit and operational risk. This means that the savings potential for operational risk depends on the outcome of the credit risk approaches (and hence the credit portfolio). In certain cases (more than 20 percent reduction in the credit risk charge as compared to Basel I) this leaves no incentive at all to move in the short term from the standardised approach to the AMA.

We consider that the Committee should adjust the incentives in order to fully reflect the stated goal that banks are encouraged to move along the spectrum of approaches.

3.6.2 Developing the AMA soundness standard

The AMA soundness standard asks for comparability to the IRB approach (i.e. comparable to a one year holding period and a 99.9 percent confidence interval).

Although it might make sense to align operational risk models with credit risk models to some extent, it appears to be very difficult in judging numbers representing one in a thousand years events.

In conjunction with the early state of development of measurement methodologies and the scarcity of relevant data, the requirement to independently validate the operational risk measurement system is a challenge both for banks, for external auditors and for supervisors.

We consider the committee should carefully rethink the feasibility of the proposed AMA soundness standard.

3.6.3 Dealing with the planning risk presented by AMA

KPMG considers that the flexibility given in the AMA approach is beneficial for the further development of operational risk as a discipline. However, the notion of the committee being able to "refine its proposals if appropriate" by the end of 2006 poses a

major planning risk in the development of AMA models both for banks as well for advisory firms helping them in implementing those models.

We consider that the committee should retain the qualitative and quantitative criteria outlined in CP3 and that supervisors should make the decision to approve or reject an internal operational risk measurement system as the basis for an AMA with no further restrictions applied. Any changes to Basel II should be a longer-term goal.