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SBA Position on "Basel II" / CP 3

- **Introduction**
- **Scope**
- **Pillar 1**
 - Credit Risk
 - Fundamental Aspects
 - Specific Aspects
 - Standardised Approach
 - Internal Ratings Based Approach
 - Credit Risk Mitigation and Securitisation
 - Operational Risk
 - Fundamental Aspects
 - Specific Aspects
 - Trading Book Issues
 - Fundamental Aspects
 - Specific Aspects
 - Proposal
- **Pillar 2**
 - Fundamental Aspects
 - Specific Aspects
- **Pillar 3**
 - Fundamental Aspects
 - Specific Aspects
- **Implementation**
 - Fundamental Aspects
 - Specific Aspects

Introduction

The Swiss Bankers Association (SBA) generally supports the goals of "Basel II", namely to promote the safety and soundness of the financial system, to enhance the competitive equality, to improve the risk sensitivity of the regulatory framework and to address risk in a comprehensive manner.

We appreciate that during the development phase of "Basel II" changes have been made to ensure that the overall calibration of the capital requirements under Pillar 1 meets the regulators' expectations and that the capital calculation for some portfolios has been adjusted to answer some concerns expressed by the industry and other interested parties. In many respects, however, the proposed New Accord has remained unchanged over time and many suggestions and recommendations, which we believe are crucial for the success of Basel II, have not been taken into account.

Whilst we endorse the three pillar approach and the idea of offering a menu of methods to banks under Pillar 1, we continue to believe that the stability of the financial system does not only hinge on capital alone. We should mention two other elements, which are of significant importance. **First**, risks entered into by a financial institution should be assessed against its ability to generate profits. As we already observed critically in 2000, it is an omission in the proposed framework that there is no reference to the fact that a diversified and more stable earnings base provides a strong buffer against "unexpected" losses. The importance of a balanced approach between risk taking and revenue potential should at least be explicitly acknowledged under Pillar 2. **Second**, the first symptom of a potential problem typically is insufficient liquidity of a financial institution, which can have many causes, even unfounded market rumours. It is therefore important that there be clear policies that govern a bank's access to liquidity in case of unforeseen events.

It will remain a major weakness of the New Accord that it is likely not to be uniformly introduced and applied throughout at least the major industrialised countries. In Pillar 1 there are more than 40 national discretions. Implementation of Pillar 2 is to a very high degree left to national supervisors. Another important concern for us is the fact that there are still no established common regulatory capital standards amongst all systemically relevant financial institutions and, in particular, between banks and non-regulated financial market participants. We recommend the Basel Committee strengthen its discussions with other regulatory bodies to try and achieve a harmonisation of the supervisory approach.

In the following, we will comment on the three Pillars in turn. Thereby, we differentiate between strategic or fundamental aspects on the one hand and specific or technical ones on the other.

Scope

We interpret paragraph 2 as implicitly excluding insurance activities within a banking group from Pillar 1, 2 and 3 requirements. **We suggest altering the wording of paragraph 2 to make the exclusion of insurance subsidiaries from the scope of the Accord explicit.**

We feel that paragraph 6 requires clarification regarding: 1) the criteria which will be used to adjust the amounts of minority interests that may be included in capital in the event the capital from such minority interests is not readily available to other group entities; and 2) whether the criteria also apply to minority interests within the banking group.

Moreover, we feel that paragraph 9 requires clarification regarding the definition/treatment of a bank holding several insurance companies with regard to: 1) surplus capital (in particular its definition); 2) capital shortfall (in particular its definition); and 3) deduction of banks' investment in such subsidiaries from capital (in particular with regard to its allocation to tier 1 or total capital). Practical aspects make a consolidated treatment complex. Therefore, we suggest employing aggregation as proposed in the BIS paper of February 1999 on Supervision of Financial Conglomerates, "Capital Adequacy Principles".

Pillar 1

Credit Risk

Fundamental Aspects

The larger scope for a more differentiated treatment of credit risk provided for in "Basel II" is appreciated. We view the methodology suggested under the IRB foundation and advanced approaches as resting on sound theoretical foundations and providing the potential for an advancement of the industry towards best practice. However, several aspects of these theoretical foundations are cumbersome to implement in practice and would need to be reformulated to allow an effective validation.

Our observations from the results of the QIS 3 are that whilst the stated goal of maintaining the same level of capital in the system may have been achieved, there is a large discrepancy between the data of individual banks. If the differences in risk capital were mostly reflecting different risk profiles of the banks, the result would be a desired one. Since the variance of the results is so large, we doubt, however, that this is the only factor. If significantly different capital requirements are due to interpretations of loss histories (default definition, bank practices etc.) and choices of parameters (assessment of borrowers, granularity of ratings, estimations of PD, LGD and EAD, inclusion of a conservative bias etc.) the comparability between banks will be no better than under the current Accord. Banks which have a more conservative approach than others will be punished under "Basel II" because the higher estimations of expected loss will directly translate into increased capital requirements (or into a lower "BIS ratio"). In many cases it will be impossible for regulators to assess the level of conservatism since loss data are notoriously scarce in many sectors of a bank's portfolio, especially the large(r) corporate and correspondent bank segments. **We strongly recommend that the Basel Committee undertake detailed studies in this regard prior to the finalisation of the Accord.**

Another concern is the issue of **procyclicality**, i.e., the uncertainty regarding the volatility of capital requirements once the New Accord is implemented. If the loss histories of banks and the initial calibration of the risk weight functions are based on data which cover a period where the economic environment was not uniform across the globe, but in many cases still relatively benevolent, and if individual institutions have rating systems that react noticeably to swings in the economic cycle, the capital requirements and the volatility may increase significantly in the future, especially when the major economies stagnate or even fall into a depression. Banks could then face a liquidity crunch, if their risk measures lead to a reduced capital ratio causing a lack of confidence of retail and wholesale depositors, and even solvency problems, which may require the issue of new equity when this will be most difficult. In order to counter such effects, institutions may have to severely curtail lending with an impact on their profitability and – more importantly – on the economy as a whole. As we stated previously, we feel that it is of paramount importance to have a view of

the regulators as to the band within which PDs and other parameters should fluctuate in response to economic conditions.

The complexity of the framework has been criticised throughout the development of the New Accord. The desire to lay down rules that are prescriptive and aim at covering all possible aspects is likely to be counterproductive. First, since markets will always develop ahead of changes to the regulatory framework, it appears to be more important to adopt a principle-based approach that covers more than an overly prescriptive rulebook which creates ways for exploiting "loopholes". Second, the proportion of guidelines with respect to risk mitigation and asset securitisation is out of relation to the overall rules under Pillar 1. The basic risk drivers are counterparty risk assessment and transaction structures (i.e. PD and LGD) and it is in these areas where it is difficult to establish a "firm grid". In addition, we observe an inconsistency in the regulatory approach because the capital treatment of the other risk categories (market and operational risks) are much more based on principles. In particular, we suggest to simplify the IRB framework (risk mitigation, eligibility requirements) by focusing on principles.

Furthermore, it should be left to the banks' discretion whether they return to the Standardised Approach once they adopted an IRB Approach. National supervisors could be given the right to veto provided substantial threats of misuse of the bank's right to change its approach.

As to asset securitisation, the New Accord does not sufficiently recognise that banks should be encouraged to use state-of-the-art portfolio management techniques, an observation that can also be made in the context of Pillar 2. As far as Pillar 1 is concerned, we strongly support the industry-wide viewpoint that the philosophy of a "capital neutral treatment" (same capital for same credit risk, irrespective of whether it is securitised or not) should be the first principle guiding the treatment of these important transactions in the regulatory framework. We believe that the real issue is again one of prescriptiveness where, for example, artificial regulatory categories of "originator" and "investor" have been created for participants in securitisation transactions. A far more transparent and flexible approach would be to allow institutions to choose the most appropriate capital calculation with information actually available to them and then have their approach reviewed by their regulator.

Specific Aspects

Standardised Approach

The following comments concentrate on paragraphs 24 to 179 of document "Part 2: The First Pillar - Minimum Capital Requirements".

- **Paragraph 26:** In the IRB Approach the method of using portfolio-specific general provisions is being discussed. The Standardised Approach, however, does not mention general provisions. Does this mean that under the Standardised Approach general provisions, which are designated as provisions (and not "hidden" reserves) are neither accepted as equity nor as a deduction from the exposure (the latter would result in a reduced capital charge)?
- **Paragraphs 37, 40 (as well as paragraph 27):** Exposures with a rating below "B-" receive a risk weight of 150 %, whereas unrated exposures are weighted at 100 %.

This might lead a bank to "forget" that its client is rated if the rating falls below B-. We suggest capping risk weights at 100 %. An unrated entity might not have a better credit standing than "B-". If the loan is past due, the exposure will automatically be risk-weighted at 150 % (or less if provisions are higher than 20 % of the outstanding amount).

- **Paragraph 47:** Mortgages on commercial real estate are weighted at 100 %. Loans to small businesses up to EUR 1 million are weighted at 75 %. So banks are better off having unsecured exposures to SMEs (as compared to a mortgage on commercial real estate). We suggest evaluating including a risk weight of less than 100 % for mortgages on commercial real estate up to a certain amount (e.g., EUR 1 million).
- **Paragraph 56:** We suggest to distinguish between commitments which secure credit lines and others (rather than according to maturity). The current distinction of the Swiss Banking Ordinance (Art. 12 d) which includes sureties for construction workers for the completion of buildings in Switzerland at 25 % risk weight seems to make sense.
- **Paragraph 78:** We rather doubt that ECAs putting pressure on entities through unsolicited ratings might be easily identifiable. It should be in the discretion of the bank to determine whether to use an external rating or not. This problem diminishes further if risk weights are capped at 100 % (see above).
- **Paragraph 176:** The restriction regarding the asset with the lowest risk weighted amount is very conservative. The condition that the notional amount of this asset is less than or equal to the notional amount of the credit derivative does not make sense based on the fact that partial hedges are allowed otherwise. Therefore, a bank should be free regarding the asset to be chosen and the condition "notional amount of the asset \leq notional amount of the credit derivative" should be cancelled.

Internal Ratings Based Approach

The problem with IRB lies in its complexity and – even more importantly – the requirements for sufficient data and some stability of observed defaults and subsequent losses. In a retail banking environment and with corporate loans to SME, reasonably big banks should be able to work with a loss history and adequate client information to calibrate their internal rating tools and LGD measures. The Basel Committee has recognised the data problem with some forms of "specialised lending". We would note, however, that also for Investment banking activities with exposures on highly rated banks and so-called investment-grade corporate clients it is an illusion to believe that the industry will ever have enough data to statistically "prove" the assumptions/estimates made for the calibration of credit ratings, let alone LGD and EAD. Institutions with the same client base can therefore show very different default probabilities and hence capital requirements, depending on the basis of their analysis.

These considerations should also apply to validation tools for the assessment of the model performance. Regulators must however recognise, when approving models in 2006, that there exist credit portfolios where a thorough statistical validation is possible and that there are other portfolios where a pure statistical/quantitative validation approach has to be

replaced and/or supplemented by a more qualitative validation based on expert judgement.

Whilst data collection and IT systems play a very important role in ensuring the statistical basis for the development and validation of rating tools, the Accord has onerous requirements that are unnecessary and barely practicable. For example, to have a complete rating history for clients on an individual basis for literally decades adds no value and is costly. We recommend restricting the level of detail required at the bank's discretion. Banks should be obliged to collate as many data as reasonably possible (feasibility and cost/benefit relationship) in order to be in a position to validate existing rating tools and develop new statistical rating models.

Too rigid standards and inflexible rules to allow for exceptions (materiality not only in terms of exposure but also with respect to the contribution to a bank's overall losses) must be avoided. In this context, the "all-or-nothing" approach (although tuned-down with some exemption rules in the latest proposals) is still an area of concern. The origin of this requirement seems to be a suspicion that banks will opt for the "most favourable" model for each segment of its business. Whilst such an approach would be unacceptable, different levels of sophistication might actually be more adequate and honest than a fudged compliance with regulatory requirements. This holds particularly true for the choice between Foundation IRB and Advanced IRB. Whilst AIRB may be used in many segments (SME and similar exposures where sufficient loss data are observable over an economic cycle), it is unlikely to be of any value in other business segments. It should be formally recognised that what counts is that banks aspire to the highest possible level of statistical risk measurement and that they use their own "expert" knowledge in other areas. If expert knowledge is not sufficient without statistical validation for AIRB, the list of exceptions from the "all-or-nothing" principle must be much larger and potentially cover entire segments.

We welcome the higher flexibility provided by a phased roll-out of the requirements for the adoption of the IRB Approach across all exposures and business lines. Nevertheless, we would continue to urge the IRB requirements be applied in a manner commensurate with the business lines, allowing for approaches best suited for individual lines. Also we are very much concerned that for exposures in non-significant business units capital requirements would be determined according to the Standardised Approach, with the national supervisor determining whether a bank should hold more capital under Pillar 2 for such positions (paragraph 228). This would oblige an international banking group to operate, in parallel, an IRB Approach and potentially several different Standardised Approaches if individual small business units chose different external ratings. Also international banking groups generally have non-significant business units in several jurisdictions. **We interpret that CP 3 by "national supervisor" means "home supervisor of the parent" and not the "host supervisor" in each jurisdiction in which such non-significant business units operate. We suggest to make this explicit and replace "national supervisor" by "home supervisor of the parent" in the wording of paragraph 228.**

Definitions

Exposure Types / Maturity: The risk characteristics of commodities finance exposure (paragraph 192) justify a distinct treatment from the other asset classes defined. In this context, we understand that "short-term" would refer to maturities below 1 year and would suggest to specify this explicitly in paragraph 192.

We are highly concerned about the concept of economic maturity (section (iv) and in particular paragraph 290), which is highly cumbersome to implement in practice. We

suggest using the more practical concept of nominal maturity. Also the “economic maturity” of variable (non-maturing) assets would need to be defined, as these exposures do not have fixed/contractual maturity. Such assets include variable loans – e.g., mortgages or working capital current account loans for corporates – which are significant in the retail business and the business with small and medium sized enterprises. For such variable loans we suggest relying on the contractual cancellation period, after which the banks can take action, and not on an economic maturity concept.

Reference definition of default: “Basel II” introduces a standardized definition of default applicable to all calculations under the IRB Approaches. The definition affects both the classification of current assets as defaulted assets for the purpose of applying a capital charge, and the assessment of default probabilities using historic data. CP 3 has attempted to rationalize this definition and represents an improvement on earlier versions. **However, the definition is still inconsistent with both rating agency and industry practice.** This inconsistency results from the first bullet point of paragraph 414 (i.e., “The bank considers that the obligor is unlikely to pay its debt obligations in full, ...”) and from the second bullet in paragraph 415. This is broader than the definition of default used by rating agencies. This inconsistency could impinge on the applicability of mapping techniques as provided for under paragraph 424. Also the fourth bullet of paragraph 415 would imply that all London/Paris club rescheduled export credits as well as when a bank – exactly for the purpose of avoiding a default or significant loss – grants a small restructuring (e.g., changing from an expensive old fixed term/rate loan to a cheaper new one) are to be considered in default. The imposition of a definition, rather than a set of guidelines, will interfere with best practice, and in particular a critical source of historic default data – rating agency historic data – may be invalidated.

A minimum definition of default or equivalent guidelines are desirable to ensure timely recognition of assets to which a defaulted asset risk weight should be applied (this is the first purpose referred to above). However, the Accord should distinguish between the prospective recognition of default and the other important process with which the definition will interfere, namely collation of default data for PD estimation purposes. Accordingly, for PD estimation it is in most cases possible to recognize default by the occurrence of material economic loss or other tests of substance, so that precise adherence to a definition designed to detect default in prospect is not needed, and therefore should not be imposed.

We therefore suggest taking out bullets 2 and 4 of paragraph 415 or, alternatively, rewording the first sentence of paragraph 415 as follows: “Elements that, to the discretion of the bank, could be taken as indications of unlikelihood to pay include: ...”. In order to allow banks which have been using a broader definition of default as rating agencies to use their internal databases, we suggest rephrasing bullet 1 of paragraph 414 (and move it after bullet 2) as follows: *“Banks can opt for using more conservative definitions of default, e.g., by considering unlikelihood of repayment of an obligor’s debt obligations in full as default. Banks must document the specific reference of default used internally.”*

Also, we strongly suggest to drop or reword the part relating to overdrafts: No limit should be communicated to the client, there should only be an internally established overdraft limit.

Definition of loss / economic loss (paragraphs 422, 430): We are concerned that the Accord’s definition of economic loss provided in paragraph 422 would result in making an LGD determination on a facility level barely impossible, only allowing for a client level (in case of several facilities or collateral) LGD determination. In practice, the specific

registration/allocation of indirect costs to a given facility is not feasible. IAS or US GAAP specify accounting requirements for losses and determine the manner in which banks collect loss information. The Accord should allow collection costs, especially indirect ones, to be allocated by a key and not impose these to be registered for the specific defaulted facility. Therefore, and in order not to make most historically recorded loss data obsolete, we suggest to fully drop the reference to indirect cost in paragraphs 422 and 430.

Along the same lines and considering the points we make regarding LGD computation, we view provisions set up against defaulted assets as best estimate – in the sense of economic loss – of the bank for the expected loss. We suggest inserting a new paragraph under section “(vii) Requirements Specific to Own-LGD Estimates” explicitly recognising this methodology, i.e., provisions constituting the expected loss for defaulted assets.

Treatment of Collateral

We believe that paragraphs 160-161 require clarification as to the treatment of “joint and several guarantee” (Solidarbürgschaften). We would suggest treating them equally to guarantees, despite the fact that they are conditional.

Definition of Retail Exposures

We observe an inconsistency between the definition of residential real estate in the Standardised Approach and the definition in the IRB Approaches. In the Standardised Approach, claims secured by residential property are defined as lending fully secured by mortgages on residential property that is occupied or let by the borrower. However, in the IRB Approaches residential mortgage loans are eligible for retail treatment only if the borrower is an owner-occupier of the property. Since the risks intrinsic to an object that is let by the borrower are much more comparable to the risks intrinsic to an object that is owner-occupied than to the risks that are associated to corporate lending, we suggest not to make a difference between “owner-occupied” and “not owner-occupied” residential property. If the Basel Committee decides to maintain this differentiation, we suggest that not owner-occupied residential property is treated as retail and to introduce a preferential risk weight curve for owner-occupied residential property. It would be a major difficulty if a bank were forced to treat some parts of its real estate portfolio as corporate since usually it estimates the Expected Loss of an object, rather than the PD of the borrower. The latter would not make much sense, because the value of the property does not materially depend upon the credit quality of the borrower.

Retail and SME Exposures

The guidance provided by paragraphs 186, 199 bullet 3 and 242 to draw the line between corporate, SME and retail exposures is overly burdensome to implement in practice. We would suggest to exclusively rely on exposures for this purpose. In practice, not all firms are required to present their financial statements to the bank, e.g. small businesses, as this would not be cost efficient, or financial statements can be rather meaningless for risk assessment. It will therefore be difficult for a bank to recognise if a firm that was retail has suddenly become an SME (or even a corporate), because total sales (or assets) will not be available. Also, if there are financial statements, these will not in all cases be on a consolidated basis. **We therefore strongly suggest that the firm size adjustment of paragraph 242 should be made on the basis of an exposure limit, not a sales (or asset) number, as for the retail threshold.** This would make the practical implementation of paragraphs 186, 199 bullet 3 and 242 possible for most banks and simultaneously clarify “slotting”.

Also, we would suggest to count exposures to medical doctors, lawyers and other self-employees as exposures to individuals and not to small business, largely because such a treatment would significantly reduce the complexity and burden of implementing Basel II and also noting that limits to such counterparties do generally not exceed EUR 1 m.

A further related issue to the SME exposures (connected with section "H Rating") is the significant burden imposed upon banks by exposure level swings resulting from temporary increased sales or exchange rate moves, if these swings call for a reclassification of the firm back and forth between the corporate and the SME category or the retail and SME category. **The Accord has to provide for a pragmatic treatment that would avoid requirements for, e.g., instant changes in the rating model to be applied or shifts in the internal organisation treatment of that exposure.** We would suggest that a new paragraph is inserted in section "H Rating" limiting the allocation of counterparties in individual exposure classes to annual review requirements and relying on a documented bank internal policy for such review purposes.

The issue of asset class slotting is even more general. We therefore urge the regulators to provide a flow chart for the slotting of assets into regulatory exposure classes, as there are overlapping criteria, or it is not always clear which criterion is dominant or should come first.

Rating Process (Part H)

The requirement of paragraphs 244, 249 and Annex 4 regarding specialised lending slotting criteria are somewhat confusing. It is unclear to us, why an IRB bank not meeting PD estimation criteria for SL should get a less favorable treatment than under the Standardised Approach. We suggest bringing in line the SL IRB slotting risk weights with the Standardised Approach risk weights for such exposures. Also Annex 4 does not provide any guidance on how for each Table the individual criteria assessments – e.g., good in a few criteria, but only weak in other – for a SL exposure should be weighted to add up to an overall risk weight slotting. **We suggest to leave it up to banks to justify the overall risk weight slotting and to reword the second sentence of paragraphs 244 and 249 as follows: "Banks will consider the criteria of Annex 4 to perform this mapping."**

We wonder in paragraphs 360/361 and 384 whether an IRB bank should have a separate facility rating dimension for EL or LGD in FIRB, or exclusively for LGD in AIRB. An AIRB bank must have LGD-estimates (per facility type or collateral etc.), as well as a borrower rating system, in order to quantify PD, which is also required under FIRB. But otherwise, the facility rating dimension has no real meaning. We therefore strongly suggest to drop or reword this part in order to avoid further confusion and the set up of potentially costly "as if" facility rating systems that add virtually no value.

According to paragraph 366 the supervisors may require banks to have a greater number of borrower grades than 7+1 as proposed by the Basel Committee. If a bank were forced to increase its number of borrower grades, this would have a major impact on its rating system and especially on the data histories. With respect to the required number of borrower grades there must be a reliable definition which might not be changed by the national supervisors. Therefore, we suggest to leave the number of required borrower grades as proposed in paragraph 366 and to remove the last sentence from paragraph 366.

The requirement of paragraph 386 regarding the integrity of the rating process and, particularly, the independence of rating assignment appears overly stringent for higher risk

exposures in view of existing banks' practice. Banks very often move the management of higher risk exposures – i.e., exposures that have deteriorated, but are not in default – into a workout department. In such departments, there is no longer a separation of the credit decision / rating ("personal unity", but specialised staff), i.e., the party approving the rating could potentially benefit from the extension of credit. We however believe that – as long as the workout department is under the control of a (separated) credit management and not attached to any line management – the rating assignment of such workout departments should qualify for the independence criteria. We thus suggest rewording paragraph 386 accordingly, i.e., rephrasing the first sentence as follows: *"Rating assignments and periodic rating reviews, excepting workouts, must be completed or approved by a party that does not directly stand to benefit from the extension of credit."*

The requirement of paragraph 387 for annual or more frequent rating refreshes appears overly stringent from an implementation point of view. A "full rating" involves several steps, including a detailed analysis of the counterparty, in some cases a sight visit/interview of the management of the counterparty, a rating report and an extensive approval process. A "full re-rating" is thus a resource-intensive and costly process. Rating refreshes should not be unduly costly, if not justified by the situation. Paragraph 387 should provide for a check of financial conditions of the borrower to suffice for rating refreshes. Only if this "check" reveals a significant deterioration, a full re-rating would have to be performed. Similar comments apply to facility ratings. We suggest to reword paragraph 387 accordingly, i.e., rephrasing the first sentence as follows: *"Borrowers and facilities must have their ratings refreshed, based on checks which must not always include a full rating, at least on an annual basis."*

Computation of PD and Stress Test

The overriding guidelines are for banks to ensure that they use a conservative bias (or even some element of stress testing) when they calibrate internal rating tools. The problem is not that bankers should have a conservative bias when dealing with risk aspects, but that "conservatism" is not a measure that can be easily assessed and compared. The sparse data - even in some more homogeneous segments - will often mean that it will at best take many years before the validity of the assumptions made can be examined. During such a long time period, it is obvious that also bank practices, rating tools and client segmentation will not be static, which renders a review extremely difficult. Furthermore, it is not certain that long term averages are more representative for the defaults that can be expected on average during a future medium-term period. The issue is that two banks with an identical portfolio can potentially have significantly differing capital requirements and that the general public reading the detailed information under Pillar 3 does not necessarily get a balanced picture for it assumes that "the same is measured almost identically" across the industry. Both banks can even claim that their estimations have been based on conservative values.

Whilst the aim is to derive a one-year default probability, the draft Accord requires the banks to use conservative measures and perform stress analyses to assess the longer term future of an exposure when assigning a rating. This continues to be a contradiction in itself.

Moreover, the requirement to use conservative ratings based on a longer time horizon than one year would force banks to use different PDs for pricing and internal risk management than for regulatory purposes. Since according to our understanding one of the aims of the IRB Approaches is to reach a convergence of these concepts, this would be counterproductive.

In essence, a rating tries to assess how far a default is away (or alternatively, how likely it is over any given time horizon) and ranks borrowers in a relative way by this risk. PDs will remain identical independently of any shifting the rating scale based upon:

- longer time horizons,
- inclusion of stress tests, or
- conservatism across the board.

We therefore believe that including stress tests and restricting the rating assessment horizon to one year - especially if this prevents using other time horizons that are more appropriate for a specific business - are counterproductive and unnecessary restrictions as long as it is secured that a bank rates its counterparties and maps its rating into PDs in a consistent manner. We therefore suggest to drop section (iv), paragraphs 376-378 entirely.

Pillar 1 (paragraphs 396-399) calls for stress testing to support the general capital planning and budgeting activities of the bank, which is a reasonable requirement. However, an additional specific stress test described as measuring the effect of "certain specific conditions" including "at least a mild recession" on capital is also prescribed; this specific stress test is linked to potential additional capital requirements.

We are concerned that in the end, the actual required capital will be determined by these stress tests exclusively (except in case of paragraph 399). Such a matter of affairs would make all other IRB requirements redundant and we believe that this is inconsistent with the aim pursued in the Accord. It is thus essential to clarify further the imprecisely defined test.

The objective of the test, which is the mitigation of volatility in capital requirements through the business cycle, cannot be achieved by a stress test, because a meaningfully conservative stress test will suggest additional capital requirements at all stages of the business cycle. Moreover, by linking stress tests directly to capital requirements, management and regulatory attention will be wastefully focused on the precise degree of conservatism and resulting buffer capital required. In practice, variability in bank capital requirements over time is inevitable and can only be managed without undue cost by cooperation between banks and supervisors in a prudent but flexible approach. A range of general stress tests designed by the institution will provide the best guide to future capital requirements. These tests will typically show the potential for additional capital requirements in future, depending on economic developments, and a variety of reactions must be available to the supervisor, including, but crucially not restricted to immediate demands for more capital.

We thus suggest to explicitly exclude section (v) (paragraphs 396-399) on stress testing from Pillar 1. We also suggest to reword paragraph 724 accordingly: "A bank should ensure that it has sufficient capital to meet the Pillar 1 requirements. A bank should also employ credit risk stress test that supervisors may wish to review to assess under Pillar 2 whether the supervisor would require the bank to reduce its risks and/or to hold additional capital/provisions".

Computation of LGD

The Accord specifies that LGD represents economic loss. We agree in general with this statement but the link to existing practice (see comments on paragraphs 430-435) and accounting rules must not be overlooked. The loss history will be measured on the basis of a bank's loss experience and the latter is represented by the charge to the profit and loss account under "credit loss expenses". Creation of a different measurement basis must be

avoided since it will distort the comparability of external information on loan losses that is based on IAS, where section 39 prescribes how provisions, and hence loan losses, are determined. IAS already requests the application of the economic loss concept. Hence, we strongly recommend adoption of the same definition for the determination of LGD.

We support the observation in paragraph 415 that LGD must be a default-weighted average across time, but do not see the need for choosing the most conservative value rather than the long-run average, given that sufficient years of observation are available.

We are concerned by the requirements spelt out in paragraphs 430-435 in the sense that own-LGD estimates are overly cumbersome from an implementation point of view. Many banks do "outsource" (at least parts of) their defaulted exposures, e.g. to a specialised subsidiary/workout unit, or write them off at some point in time prior to final settlement (which can be very different due to policy etc. issues). At the point in time when such an exposure is outsourced, an expected final loss is determined (for the "transfer price" or write-off). It is not uncommon that several years elapse between the transfer to a workout unit and closing of the files – i.e. realization of the final loss – regarding individual exposures in the workout unit. Recoveries (or increases of losses) that may come afterwards can often no longer be attributed to the original defaulted position without excessive tracking costs. Also, in practice the majority of very small exposures and/or real estate properties acquired at auction (origin are mortgages) in retail are handed over to a "collection" subsidiary/unit and no more tracked under credit risk at the time the "loss" is effectively realized. We therefore suggest that the expected final loss at the time the exposure is transferred from credit risk to workout units – i.e. the "transfer price" or write-off – should be qualifying as an economic loss for estimating own LGDs and constitute the basis for demonstrating effective LGDs. Tests by national regulators (or auditors) to ensure the bank is not systematically using too low transfer prices or write-offs could be envisaged to establish the confidence about such a practice.

We cannot see the rationale (paragraph 434 vs. 425) in non-retail business for requiring a longer data history for LGD estimates (7 years) than for PD estimates (5 years). This would make compliance much more complicated without adding real value. We therefore suggest using the same wording in paragraph 434 as in 425 – i.e. at least 5 years.

Computation of EAD

The requirement (in paragraphs 277, 305 and section G) that exposures should be measured i.a. "gross of (partial) write-offs" seems unnecessary. In Switzerland, (partial) write-offs are no more legally owed to the bank. Thus, while it is clear that (partial) write-offs form a part of the economic loss, they are not kept as balance sheet information (unlike, e.g., provisions) and therefore not easily available in the current exposure measurement. In practice it will often be difficult to allocate "old" partial write-offs to currently existing exposures. We suggest to drop (partial) write-offs from paragraphs 277, 305 and section G to allow for a practical implementation of the Accord.

In analogy to above, we cannot see the rationale (paragraphs, 440 vs. 425) in non-retail business for requiring a longer data history for EAD estimates (7 years) than for PD estimates (5 years). This would make compliance much more complicated without adding real value. We therefore suggest using the same wording in paragraph 440 as in 425 – i.e. at least 5 years.

For estimate of off-balance sheet CCF's for facilities that are uncommitted, unconditionally cancellable (etc.) to warrant consistency, we suggest to apply the same rules as in

paragraph 281, i.e. using zero CCF. In practice, it will be almost impossible to estimate reasonable own CCFs for these items, especially for all retail pools, and historically.

Credit Risk Mitigation

We appreciate the efforts made by the Committee to come up with a sound and more complete treatment of credit risk mitigation techniques (CRM). **It is our view that the guiding principle of the New Accord with respect to CRM should be that the required capital reflects the underlying risks independently of how these risks were generated through different types of CRM.** At present this principle is not fulfilled, opening the door for new types of future regulatory capital arbitrage opportunities. We would like to illustrate the inconsistencies we have in mind through the following examples:

- Unsecured loan guaranteed by a third party: A bank has lent \$ 100 for 1 year to a corporate A (PD=100bps) and has obtained a guarantee for the full amount from a third party corporate B with an external rating equal to AAA (PD=8bps). Under the IRB approach the regulatory capital cannot be less than the capital charge for the same exposure with the guarantor as the new counterparty; with a PD=8bps, an LGD=45% and a time to maturity of 1 year we get $K=1.31\%$.
- Unsecured loan collateralised by a corporate bond: A bank has lent \$ 100 for 1 year to a corporate A (PD=100bps) and has obtained as collateral a corporate bond issued by company B with the same maturity and the same currency as the loan and an external issue rating of AAA. Under the IRB approach the regulatory capital for the collateralised loan is determined through adjusting the LGD by the following formula: $LGD^*=LGD \times E^*/E$, where $E^*=E-C \times (1-H_c)$ and LGD=45%; with a PD=100bps and C=100 and a time to maturity of 1 year we get $K=0.063\%$.
- Unsecured loan synthetically guaranteed: A bank has lent \$ 100 for 1 year to a corporate A (PD=100bps) and has obtained a synthetic guarantee for the full amount from a third party corporate B with an external rating equal to AAA (PD=8bps) through the following construction: Corporate B borrows \$100 and deposits the proceeds in the bank; the deposit is used to secure first \$100 of combined losses on the two loans to company A and company B. Under the SFA approach the bank's net position can be treated as \$100 senior position in a pool with two assets. $K_{IRB}=1.31\%+6.31\%=7.62\%$, $N=2$, $LGD_{pool}=45\%$ and hence the capital the bank must hold is equal to $K=0.56\%$.

These examples clearly illustrate that under the current approach similar risks do not attain similar amounts of regulatory capital.

Special Considerations for Securities Financing Transactions (Repo/Reverse Repo and Stock Borrowing/Lending)

We support the requirement of appropriate model validation for VaR-based measures of counterparty exposures. However, the individual techniques used to validate a model should take due account of the structure of a firm's repo-style transaction portfolio and its main risk parameters relevant to it, rather than descriptively demand a specific backtesting regime, as currently proposed.

Backtesting of an exposure value, which is one of many factors in the capital calculation formula, also should not be compared to backtesting of market risk VaR, which as a value is the capital number itself (using a multiplier). The effect of the latter VaR value on capital requirement is much more direct than the effect of the exposure VaR number, hence it does not necessarily require the same validation standards.

We therefore do not support the inclusion of a detailed backtesting requirement for repo-style transaction VaR models in the Accord but suggest that a firm decide with their home supervisor on an appropriate validation technique given the very low and short term risk profile and costs involved.

Should backtesting continue to be a specific requirement in the Accord, we question the proposed multipliers. We do struggle to see the technical foundation of the multiplier's size and a multiplier of 2 for the first yellow zone exception category is far too high. We would expect a much flatter curve between the zones and within a zone.

Securitisation

In our view, securitisation has to be considered as an extremely efficient instrument for both risk allocation and refinancing purposes. This is particularly true in the case of the small and medium size banks of Switzerland, with limited access to the international financial markets and heavy regional risk concentration. Although for several reasons (e.g., missing legalisation, tax provisions) securitisation has so far played a minor role in Switzerland, we have no doubt that this will dramatically change in the future. We therefore consider it of outmost importance, that regulatory provisions are based on economic principles and will not unduly restrict this new market.

The following general issues are of major concern to us:

- risk weights of tranches below investment grade
- differential treatment of originator and investor
- cliff edge effect inherent to the provisions of paragraph 575

In our view, there is no sound economic foundation to a higher risk weighing of securitisation tranches as compared to corporates. In particular, we cannot follow the theoretical deliberation of the securitisation group. First, the assumption of an a priori higher LGD (of securitisation tranches) remains theory while an outstanding dynamic rating performance, particularly in the case of RMBS, is a statistical fact (e.g., rating migration). Second, the risk diversification effect of securitisation as compared to a corporate will depend on its correlation with the bank portfolio. Clearly, even a highly granular securitisation tranche can have a more beneficial effect than a corporate considering the marked risk concentration of credit portfolios on the books of Swiss Cantonal and Regional Banks.

Also, we do not see a viable economic argument for the differential treatment of the originator and investor. We believe that the regulatory framework should be based on the principle of capital neutrality as this will provide the best measure against arbitrage. In this view, the regulatory treatment should definitely not represent an incentive for the banks' decision on securitisation, the choice of assets and the role within a transaction.

There is a "cliff edge" inherent in the provision of paragraph 575. Whether K_{IRB} can or "cannot be calculated" will be a matter of judgement depending not on mechanical ability

to perform a calculation, but rather regulatory satisfaction as to the integrity of the data used. Other CP 3 wording indicates that the standard of test will not be very different from the usual IRB standard (including where the “top down approach” is used, since the concessions in that approach are minor). There will therefore be a very strong element of judgement as to whether a bank’s proposed calculation of K_{IRB} is really acceptable. The amount of capital resting on this may be ultra-material, being potentially the difference between deduction of the entire notional versus - if the calculation is acceptable - potentially low risk weights reflecting good quality pool assets. Such a “cliff effect” creates tensions between the supervisor and the bank and is inadvisable. To tackle this issue, paragraph 575 should expand on the nature of supervisory review of the acceptability of K_{IRB} calculations and - like other areas of supervisory review including eligibility for the IRB approach generally – specifically indicate that the level of the review will be the conduit or securitisation business of the bank, not individual assets.

We therefore suggest to reword paragraph 575 as follows: Replace “Where K_{IRB} cannot be calculated, the entire retained position must be deducted” with “*A bank which is not able to provide satisfactory calculations of K_{IRB} may be required to deduct retained originated securitization positions from capital. (This does not apply when a specific exemption from calculating K_{IRB} is applicable, for example as set out in paragraphs 600 – 603). For this purpose:*

- *As a general rule, satisfactory calculations of K_{IRB} are those which meet the minimum standards for IRB calculations generally (paragraphs 349 – 399), although subject to compliance with these minimum standards, a supervisor may allow standards associated with calculation of K_{IRB} to be lower than those maintained by the bank on balance sheet holdings of similar assets.*
- *Where a “top down approach” is used to calculate K_{IRB} (paragraphs 209 - 211), the general standard of calculation required shall be as for retail exposures (paragraphs 363 - 371).*

As for other IRB calculations, and other than in exceptional circumstances (for example, where a transaction is a “one off” and the bank has no experience of similar transactions), a supervisor’s assessment of K_{IRB} calculations will be at a business line level or similar overview level, and in particular, at such a level of aggregation that the overall process can be reviewed and meaningful conclusions about compliance with IRB data and calculation standards can be drawn.”

A conduit facility must satisfy paragraph 538 subclauses (a)-(e) to be eligible for the “concession” of applying RBA risk weights – the alternative being deduction if K_{IRB} cannot be calculated (see comments on paragraph 575 above). This extends the potential cliff effect referred to at paragraph 575. We believe that clause 538 (a) should not prohibit acquisition of assets at above fair value when fair value is not substantiated as an actual market price (e.g. where generated by a model), or where there is uncertainty about the actual market value, or where the supposed discount to fair value is not material. We suspect that the intention of clause 538 (a) is to prohibit the acquisition of impaired assets at a price that represents a substantial discount to a fair market price and is not a price characteristic of an arms length transaction. Also clause 538 (e) seems to contain drafting errors and has no clear interpretation.

We therefore suggest rewording paragraph 538 as follows: Replace “acquire assets at above fair value” in paragraph 538 (a) with “*acquire impaired or distressed assets at materially above their fair or market values*” and replace 538 (e) with “*The terms of the facility must include safeguards which allow the facility provider to duly restrict lending on deterioration in the credit quality of (a) the seller or (b) the receivables within the pool.*

Such safeguards may include definition of the borrowing base, advance rate contingencies, and early termination triggers. Safeguards must be effective in that information must be on hand to the facility provider to enable timely action by the liquidity provider to protect the facility from loss in accordance with the safeguards."

Operational Risk

Fundamental Aspects

While constructive work with the industry has resulted in relaxing some of the constraints on the Pillar 1 operational risk charge as proposed in CP 2 as well as in introducing more flexibility in the Advanced Measurement Approaches (AMA), some substantial challenges still remain.

As a general point of critique, concerning both the Basic Indicator (BIA) as well as the Standardised Approach (STA) we still strongly object to the assumptions underlying these two approaches: It is not clear at all why it should be possible to approximate something as complex as operational risk by a variable as gross income. Moreover, there is no evidence for a linear relationship between gross income and operational risk. The Basel Committee has well recognized this and has tried to improve on the most important deficiencies, e.g., by introducing in CP 3 the new "Alternative Standardised Approach" for operational risk in retail and commercial banking. By doing this, the spectrum of available approaches banks can use to optimise their capital calculation gets larger, but the basic methodological deficiencies of the approaches stay the same.

With respect to the Basic Indicator and Standardised Approach, the Committee relies on arbitrary risk measurement proxies, like gross income. Using gross income as an indicator for operational risk ceteris paribus penalises profitable banks and gives rise to perverse incentives. Given that AMA methods are based on very different risk measurement drivers, it is difficult to imagine how the Committee intends to grant appropriate incentives over time for firms to move into the most sophisticated part of the spectrum of approaches.

Under AMA, the Committee still relies too much on the assumption that market risk measurement techniques are philosophically the right methodological foundation to assess operational risk. Reference is made to loss distribution parameters, like a 1-year holding period and a 99.9% confidence interval that must be met whatever approach the bank uses, and to notions like expected/unexpected losses and correlation. As a reliable operational risk loss distribution is much more difficult to obtain than in market risk (operational risk losses are unique events in that they carry specific and unique time and environment dimensions), subjective risk assessment becomes relatively so important as to empty loss distribution approaches from any significant role in operational risk management. Loss distribution parameters should not be given the role of methodological cornerstones.

The SBA believes that tangible progress in operational risk management stems more from qualitative (control or organisational) aspects than from pure modelling of internal event data. The analysis of external events, possible scenarios and key risk indicators are useful for assessing any control framework but may not be crucial to the modelling of event data that is used to determine capital requirements. This distinction is not sufficiently reflected in the present proposal.

Specific Aspects

We are highly concerned by CP 3's misplaced reliance on market and/or credit risk inspired quantification methodologies, i.e., compulsory inclusion of a distribution-based approach in Advanced Measurement Approaches (AMA), for operational risk.

This reliance:

1) ignores the fundamental differences between operational risk and market or credit risk. These differences have a critical bearing on a relevant and credible measurement of Operational Risk and relate to:

- **Position equivalence:** The lack of an equivalent quantifiable size (analogous to a risk sensitivity) in operational risk is a fundamental difference to market and credit risk.
- **Completeness:** The scope of operational risk is much broader than market and credit risk. This makes the determination of a complete portfolio of operational risks extremely difficult and impinges the quantification of the overall operational risk.
- **Context dependency:** The evolution of organizations, their environment and their structure has a major impact on the stability of operational risk models. Also, major operational risk loss events (high-impact, low-frequency events) are non-repetitive, triggering banks to overhaul the control/management environment to prevent impacts of such events in the future, and cannot be used in a loss distribution setting.
- **Tradability:** In contrast to market and credit risk, operational risk taking is not revenue driven. Banks therefore focus on minimizing operational risk via management action and efficiency enhancement. High-frequency, low-impact operational risk data can be useful in this connection (expense management, budgeting, provisioning) but do not pose a threat to capital.
- **Validation difficulties:** Relevant data/observations are extremely scarce for operational risk as compared to market and credit risk. This prevents a purely quantitatively based validation along the market risk model setting.

2) disregards general industry practice relying on active qualitative management of Operational Risk and using quantitative indicators for selected operational risk components at a very low management unit level only on a case by case basis. Typically, less than 5% of banks' operational risk staff is devoted to the quantification of the overall operational risk while more than 95% focus on operational risk relevant qualitative management matters (e.g. business continuity planning, crisis continuity planning, audit, compliance, etc.). In AMA the importance of operational risk quantification is dramatically overweighted and the central role of qualitative management tools barely factored in.

We are also concerned about the potentially unintended consequences, i.e. incorrect or inappropriate management decisions, that arise from an undue reliance upon the use of quantitative operational risk models for practical risk management purposes, driven by, e.g.:

- Inappropriate management decisions based on misleading model output, if reliance on the model for management purpose is compulsory
- Inappropriate management decisions based on lacks in modelling cause and effect links, if reliance on the model for management purpose is compulsory
- False reliance/sense of security regarding data generated by a fancy operational risk-modelling solution

- Distraction of scarce resources into an illusory precise quantification and away from the effective management of operational risk.

We therefore strongly suggest refocussing AMA on the qualitative management aspects. With regard to quantification we strongly suggest 1) dropping AMA requirements to allocate or quantify operational risk at other levels than the entire organisation and 2) providing banks with an effective option to choose only one of the various quantification approaches, e.g. scenarios, loss distributions or combinations of both.

Based on the differences of operational risk to market or credit risk, we also suggest to rely on a more qualitative-based approach to approval and validation of AMA, i.e., to rely on:

- Demonstration that a clear, reasoned thought process and rationale has been followed.
- Pragmatic approach regarding model parameters for which the correct choice of inputs will be very difficult to "backtest" quantitatively and will require acceptance of qualitative "proofs".
- Pragmatic interpretation of the rules as their strict interpretation would not be implementable (at undue cost if at all) or would result in a deterioration of risk management.

These suggestions will have a bearing on paragraphs of core concern to us:

- Correlation assumptions and their validation (paragraph 626 (d))
- Use of capital as means of creating incentives to improve business line management (paragraph 622)
- Integration of operational risk measurement into the day-to-day risk management processes (paragraph 626 (b))
- Application of a soundness standard (paragraph 627)
- Threshold for loss data collection (paragraph 633)
- Risk Mitigation/Insurances (paragraph 637)

Here, we would like to point to another important concern we have regarding the treatment of insurance: CP 3 defines – as the previous CPs – that only banks using the AMA will be allowed to recognise the mitigating impact of insurance (paragraph 637). **In our opinion however, banks using the Basic Indicator or the Standardised Approach should also be allowed to use the mitigation impact of insurance.** The effectiveness of risk mitigation by use of insurance does not depend on whether the bank uses the Basic Indicator Approach, the Standardised Approach or AMA in order to calculate regulatory capital.

As far as the qualifying criteria for the Standardised Approach (paragraph. 624) are concerned, we would like to point to the fact that those are almost at the level of the ones for the AMA. **We are of the opinion that there should be a difference between the two approaches since the AMA allow for lower capital charges and should, therefore, have more stringent qualifying criteria.**

Trading Book Issues

Fundamental Aspects

In our view, the proposed trading book treatment of credit derivatives, in particular the rules for specific risks of hedged positions, is far too restrictive. It must be emphasized that, in a trading book context, most hedges will only qualify for partial allowance. This is due to the fact that most credit derivatives trade with five years maturity, regardless of whether the reference obligation has a longer maturity. Moreover, banks holding positions in other currencies than USD and EUR will find it difficult to hedge their positions without having to put up with a currency mismatch, since there is almost no market for other currencies. Under partial allowance, however, the specific risk capital charge for a hedged position is higher or equal to that of the cash position alone, thus offering no incentive to hedge positions in the trading book. Moreover, if a bank has other intentions than hedging alone, e.g. providing two-way market making, it might be seriously discouraged by such a restrictive regime.

We also like to point out that the trend in the credit derivatives market toward simplicity, most notably the increased demand for standardised, "plain vanilla" credit default swaps with a limited choice of parameter values, has been an important factor in the development and maturing of the credit derivatives markets in recent years. It has enhanced their liquidity and versatility, which in turn has attracted a wider range of market participants. It seems fair to say that the standardisation process, while indeed implying parameter mismatches and therefore residual risks, is also helping the formation of a more efficient and transparent market for mitigating credit risk, thereby arguably reducing the overall systemic risks.

Besides being highly restrictive, the proposed treatment of specific risk capital charges offers opportunities for regulatory arbitrage between cash and derivative positions. This is due to the apparent inconsistency that, while for cash positions in non-identical issues there is no allowance at all, positions hedged by credit derivatives may qualify for partial allowance or even an 80% allowance. In our view, a consistent and transparent regulation of market risks for cash and derivative positions should be based on a decomposition principle, resting on the well documented representation of credit default swaps (CDS), credit linked notes (CLN) and total return swaps (TRS) as combinations of cash positions. A corresponding proposal is drafted below.

Specific Aspects

The following specific shortcomings of the current proposal should not be left unmentioned.

In view of the fact that event and default risks can be ignored for short positions, the specific risk capital charge should be smaller for short positions than for long positions.

There is a lack of symmetry regarding the formulation of paragraph 162 (g). If a short cash position is hedged by a short position in a credit derivative, the cash position should be allowed to be junior to the reference obligation, not vice versa.

From the current proposal, it is not evident how to treat the specific risks for credit linked notes, i.e., whether there is a capital charge for the reference obligation as well as for the

note itself. Moreover, there is no mention of add-on factors to account for counterparty risk with respect to the embedded CDS.

Proposal

We propose to base the treatment of market risks for CDS, CLN and TRS on their representations as combinations of cash positions. To this effect, a CDS is viewed as a combination of two floating rate obligations, and a CLN as a combination of a floating rate obligation and a CDS. A TRS is viewed as a position in the reference instrument.

The concept of a permissible asset mismatch must be extended to cash positions. Paragraph 162 (g) must be adapted so that an asset mismatch is permissible if the short position is pari passu with or junior to the long position, and if legally enforceable cross-default or cross-acceleration clauses are in place.

With these definitions, allowance of specific risk capital charges for cash positions, and thereby indirectly for credit derivatives, can be formulated as follows:

- Full allowance applies to offsetting cash positions, if the maturity and currency coincide, and if the positions satisfy the conditions of paragraph 162 (g).
- An 80% allowance applies for offsetting cash positions with a maturity or currency mismatch, if the positions satisfy the conditions of paragraph 162 (g).
- In all other cases, no allowance applies.

The 80% allowance under a maturity or currency mismatch seems justifiable by the fact that, in case of a credit event, the losses experienced by the obligations in question are highly correlated. The remaining 20% charge accounts for residual risks.

Pillar 2

Fundamental Aspects

If the principles as currently stated under Pillar 2 are taken over into national implementation, they will most probably give rise to a huge mass of new policies as well as descriptions of processes and methods and the like. The corresponding reporting and monitoring systems would have to be massively enforced, with heavy consequences on the costs and effectiveness mainly of small and medium-sized banks. **Therefore, as a general comment, we strongly recommend that the implications of Pillar 2 in terms of implementation costs are explicitly taken into account by the Basel Committee.**

We remain critical with respect to the principles that (i) require banks to operate above the minimum regulatory capital requirement and (ii) formalise the regulatory early intervention in case capital adequacy was deemed insufficient. Pillar 1 has been designed to cover risks with a high level of confidence; the requirements for the estimation of the parameters and the calibration of PD to the risk weight function already include many buffers for uncertainties, e.g. stress testing for IRB (if these will be maintained) and scenario analysis for AMA, and hence cover a large variety of "unexpected" events. Moreover, total regulatory capital is still the result of a simple sum across risk categories.

For a bank with sound internal practices and standards, the capital calculated under Pillar 1 should constitute the regulatory capital requirement, with no further buffer, and the circumstances where an additional charge might be imposed should be

clearly defined. Other than in these limited circumstances, regulators should generally not determine the level of capital that a bank should hold in excess of the regulatory minimum, as this is a strategic decision and the responsibility of the bank's management.

Specific Aspects

Amongst the new elements, which raise concern, we highlight two.

First, we notice (in paragraph 700) a reference to strategic and reputation risks in CP 3, which is new. We believe that a link of these risk categories to the capital framework is not desirable. Strategic risks are inherent in any business environment and an (indirect) interference of national regulators over a bank's strategy could be very problematic from an economic and potentially even a legal perspective. Since the proposals do not include the earnings capacity of an institution as an important feature for the overall assessment of the soundness of a firm, a potential focus on strategic risks (which may impact the earnings power in future years) would also be inconsistent. Finally, if the risk profile of a bank changes following a strategic change of direction, this will immediately show an impact on the capital charges under Pillar 1 (in all three areas of credit, operational and market risks). As to the reputation risks, we wish to caution against any attempt to test a bank's determination to safeguard against them in a formulaic sense. Whilst the importance of policies and procedures is undisputed, the essence lies in the culture of a bank and how individuals value the reputation of their firm. The responsibility for the protection of the good reputation of a bank can neither be delegated to authorities within the firm nor addressed simply by manuals, which supervisors may peruse and assess. Formally subjecting these risks to capital rules would create an unwarranted and highly arguable intersection between business management and supervision.

Second, we wish to emphasise the importance of an active portfolio management for ensuring financial stability. The New Accord should therefore encourage the proper use of the growing possibilities of managing credit portfolio risks - inter alia, by way of asset securitisation - and not discourage firms by setting unnecessarily high hurdles.

The idea of establishing mandatory minimum capital requirements by national regulators (paragraph 720) will disturb the "level playing field". Pillar 2 should not contain any mandatory capital requirements. These should be treated only under Pillar 1.

Pillar 3

Fundamental Aspects

We generally believe that disclosure is an important element and that markets honour transparency. We also acknowledge that Pillar 3 has been substantially reduced in relation to CP 2. More concretely, we welcome the fact that the Committee has scaled back considerably the requirements for disclosure to avoid potentially flooding the market with information that would be difficult to interpret and to avoid substantially more costs for the banks to produce such potentially unnecessary information. From our perspective, however, the requirements regarding disclosure in Pillar 3 are still much too detailed and complex and primarily aimed at "expert users".

Pillar 3 requirements center on details of the Pillar 1 calculations, instead of internal risk measures and broader information on the management of risk, which would be more relevant to most users. As other supervisory bodies, such as securities exchange regulators as the SEC, already promulgate rules for detailed quantitative and qualitative disclosures about risk and statistical disclosures such as loan portfolios, the rigid disclosure requirements in CP 3's Pillar 3 would add duplications and additional complexity. Extensive explanation to the readers will become necessary, especially in cases where the Pillar 3 disclosures are made in one document, as somehow recommended in paragraph 765.

Differences between the definitions underlying the credit risk rules and those characterising accounting standards increase market opacity and implementation/running costs at banks. Thus, if the definition of default and the valuation of impaired assets, which drive the major parameters under Pillar 1 (PD, LGD), are different for accounting and regulatory purposes, banks will have to report two different sets of information regarding their portfolio and impaired assets. It is clear that this rather dilutes than increases transparency. **We reiterate our request that accounting and regulatory standards be fully harmonised.**

The level of prescriptiveness adopted within Pillar 1 for credit risk influences the detailed disclosure required under Pillar 3. Unfortunately, the false sense of uniformity across the industry suggested by the detailed construct of the Pillar 1 framework carries over Pillar 3 and the market, promoting dangerous comparisons amongst firms. Although many readers of external risk disclosure are expected to be educated on this important subject, there remains a risk that information - especially if structured in a rigid and prescribed way - is misinterpreted, with potentially damaging consequences. First, this relates directly to the level of conservatism adopted by a firm when defining the parameters and to the sensitivity of its rating systems to swings in the economic conditions (see our remarks in the section on Pillar 1). Second, expected loss in itself is a poor measure for portfolio risks for it ignores "lumpiness" of exposures and risk diversification on the one hand and the related profit stream on the other.

Regarding the quantity of information, the proposals in several areas , however, remain excessively detailed and will be onerous to provide. The requirements center on details of the Pillar 1 calculations, instead of internal risk measures. Therefore, and particularly in the area of securitisations, where the Pillar 1 calculations are especially complex and technical, much of the information disclosed will be of practically no benefit to users.

A credit risk approach under Pillar 1, which is based on principles rather than rules, would benefit both the accounting and transparency points made above. Pillar 3 could be drafted as a set of principles that guide what the disclosure is trying to achieve. The principles would be consistent with banks having differing interpretations. Over time, regulators could use good disclosures from some banks as examples for other banks. Alternatively, the scope of the Basel disclosures could be substantially streamlined and reduced to a few, high-level tables rather than the highly-detailed mass of data currently required.

Furthermore, we are particularly concerned about areas where disclosures still involve commercially sensitive information. For example, disclosure is required of cumulative gains and losses arising from sales of banking book equity holdings. Similarly, in the disclosures relating to market risk, we believe details of VaR outliers should not automatically be placed in the public domain, where under current IMA regulations these exceptions are discussed on a confidential basis with the relevant regulator.

Specific Aspects

Whereas quantitative disclosure requirements regarding operational risk are now on an appropriate level, requirements regarding credit risk are still very extensive. This is especially true for banks with only minor activity in the credit area (e.g. banks which are mainly active as asset managers): the publication of extensive and detailed information on credit risk as opposed to market and operational risk, including e.g. average exposure values etc., will be misleading.

In this context, we consider the new explicit statement on materiality in paragraph 766 very important ("A bank should decide which disclosures are relevant for it based on the materiality concept"). In addition to that, at national supervisory discretion a supervisor should be able to give groups of banks – as e.g. asset managers - with only minor (and mainly secured) credit activities relieve from extensive credit risk disclosure. This leads to a consistent disclosure policy and avoids discussions and arbitrary decisions between banks and their auditors.

The requirement of paragraph 767 for a semi-annual disclosure frequency for very detailed aspects is bound to undermine risk management – for the sake of warranting the competitive position and/or risk reporting – and is excessively onerous. For example, the quantitative disclosure requested in Table 13 on IRRBB could undermine a bank's interest to manage its IRRBB at best market rates in order to prevent 1) its counterparties from taking advantage of the information and/or 2) potentially adverse market availability for the bank. Also the volume of information requested for quantitative elements is considerable and by all means not readily available. This would drive the limited risk management resources into largely unnecessary reporting activities. For the most significant part of the banking community the qualitative and quantitative information on structures, methodologies, parameters, key inputs will not change significantly over a relative short time horizon of 6-12 months. We would therefore suggest, that – without loss of quality – it would be more efficient for the Accord to require: 1) full disclosure as proposed on an annual basis; 2) quarterly disclosure of capital and capital adequacy related information; 3) quarterly confirmation that there are no significant changes in qualitative elements as published in the last annual report; 4) in case of significant changes of qualitative elements or in risk-structure, the full set of disclosures would be required. We suggest to reword paragraph 767 accordingly. The following comments focus on some of the tables. Not discussing all of the tables does not mean that our assessment's result can be considered as a general agreement, but that the general comments in the first block of this section sufficiently summarize our conclusions.

The scope of application requirements of paragraph 771, particularly point b) of Table 1, could potentially divert market participants' attention from the material elements. It is not uncommon that large banking groups have more than 100 subsidiaries. Common practice of accounting disclosure is to compress – subject to external audit review – the disclosure to material information. **We therefore strongly suggest to rely exclusively on existing related information and limit all information required in Table 1 of paragraph 771 to "significant subsidiaries" and reword the table accordingly.**

In Table 6 we are concerned with CP 3's proposal to publicly disclose this level of quantitative details about risk assessment and historical results. We therefore recommend considering a significant streamlining of Table 6 by focusing on quantitative disclosure and some qualitative disclosures, if any, in the spirit of Table 5.

The qualitative disclosure requirements for Table 7 include information that is either proprietary (the differentiation between holdings on which capital gains are expected and

those taken under other objectives including for relationship and strategic reasons) or already disclosed in other sections of an institution's financial publications (discussion of important policies covering the valuation and accounting of equity holdings in the banking book). In addition, we perceive some of the quantitative disclosures too extensive to be publicly disclosed, not only in the light of business sensitivity but also exaggerating the deepness of information at all. We therefore recommend considering a significant streamlining of Table 7 by focusing on quantitative disclosure in the spirit of a general discussion of strategies and processes of managing banking book positions. Quantitative disclosures should be limited to first elements of (b) and (c).

We assess the quantitative disclosure requirements for Table 9, where Pillar 1 calculations are especially complex and technical, as being too detailed and with little benefit to users. We therefore recommend considering a significant streamlining of Table 9 by focusing on limited quantitative disclosure and some qualitative disclosures.

Table 13 of paragraph 775 covers sensitive and proprietary elements. For qualitative disclosures we believe that assumptions regarding loan pre-payments and behaviour of non-maturity deposits should only be generally discussed as proprietary models can apply. Also if the bank is compensated by the customers for loan/deposit pre-payments, this should be excluded from further qualitative discussion. Regarding quantitative disclosures we believe that no break into maturity gaps should be required. We therefore suggest to reword Table 13 accordingly, i.e., that assumptions should only be discussed generally and that no break into maturity gaps is required.

Implementation

Fundamental Aspects

Whilst we support the general direction and evolution of the regulatory framework, it has to be accepted that credit and operational risks cannot be put on par with market risk when it comes to risk quantification. **We remain convinced, therefore, that many aspects of the New Accord have to be interpreted in a pragmatic way and that judgement must be applied to many issues which cannot easily be quantified with precision.** The costs of implementing "Basel II" for a bank that uses already risk quantification methods should therefore not be excessive. We appreciate that the "all or nothing" notion has been de-emphasised over time and urge for pragmatism so that advances are made and costs incurred where it is material for both, bank management and supervisors.

The other fundamental issue is that internationally active banks must have certainty as to which rules apply to their integrated cross-border business. We strongly suggest to stipulate clearly and early the principle of lead home country supervisor – whereby rules set out by the recognised home regulator should be the basis for the assessment of a bank group by host regulators (lead home regulator's principle) – accompanied by increased harmonisation and efficiency in the supervisory process of global firms.

It is critical that regulators agree how to manage the many home/host relationships that will arise. Absent any governing framework, an institution is likely to face an administrative nightmare of duplicative or contradictory requirements from its different regulators, each performing its own national or regional supervisory duty.

The distribution of roles between the home and the host regulator/s is critical for allowing an international banking group to operate under "Basel II". We understand that all supervisors may be interested in the integrity of the implementation of an IRB/AMA methodology in their own jurisdiction, but concern exists that full IRB/AMA review and approval processes in host states, covering conceptual soundness of the IRB/AMA in addition to its implementation, would impose undue burdens on both banks and supervisors. In our view, it cannot be conceivable in the Basel II spirit that an international banking group would have to operate different IRB and/or AMA approaches or use different data samples for such approaches for each individual jurisdiction.

Specific Aspects

The home versus host regulator issue is of central importance to any internationally active bank. In our view, the Basel Committee, via the Accord Implementation Group, must aggressively pursue mechanisms that allow approvals in one jurisdiction to be valid in others (or with only a minimum of further review). In particular, Basel should aim at:

- Ensuring a national implementation as close as possible to the letter of the final Accord, with no divergence in the requirements requested for the internal rating system and its validation
- Regulators devoting little resources to their host supervisor position for subsidiaries where say the home regulator has granted IRB/AMA approval for the parent banking group in order to focus on the institutions for which they are home regulator.

Under "Basel II", situations could potentially emerge where the consolidated capital requirement is smaller than the sum of the capital requirements in the specific jurisdictions due to local adjustments of IRB/AMA parameters under Pillar 1 and/or the local exercise of a Pillar 2 additional capital charge. In cases when the bank uses a global system or a high level capital calculation, the allocation of regulatory capital to one specific jurisdiction is also difficult. A coordination among home and host supervisors with regards to Pillar 1 specifications and the limitation of Pillar 2 competence to the home regulator could largely avoid that such situations come about and, therefore, that the allocation of regulatory capital cross border becomes an issue.

We believe that IRB/AMA banks should have the flexibility to develop mechanisms for allocating regulatory capital to individual entities in the Business Unit in a manner that is consistent with, and part of, this overall IRB/AMA methodology (and indeed for the AMA do not believe that there should be a requirement for quantifying capital requirements at any level other than the entire organisation). Consequently, the home supervisor should be primarily responsible for reviewing and approving regulatory capital allocations within the Business Unit as part of the review and approval process for that bank's IRB/AMA.

The home supervisor should have the lead in all Pillar 1 both for credit and operational risk matters (e.g. setting out the requirements and performing the approach validation) and be responsible for ensuring that host supervisors accept the validation of AMA and IRB Approaches. The home supervisor should be responsible for approving the conceptual soundness of a bank's IRB/AMA (including any top-down allocation mechanism) and the operational risk data used to determine regulatory capital because the home supervisor is most likely to understand best a bank's global operations. For this purpose, the home supervisor should proactively seek detailed validation issues from all relevant host supervisors. Where diverging requirements are identified, a mechanism to

sort the issues should be provided by the New Accord. Such a mechanism should provide for a discussion involving a representative from the bank concerned, the home regulator, the host regulator and the Accord Implementation Group in order to agree upon a pragmatic resolution.

A mechanism ensuring information sharing among regulators could be helpful in enhancing the supervision efficiency both for banks and supervisors. This mechanism could take the following form. The home regulator, based on the list of jurisdictions in which a bank operates, would proactively inform host supervisors of the relevant parts of discussions with the bank. The home regulator would also proactively seek issues from host regulators that they would like to raise with a bank and ensure that these issues are taken on the agenda of regular meetings with the bank.
