Treasury Strategies

The Power of Experience[SM]

July 30, 2003

Basel Committee on Banking Supervision
Bank for International Settlements
2 Centralbahnplatz
CH – 4002 Basel
Switzerland

Re: Comment to "The New Basel Capital Accord"

Gentlemen:

Treasury Strategies, Inc. (Treasury Strategies) appreciates the opportunity to comment on the proposed New Basel Capital Accord ("New Accord"). Our outlook is gleaned from over two decades of experience in treasury and financial strategy consulting to companies, financial services providers, and regulators. This breadth of coverage has afforded us with unique perspectives on the impacts of financial regulation and market innovation.

Summary

We believe that the proposed New Accord, although incorporating many beneficial improvements, could give rise to significant market disruptions – ultimately undermining the objectives of the Basel Committee on Banking Supervision (the "Committee").

The New Accord represents significant advancements in methodology and process towards the goal of assigning capital more accurately to risk. To the extent that market participants properly execute the new methodologies, this would transform the underlying market economics and lead to more rational resource allocation in the supply of financial services. These changes would be welcome.

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Our concerns revolve around the following areas:

- The proposed New Accord calls for a level of sophistication in measuring operational risk that is currently infeasible. Additionally, the new operational risk capital allocation methodologies are being implemented concurrently with other far-reaching changes;

- These measures could lead to erroneous viewpoints about business profitability;
- This is likely to cause market participants to retrench from innovation, re-price, or otherwise reduce the supply of operating services;
- Such activities could create significant market disruptions and increase financial market risk during a critical period of innovation in which cross-market settlement networks offer the promise of significant reductions in operating and settlement risk; and,
- Finally, differential impacts across financial institutions could weaken the economic basis of the banking sector – thereby undermining the Committee's primary objectives.

We support the Committee, but for the reasons listed above, believe that the pace of introduction of the operational risk components must be tempered to reflect the limitations of how risk can be quantified.

Background: Evolution in Financial Services

To provide context, it is useful to review the evolution in financial services in the close to two decades since the introduction of the original Basel Capital Accord.

Operational Services and Financial Institutions' P&Ls

The provision of fee-based operational services has become an important component of financial institutions' P&Ls. During this time banks have extended their product set beyond the provision of basic money transmission services. This expansion has taken place across the commercial trading value chain, as banks have developed services that facilitate better management of corporate payables and receivables. They have also expanded service offerings across the broader financial value chain and into working capital management. As a result, today, banks provide companies of all sizes and trading needs with a wide array of fee-based operational services. With take-up by the corporate sector, banks have invested in building scale, which has reduced the cost of delivery and improved providers' profit margins. This developed into a virtuous cycle, as competition lowered industry pricing, and the impact of demand elasticity increased volumes.

Benefits

The end result of this for the banking sector has been a source of income that is not dependent on risk assets or interest cycles. Moreover, while asset-based products are often purchased and renewed on an annual basis, operational services are typically purchased for multi-year cycles. In all, the growth in operational services has helped banks diversify their income streams, reduce P&L volatility, and increase shareholder value. The importance of this development to the banking sector should not be underestimated, given the significant contribution of fee income to the P&L of large banks.

The corporate sector has also greatly benefited from these developments. Companies have been able to outsource more components of their financial value chain, depending upon whether these activities are a source of strategic value and competitive differentiation. Although the macro-economic impact of this effect has not been fully investigated, we hypothesize that this has been one source for the growth in US productivity since the late 1980s.

The Future

The financial services industry in North America and Europe is entering a critical period of innovation.

In the US, the shift from paper-based to electronic payments is gathering significant momentum. Over the past year, for the first time in the history of the US payments system, paper-based payments have declined while electronic transactions have grown. Participants agree that this shift from paper to electronic will accelerate, driven by legislation and regulation (such as the proposed Check21 legislation), as well as changing commercial and consumer behavior. These developments will require the banking sector to make significant investments in new infrastructure. The shift from paper to electronic will also alter the P&L dynamics of banks' operational businesses, as higher revenue generating paper volume is displaced by lower revenue (but higher margin) electronic traffic.

The European Commission continues to drive the process for establishing the Single European Payments Area. As a result, banks' income from cross-border payments is declining. The industry is responding with initiatives to facilitate more efficient processing of these payments, such as Step2, Step3, and PEACH (Pan European ACH). European banks will need to invest in new infrastructure to support this change, just as their P&Ls are impacted by the reductions in payments fee income.

Treasury Strategies' Assessment of the New Accord

As proposed, the New Accord is likely to induce both beneficial changes as well as adverse consequences.

Benefits of the New Accord

We believe that the New Accord, as proposed, marks an important advancement over the existing mechanistic capital adequacy framework. Currently, systemic regulatory capital levels are well in excess of mandated minimums. However, the existing regulatory framework has been superseded by evolutions in market practice, particularly at the larger financial institutions that account for the bulk of industry assets. The result has been an increasing divergence between regulatory and economic risk capital, as evidenced by the behavior of financial institutions in managing to their own measures of economic risk.

We see three primary benefits of the proposed New Accord:

1) Greater sophistication in the identification, measurement, and management of a comprehensive set of risks. Improved risk calibration, as envisaged in Pillar I, will facilitate a more rational assignment of capital to credit, liquidity, and operational products.

2) More nuanced supervisory review process. Pillar II will provide incentives for the development of enhanced risk measurement and management techniques on both sides of the supervisory divide.

3) Greater transparency in the disclosure of risks to market participants. The disclosure requirements in Pillar III will introduce appropriate and robust external market discipline into the overall process.

Concerns with the New Accord

Our concerns lie in the consequences of the proposed New Accord on financial market evolution, stemming from the proposed capital allocations for operational risk. When implemented in the context of the other changes envisaged in Basel II, these could have significant impacts on the financial sector and the economy as a whole.

The Quantitative Impact Studies (QISs) have demonstrated that the implementation of the New Accord will have little impact on aggregate capital allocation within the banking system. For many banks, regulatory capital allocations for risk assets will be reduced, but largely offset by increased capital allocations for operational risk.

We have five major concerns:

1) Infeasibility of Accurate Operational Risk Capital Allocations
   As acknowledged by both industry participants and supervisors the discipline of operational risk management is less well developed than credit risk management. Although great strides have been made, the identification and measurement of operational risk is still problematic due to methodology issues and systems infrastructure. Unlike the situation regarding credit losses, there is also a paucity of consistent operational loss data available within the industry – partly because, historically, these have been of lesser magnitude than credit losses. Hence, the calibration of operational risk and capital allocations will require additional advances in conceptual, methodological, and technological techniques. The operational risk capital allocations in the New Accord introduces a source for additional complexity in the already far-reaching new capital adequacy framework.

2) Inaccurate Measurement of Business Profitability
   Given the difficulties in accurate operational risk capital allocations, when confronted by the increased scrutiny of regulators, rating agencies and financial markets, we believe that banks will err on the side of caution in allocating risk capital to operational products. As a result, the return on capital on operational products may be understated. While the returns on regulatory capital on asset products will be more closely aligned with economic reality, this will not be the case for operational products.

3) Impediments to Innovation and Supply
   In the aggregate, banks will be faced with lower return on capital on operational products. The short-term potential negative impacts of this include:

   - Industry-wide price increases, as banks attempt to recover profitability;

   - Reduced product innovation, as banks take a more risk averse stance to investment in new product development;

- Reduced supply, as banks exit the provision of specific operational products or cease serving industry segments for which the returns are currently marginal;

- Reduced investment in infrastructures, at a time the industry is facing major shifts as described previously, which will exacerbate operational risk.

4) Market Disruption
Across the financial services industry, these forces will be tempered or accentuated by the wider impacts of the New Accord, creating the potential for market disruption, and increasing risk during a critical period. In this context, we segment the industry into four broad groups:

- Diversified Universal Banks – Large banks with broad franchises encompassing wholesale, retail and small business segments will be favorably impacted by the reduction in asset risk capital, which will more than offset the increases in operational risk capital. This will temper the negative impacts described above.

- Wholesale Banks – Institutions with primarily wholesale franchises will be adversely impacted to the extent that operational services are an important component of their P&L (as is the case with many of the largest banks in this group). The increase in allocated operating risk capital will not be offset by as large reductions in asset risk capital. This effect will accentuate the negative impacts described above.

- Processing Banks – Institutions with significant strategic focus in the payments and securities businesses will be more adversely impacted, as the increase in allocated operating risk capital will not be offset by reductions in asset risk capital. This will accentuate the negative impacts described above.

- Non-Regulated Providers – Banks do not have a monopoly on operating services and, indeed, an expanding group of non-banks are already competing to provide services along the financial value chain. However, only banks and investment firms (and their subsidiaries) fall under the remit of the New Accord. The New Accord creates impediments to industry parity, as the non-bank Non-Regulated Providers will not be affected by the capital allocation rules for taking similar operating risks. They will have added incentive to invest in building product sets that enable them to compete strongly in the payments and securities settlement value chain space, still largely controlled by banks.

5) Potential Weakening of the Economics of the Banking Sector
Ultimately, one potential impact of the New Accord is an unwinding of the trend of the last two decades, during which bank P&Ls became less sensitive to asset-based income. The banking sector may revert to greater dependence on credit as a key driver of income. Since large, creditworthy companies in developed economies directly tap the capital markets for funding, banks will be induced to accept greater credit risk. Additionally, a reduction in the pace of innovation in operational services may have negative impacts on corporate sector productivity and profitability, with consequent impacts on GDP growth and the volatility of economic cycles. The outcome for the economic basis of the banking system would be precisely counter to the intentions of the Committee in promulgating the New Accord.

Conclusion

We believe that the New Accord, as proposed by the Committee, makes significant strides in aligning regulatory capital with true economic risk. The power of these benefits is considerable, making the New Accord more than a compliance exercise. In fact, it will likely transform the underlying economics of the financial services markets, leading to significant changes in resource allocation, competitive positioning, and supply of services. These changes would, in the long-term, be welcome to the extent that market participants are able to execute the capital methodologies accurately.

However, the accord calls for a level of sophistication in measuring operational risk that is currently infeasible. The resulting measures could thus lead to erroneous viewpoints about business profitability and cause market participants to retrench from innovation, or re-price, or otherwise reduce the supply of operating services. Such activities could increase financial market risk during a critical period of innovation in which cross-market settlement networks offer the promise of significant reductions in operating and settlement risk. This will also create impediments to industry parity, whereby banks are disadvantaged against non-bank providers of financial services. The consequent impacts on P&Ls and balance sheets could weaken the economic basis of the banking sector – thereby undermining Committee's very objectives

For these reasons, we broadly support the New Accord, but believe that the operational risk components must be modified so that they reflect the limitations in how precisely such risk can be quantified. At a minimum, changes should be made to the pace at which operational risk components are introduced.

We look forward to working with the Committee and assisting in the finalization of a comprehensive and robust framework that achieves the stated goals, while minimizing these potential unintended consequences.

Very truly yours,

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