Group Risk Management
Level 1, 60 Martin Place
Sydney NSW 2000 Australia
Telephone: (02) 9226 3026
Facsimile: (02) 9223 1990
Email: jcoleman@westpac.com.au

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Guy Eastwood
Senior Manager, Capital & Risk Analysis
Australian Prudential Regulatory Authority
GPO Box 9836, Sydney NSW 2001

RE: Basel Committee on Banking Supervision's April 2003 Consultative Document "The New Capital Accord"

Dear Guy

The new Capital Accord has come of age with the latest set of draft standards, referred to throughout this letter as CP3. The Basel committee are to be congratulated for their efforts in balancing the competing requirements of multitudinous stakeholders. The comparison with previous drafts is marked. In the majority of cases, Pillar 1 is now clear, flexible and direct where it was once obscure, prescriptive and ambiguous. Pillar 2 remains an adequate description of regulatory best practice. The rewrite of Pillar 3 continues the trend that was observed in December's working paper (see my letter of January 21) towards making the increased disclosure requirements meaningful and Westpac is satisfied with the current version.

A very few clauses remain where the wording of the Accord seems at variance with what Westpac believes the intent of the Basel committee to be. There are rather more paragraphs where the meaning is ambiguous. In the latter cases, APRA's guidance is sought to help Westpac achieve its ambition of being allowed to use the Advanced IRB approach to measure its regulatory credit risk and the Advanced Measurement approach for operational risk.

Finally, the Accord is definitive but at variance with the Australian market in its treatment of clean-up calls, redraw facilities, cross-currency swaps and basis swaps in Securitisation transactions. Westpac expects APRA to take Australian practice into account when using the Accord as a basis for new Australian prudential standards.

The exclusion of a number of ambiguous paragraphs from the previous draft means that the Operational Risk section of the new Accord is now much simpler and clearer. However, CP3 still does not address a number of operational risk issues Westpac regards as important.

In keeping with previous correspondence, please find attached a list of all CP3 paragraphs that Westpac believes could be improved, either by the Basel committee or by APRA applying its national discretion. Interpretations have been suggested for the paragraphs where Westpac is seeking APRA's guidance. Should APRA's interpretation differ, please respond in writing by the middle of September in order to allow Westpac time to adjust its compliance budget before the end of the current financial year.

Should you have any questions regarding the information set out below, please contact Ed Bosworth, the manager of Westpac's Basel program. Ed can be reached by telephone on (02) 9226 3470 or by email to ebosworth@westpac.com.au.

Yours Sincerely

James R Coleman
Chief Credit Officer

Detailed Comments

Issue/Problem	Where Westpac's non-compliant processes have given rise to historical data that are used as inputs to risk-weight estimation (for example, an event-driven ratings review cycle) is it sufficient that the processes for estimating the inputs are sound or do the management processes also need to meet the letter of the Accord?
Paragraph Reference	April 2003 Consultative Document: Overview of the New Capital Accord, paragraph 33
Accord Requirement	*33 Clearly, an internal rating system is only as good as its inputs. Accordingly, banks using an IRB approach will need to be able to measure the key statistical drivers of credit risk. The minimum Basel II standards provide banks with the flexibility to rely on data derived from their own experience, or from external sources as long as the bank can demonstrate the relevance of such data to its own exposures. In practical terms, banks will be expected to have in place a process that enables them to collect, to store and to utilise loss statistics over time in a reliable manner.*
Potential Ambiguities	The connection between flexibility on process compliance (because all Banks run their risk management processes differently) and rigour on parameter estimation compliance is raised in this paragraph but not discussed in Pillar 2 (its logical home in the New Accord). APRA's interpretation would be welcomed
Recommended Alternatives	When certifying banks to use the Advanced IRB approach, greater emphasis should be placed on the processes used to estimate PD, LGD and EAD than on forcing different banks to apply the same management processes when they might have sound business reasons for doing otherwise
Resolution Priority	Moderate – Westpac understands that APRA's approach to implementation is still being thought through. Perhaps an industry forum late in calendar 2003 would be a suitable occasion to discuss this issue
International Consistency	Low

Issue/Problem	The rules for the use of internal credit risk parameters in Specialised Lending [SL] are ambiguous. Depending on how the rules are interpreted, Banks may either apply PD, LGD and EAD validated on their entire corporate portfolios to the SL portfolio or be forced to use the Supervisory risk weights. There is insufficient default data to validate SL-specific credit parameters in the Australian market.
Paragraph Reference	April 2003 Consultative Document: The New Capital Accord, paragraphs 218 to 220
Accord Requirement	*218 Banks that do not meet the requirements for the estimation of PD under the corporate foundation approach for their SL assets will be required to map their internal risk grades to the five supervisory categories, each of which is associated with a specific risk weight. This version is termed the 'supervisory slotting criteria approach'.* *219 Banks that meet the requirements for the estimation of PD will be able to use the foundation approach to corporate exposures to derive risk weights for all classes of SL exposures except HVCRE. At national discretion, banks meeting the requirements for HVCRE exposure will be able to use a foundation approach that is similar in all respects to the corporate approach, with the exception of a separate risk weight function as described in paragraph 252.* *220 Banks that meet the requirements for the estimation of PD, LGD and EAD will be able to use the advanced approach to corporate exposures to derive risk weights for all classes of SL exposures except HVCRE. At national discretion, banks meeting these requirements for HVCRE exposure will be able to use an advanced approach that is similar in all respects to the corporate approach, with the exception of a separate risk weight function as described in paragraph 252.*
Potential Ambiguities	Do the requirements for estimating credit parameters apply to the SL book in particular or to the corporate portfolio as a whole?
Recommended Alternatives	In decreasing order of preference: (a) Allow banks that can validate their credit risk parameters on the entire corporate portfolio (ie, including SL) to use the ordinary corporate curve for all SLs except HVCRE (b) Allow banks that can demonstrate a concordance between internal risk grade and external rating to use default rates derived from externally-rated SLs to set the PD. Although this approach may be possible, it would cause banks to use grading systems that yielded different default rates when applied to SL than to the rest of the bank, which would be extremely complicated to administer (c) Require banks to use the supervisory slotting criteria but drop the risk weight for Strong exposures to 50% and 75% for Good exposures, in accordance with paragraph 246 The best approach is to allow banks to use internal default rates consistent with the bank as a whole but use pillar 2 to check that banks' SL policies do not permit highly risky exposures. For example, it is difficult to find a SL in Westpac that is anything other than "Strong". Using the supervisory slotting approach would treat all such loans identically, from a regulatory risk-weight point of view, discouraging the segmentation the bank already performs.
Resolution Priority	High
International Consistency	High – there is a paucity of specialised lending default data worldwide, so a globally consistent approach to implementation seems appropriate

Issue/Problem	As new credit data are captured, either to support Basel compliance or more sophisticated credit models, retrospective segmentation or rating may not be possible
Paragraph Reference	April 2003 Consultative Document: The New Capital Accord, paragraphs 391
Accord Requirement	*391 A bank must collect and store data on key borrower and facility characteristics to provide effective support to its credit risk measurement and management process, to enable the bank to meet the other requirements in this document, and to serve as a basis for supervisory reporting. These data should be sufficiently detailed to allow retrospective re-allocation of obligors and facilities to grades, for example if increasing sophistication of the internal rating system suggests that finer segregation of portfolios can be achieved. Furthermore, banks must collect and retain data on aspects of their internal ratings as required under pillar 3 of the New Accord.*
Potential Ambiguities	Nil
Recommended Alternatives	APRA should recognise that credit histories will necessarily be limited in areas where a bank has changed credit systems in order to address Basel compliance gaps. In particular, it may not be possible to fully segment some retail portfolios if the segment information is being collected by newly-introduced credit originations systems. There seem to be two ways to address this: (a) apply the segmentation proportions from the accounts for which data are available to the older accounts where it is not, on some pro-rata basis (b) require banks to disclose their pool of 'unsegmented' loans, to which an unsegmented PD, LGD or EAD would apply The second approach seems more consistent with the spirit of the New Accord, by matching measurement to management. Due to the non-linear relationship between PD and risk-weight, it is easy to show that finer segmentation reduces risk-adjusted assets so a lack of segmentation will require banks to hold more capital for exposures about which they have less information
Resolution Priority	Moderate – a response from APRA on their preferred approach would help in designing Basel-compliant reports
International Consistency	Low

Issue/Problem	The requirements for holding historical account-level credit data are excessive. Credit data that are more than 12 years old have little meaning
Paragraph Reference	April 2003 Consultative Document: The New Capital Accord, paragraphs 392, 393 and 395
Accord Requirement	*392 Banks must maintain rating histories on borrowers and recognised guarantors, including the rating since the borrower / guarantor was assigned an internal grade, the dates the ratings were assigned, the methodology and key data used to derive the rating and the person/model responsible. The identity of borrowers and facilities that default, and the timing and circumstances of such defaults, must be retained. Banks must also retain data on the PDs and realised default rates associated with rating grades and ratings migration in order to track the predictive power of the borrower rating system.* *393 Banks using the advanced IRB approach must also collect and store a complete history of data on the LGD and EAD estimates associated with each facility and the key data used to derive the estimate and the person/model responsible. Banks must also collect data on the estimated and realised LGDs and EADs associated with each defaulted facility. Banks that reflect the credit risk mitigating effects of guarantees/credit derivatives through LGD must retain data on the LGD of the facility before and after evaluation of the effects of the guarantee/credit derivative. Information about the components of loss or recovery for each defaulted exposure must be retained, such as amounts recovered, source of recovery (eg collateral, liquidation proceeds and guarantees) time period required for recovery, and administrative costs.* *395 Banks must retain data used in the process of allocating exposures to pools, including data on borrower and transaction risk characteristics used either directly or through use of a model, as well as data on delinquency. Banks must also retain data on the estimated PDs, LGDs and EADs associated with pools of exposures. For defaulted exposures, banks must retain data on the pools to which the exposure was assigned over the year prior to default and the realised outcomes on LGD and EAD.*
Potential Ambiguities	In fourth line of paragraph 392, the use of the word "rating" (rather than "ratings") after mentioning methodology and the person / model responsible seems to imply that these two data items must be stored for the current rating only. Is this correct or must histories of credit officer names also be stored? In paragraph 395, it appears that data need not be retained at the customer or facility level for retail exposures (including retail SME). What is needed is a record of pool definition and performance. Is this correct or does APRA intend to require Australian banks to hold credit data histories for all retail customers?
Recommended Alternatives	(a) Resolve the ambiguities in line with Westpac's interpretation (b) Allow a sunset clause of 12 years or less on historical credit data
Resolution Priority	High – resolving the historical data requirement for retail customers has a compliance cost implication
International Consistency	Low

Issue/Problem	It is unclear whether the requirements for frequent revaluation of real estate security that apply in the Foundation IRB approach also apply in the Advanced IRB approach
Paragraph Reference	April 2003 Consultative Document: The New Capital Accord, paragraph 472
Accord Requirement	*472 ...* ***Frequent revaluation****: the bank is expected to monitor the value of the collateral on a frequent basis and at a minimum once every year. More frequent monitoring is suggested where the market is subject to significant changes in conditions. Statistical methods of evaluation (eg reference to house price indices, sampling) may be used to update estimates or to identify collateral that may have declined in value and that may need re-appraisal. A qualified professional must evaluate the property when information indicates that the value of the collateral may have declined materially relative to general market prices or when a credit event, such as default, occurs.*
Potential Ambiguities	No reference to frequent revaluation of real estate security is made in any paragraphs referring to the Advanced IRB approach, presumably because any inaccuracies in security valuation will be automatically adjusted for by using LGDs based on historical experience[1]
Recommended Alternatives	Confirm that banks using LGD estimates based on their own historical experience will not need to comply with the above clause
Resolution Priority	High
International Consistency	Moderate. Jurisdictions with few banks using the Advanced IRB model may require all banks to revalue their security, for reasons of consistency.

[1] Note that a similar argument can be made for using internal PD estimates and annual ratings reviews. Although Westpac does not review the ratings of all customers annually, our PD estimates are based on the bank's default experience with an event-driven review cycle

Issue/Problem	Many Australian securitisation transactions include date-based calls under which the securitised assets can be repurchased at fair market value after a certain date (typically 7 years, more than twice the average life of the loans). While not expected, it is theoretically possible that the outstanding balance at the call date exceeds 10 per cent of the original nominal value.
Paragraph Reference	April 2003 Consultative Document: The New Capital Accord, paragraph 518 to 520
Accord Requirement	*518 The presence of a clean-up call not meeting all of the following conditions will result in the treatment outlined in paragraph 520 for regulatory capital purposes. No capital will be required if the following conditions are met: (1) its exercise must not be mandatory, in substance or in form, but rather at the discretion of the originating bank; (2) it must not be structured to avoid allocating losses to be absorbed by credit enhancements or positions held by investors or otherwise structured to provide credit enhancement; and (3) it must only be exercisable when 10% or less of the original underlying portfolio or reference portfolio value remains.* *519 If a clean up call, when exercised, is found to serve as credit enhancement, the action will be considered a form of implicit support provided by the bank and will be treated in accordance with the supervisory guidance pertaining to securitisation transactions.* *520 The presence of a clean-up call which does not meet all of the criteria stated in paragraph 518 will result in a capital requirement. For a traditional securitisation, the underlying exposures will be treated as if they were not securitised. For synthetic securitisations, the bank must hold capital against the entire amount of the securitised exposures as if they did not benefit from any credit protection.*
Potential Ambiguities	Nil – this is an area where the Accord has been made more definite but less suitable to the Australian market
Recommended Alternatives	Date-based calls are a mechanism to address the prepayment characteristics of Australian mortgages. APRA should apply its national discretion to remove the capital penalty for date-based calls that allow for repurchase after twice the average loan life.
Resolution Priority	Moderate - This issue affects all Australian financial institutions that securitise, not just Westpac, and the penalties for non-compliance (para 520) are extremely high. Should APRA affirm Basel's approach, rather than apply national discretion to as advocated above, the documentation of many securitisation transactions will need to change, potentially increasing costs.
International Consistency	Low – the intent of the Accord is to exclude clean-up calls that serve as credit enhancement (para 519), not to force national practice into a regulatory straitjacket. A national approach that limits clean-up calls to some multiple of average expected life will achieve the same goal.

Issue/Problem	The assessment of ECAIs is not impacted by whether a rating is released publicly, so it is unclear why all credit assessments must be made publicly available if it is used to determine a regulatory risk-weight. Circumstances may arise where a private rating is appropriate, for example when a conduit customer desires the transaction to be privately placed.
Paragraph Reference	April 2003 Consultative Document: The New Capital Accord, paragraph 525(b)
Accord Requirement	*525 (b) The external credit assessments must be from an eligible ECAI as recognised by the bank's national supervisor in accordance with paragraphs 60 to 78 with the following exception. In contrast with bullet three of paragraph 61, eligible credit assessments must be publicly available, meaning that the rating is of the type that is published in an accessible form and included in the ECAI's transition matrix. Accordingly, eligible assessments for securitisations do not include those that are only made available to domestic and foreign institutions with legitimate interests and at equivalent terms. In addition, "private ratings" will not qualify for this condition, even if they are available to all parties of the transaction.*
Potential Ambiguities	Nil
Recommended Alternatives	The clause should be omitted, provided a bank can provide documentary evidence to its regulator that all ratings used to determine securitisation regulatory risk-weights were obtained from eligible ECAIs.
Resolution Priority	Low – this issue was first raised in Westpac's response to the second working paper on Securitisation
International Consistency	Moderate – Although the issue could be addressed by APRA applying national discretion, private ratings are not a peculiarly Australian issue

Issue/Problem	The treatment of eligible liquidity facilities and other off-balance sheet facilities provided to securitisation conduits has been clarified. Assuming Westpac's interpretation is correct, the treatment of eligible liquidity facilities is satisfactory, although the fact that credit conversion factors for IRB banks defaulting to standardised are higher than they are for standardised banks is at variance with the paradigm of encouraging more sophisticated risk measurement. The treatment of other off-balance sheet facilities remains punitive. Credit conversion factors of 100% are inappropriate for the redraw facilities and basis swaps provided to Australian conduits. Such facilities are of entirely different nature to the letters of credit with which they have been aggregated. For example, redraw facilities are only available to fund borrower "redraw" requests and historically have not been drawn. Similarly, the exposure under a basis swap is only a small fraction of the notional amount. A lower credit conversion factor appropriately adjusts for these differences.
Paragraph Reference	April 2003 Consultative Document: The New Capital Accord, paragraph 603 and 536 to 540
Accord Requirement	*603 When it is not practical for the bank to use either the 'bottom-up' approach or the 'top-down' approach for calculating K_{IRB}, the bank may, on an exceptional basis and subject to supervisory consent, temporarily be allowed to apply the following method. If the liquidity facility meets the definition in paragraph 538 or 540, the highest risk weight assigned under the standardised approach to any of the underlying individual exposures covered by the liquidity facility can be applied. If the liquidity facility meets the definition in paragraph 538, the CCF must be 50% for a facility with an original maturity of one year or less, or 100% if the facility has an original maturity of more than one year. If the liquidity facility meets the definition in paragraph 540, the CCF must be 20%. In all other cases, the notional amount of the liquidity facility needs to be deducted.* *537 For eligible liquidity facilities as defined in paragraph 538, the risk weight applied to the exposure's credit equivalent amount is equal to the highest risk weight assigned to any of the underlying individual exposures covered by the facility.* *538 For risk-based capital purposes, banks must determine whether, according to the criteria outlined below, an off-balance sheet securitisation exposure qualifies as an 'eligible liquidity facility' or a servicer cash advance facility. For risk based capital purposes, all other off-balance sheet securitisation exposures will receive a 100% CCF.* *539 Banks are permitted to treat off-balance sheet securitisation exposures as eligible liquidity facilities if the following minimum requirements are satisfied…* *539 Where these conditions are met, the bank may apply a 20% CCF to the amount of eligible liquidity facilities with an original maturity of one year or less, or a 50% CCF if the facility has an original maturity of more than one year.* *540 Banks may apply a 0% CCF to eligible liquidity facilities that are only available in the event of a general market disruption (ie where a capital market instrument cannot be issued at any price). To qualify for this treatment, the conditions provided in paragraph 538 must be satisfied. Additionally, the funds advanced by the bank to pay holders of the capital market instruments (eg commercial paper) when there is a general market disruption must be secured by the underlying assets, and must rank at least pari passu with the claims of the holders of the capital market instruments.*

Potential Ambiguities	Westpac has interpreted the above clauses to mean that when an IRB bank provides a liquidity facility to a securitisation transaction from an institution that uses the Standardised approach, it may use credit conversion factors of 50% (20% if the original maturity is less than one year, 0% if the facility is only available in general market disruption) and the risk-weight of the lowest rated tranche of the transaction. APRA's confirmation of this interpretation is sought.
Recommended Alternatives	The default to standardised approach is both operationally simple and consistent with a regulatory approach that aligns risk management to risk measurement. The credit conversion factors that are currently applied to redraw facilities, cross-currency swaps and basis swaps should be preserved by APRA applying its National Discretion. Remove the discrepancy between the CCFs for eligible liquidity facilities between IRB banks defaulting to standardised and standardised banks (paragraphs 603 vs. 539-540) by correcting the figures in paragraph 603.
Resolution Priority	Very high – many customers of the securitisation conduits operated by the Australian major banks are small unrated financial institutions (credit unions and building societies), for which securitisation represents an important and cheap source of wholesale funding. For many unrated ADIs, securitisation is their main source of growth funding. A severe regulatory capital treatment on the off-balance sheet facilities provided to conduits would result in a prohibitive cost increase, restricting the growth of small Australian ADIs
International Consistency	Low – Basis swaps and redraw facilities are peculiar to the Australian market and highly important to Australian securitisation programs given the features of the underlying loan products

Issue / Problem	The proposed floor on overall capital together with the absence of any QIS 3 results for AMA suggest that AMA will only be adopted if imposed as a regulatory requirement rather than as an incentive. This seems to be contrary to the intention of the New Accord.
Paragraph Reference	April 2003 Consultative Document: The New Capital Accord, paragraphs 23, 609-611
Accord Requirement	*23 For banks using either one of the Internal Ratings-based (IRB) approaches for credit risk or the Advanced Measurement Approaches (AMA) for operational risk, there will be a single capital floor for the first two years following implementation of the New Accord.* *609 Banks are encouraged to move along the spectrum of available approaches as they develop more sophisticated operational risk measurement systems and practices.* *610 Internationally active banks and banks with significant operational risk exposures are expected to use an approach that is appropriate for the risk profile and sophistication of the institution.* *611 A bank will not be allowed to choose to revert to a simpler approach once it has been approved for a more advanced approach without supervisory approval.*
Potential Ambiguities	By making removing the regulatory capital floor on operational risk (where the AMA approach used to be limited to 75% of Standardised), Banks with large reductions in regulatory capital arising from the quality of their balance sheet that are also intending to adopt AMA face the internal challenge of supporting an approach that is yet to be proven cost effective. The situation is exacerbated by the fact that the Australian QIS 3 results demonstrated a higher regulatory capital requirement from the AMA approach than from the Standardised approach.
Recommended Alternative	AMA compliance should be required in order for banks to achieve significant regulatory capital relief (more than a 10% reduction, for instance) from the New Accord.
Resolution priority	High
International Consistency	Low. This problem is particular to the Australian major banks, all of which expect reductions in risk-adjusted assets attributable to credit risk that are well beyond the 20% floor envisaged by the Basel committee. Guidance from APRA on the likelihood of achieving regulatory capital relief without a high standard of operational risk management would be helpful in making the case for AMA compliance.

Issue / Problem	The requirement for an operational risk capital allocation framework belongs better in Pillar 2 than in Pillar 1
Paragraph Reference	April 2003 Consultative Document: The New Capital Accord, paragraphs 622, 624 (b) and 626 (b)
Accord Requirement	*622 …The bank's measurement system must also be capable of supporting an allocation of economic capital for operational risk across business lines in a manner that creates incentives to improve business line operational risk management.* *624(b) … The bank must have techniques for creating incentives to improve the management of operational risk throughout the firm.* *626(b) … The bank must have techniques for allocating operational risk capital to major business lines and for creating incentives to improve the management of operational risk throughout the firm.*
Potential Ambiguities	Nil
Recommended Alternative	The relevant clauses referring to allocation of capital to business lines should be removed from Pillar 1 and be covered as a sound practice under Pillar 2, either in paragraph 695 or in 723
Resolution priority	Medium – Westpac's internal allocation framework for operational risk will be consistent with its AMA model
International Consistency	High

Issue / Problem	The statistical soundness standard of one year holding period and 99.9 percent confidence level (comparable to the internal rating based approach for credit risk) is not relevant for a measure that is not purely statistical.
Paragraph Reference	April 2003 Consultative Document: The New Capital Accord, paragraph 627
Accord Requirement	*627 …Whatever approach is used, a bank must demonstrate that its operational risk measure meets a soundness standard comparable to that of the internal ratings based approach for credit risk, (i.e. comparable to a one year holding period and a 99.9 percent confidence level).*
Potential Ambiguities	An AMA model must combine qualitative elements such as scenario analysis and business environment and internal control systems with a statistical model. The statistical standard should only be applied to the statistical component of a combined measure, not to the overall measure.
Recommended Alternative	The above paragraph be rephrased to make the statistical soundness standard applicable to only measures from loss data distribution, not to the overall capital estimate.
Resolution priority	High
International Consistency	High

Issue / Problem	None of the Basel documents provide a definition of what constitutes an operational risk "loss" or a guideline regarding interpretation or identification of a loss, which is necessary before it can be collected and analysed.
Paragraph Reference	April 2003 Consultative Document: The New Capital Accord, paragraphs 630 to 633
Accord Requirement	*630 Banks must track internal loss data according to the criteria set out in this section. The tracking of internal loss event data is an essential prerequisite to the development and functioning of a credible operational risk measurement system. Internal loss data is crucial for tying a bank's risk estimates to its actual loss experience.*
Potential Ambiguities	In practice, a "loss" is not always distinguished from normal operating cost and, in particular, from the cost of related control.
Recommended Alternative	Define "loss" as the direct financial impact of specific operational risk events listed in Annex 7, ie. costs that would not have been incurred in its absence. This should exclude indirect costs such as cost of control and opportunity costs but should include rectification cost attributable to the event.
Resolution priority	Moderate
International Consistency	Preferable but not essential – a specific Australian view can be taken.

Issue / Problem	No valid rationale has been provided to support the requirement to map losses to 56 cells (7 event types and 8 business lines) just for supervisory validation purposes. It seems a legacy of the initial LDA proposal, since discontinued, in which banks were required to perform VAR analysis of losses at each of these cells first and then aggregate the result to arrive at the overall capital. In addition to the classification process being a cost overhead, it is unrealistic to expect data of any material significance in a majority of these cells. This is evident from QIS2 results – Tranche 2 results (published in January 2002), which has only 14 cells with at least 1% of the total number of events (Table 6) and only 19 cells with at least 1% of the total amount of losses (Table 7)[2]. Finally, there are a number of losses whose categorisation into one of these cells may not become apparent for a long period of time after the initial discovery of an incident.
Paragraph Reference	April 2003 Consultative Document: The New Capital Accord, paragraph 633 (first two bullet points)
Accord Requirement	*633 To qualify for regulatory capital purposes, a bank's internal loss collection processes must meet the following standards:* • *To assist in supervisory validation, a bank must be able to map its historical internal loss data into the supervisory categories defined in Annexes 6 and 7 and to provide these data to supervisors upon request. It must have documented, objective criteria for allocating losses to the specified business lines and event types. However, it is left to the bank to decide the extent to which it applies these categorisations in its internal operational risk measurement system.* • *A bank's internal loss data must be comprehensive in that it captures all material activities and exposures from all appropriate sub-systems and geographic loations. A bank must be able to justify that any excluded activities or exposures, both individually and in combination, would not have a material impact on the overall risk estimates. A bank must have an appropriate de minimis gross loss threshold for internal loss data collection, for example €10,000.*
Potential Ambiguities	Nil
Recommended Alternative	For supervisory review purposes, a practical approach would be to take an aggregate view of losses and (per bullet points 2-5 of para 633) to ensure that banks' loss databases capture the appropriate attributes, internal business lines and event types to assist internal risk management.
Resolution priority	High
International Consistency	High. The level of standardisation imposed by Annexes 6 and 7 is undesirable. Requiring banks to match losses to internal business lines imposes an alignment of risk management and risk measurement whereas requiring them to match losses to a supervisory classification does not.

[2] The number of material cells will be even fewer with a higher threshold amount than the €10,000 used in these tables, as permitted by the second bullet point in paragraph 633

Issue / Problem	Validation of assessments from Scenario analysis and Business environment and internal control factors (presumably, both comaparable to a one year holding period and 99.9% confidence level) to actual loss experience is unlikely to be feasible over a foreseeable length of time. Given the rare internal experience (fortunately) of large operational risk losses, it will be decades before any credible history emerges.
Paragraph Reference	April 2003 Consultative Document: The New Capital Accord, paragraphs 635 and 636
Accord Requirement	*635 Scenario analysis:* *…Over time, such assessments need to be validated and re-assessed through comparison to actual loss experience to ensure their reasonableness.* *636 Business environment and internal control factors (last bullet point):* *…Over time, the process and the outcomes need to be validated through comparison to actual internal loss experience, relevant external data, and appropriate adjustments made.*
Potential Ambiguities	Nil
Recommended Alternative	A practical alternative will be to validate the reasonableness of approach taken and benchmarking with industry peers.
Resolution priority	Low
International Consistency	Low. APRA may elect to facilitate peer benchmarking of operational risk management as part of the on-going development of advanced operational risk models

Issue/Problem	The Pillar 2 discussion of credit concentration risk raises the potential for introducing a regulatory surcharge for large exposures. APRA's guidance is sought as to whether they regard the large exposure standards due to be released in July 2003 (APS 221 and 222) as sufficient control over this risk.
Paragraph Reference	April 2003 Consultative Document: The New Capital Accord, paragraph 729 to 736
Accord Requirement	729 *A risk concentration is any single exposure or group of exposures with the potential to produce losses large enough (relative to a bank's capital, total assets or its overall risk level) to threaten a bank's health or ability to maintain its core operations. Risk concentrations are arguably the single most important cause of major problems in banks.* 730 *Risk concentrations can arise in a bank's assets, liabilities, or off-balance sheet items, though the execution or processing of transactions (either product or service), or through a combination of exposures across these broad categories. Because lending is the primary activity of most banks, credit risk concentrations are often the most material risk concentrations within a bank.* 731 *Credit risk concentrations, by their nature, are based on common or correlated risk factors, which, in times of stress, have an adverse effect on the creditworthiness of each of the individual counterparties making up the concentration. Such concentrations are not addressed in the Pillar 1 capital charge for credit risk.* … 736 *In the course of their activities, supervisors should assess the extent of a bank's credit risk concentrations, how they are managed, and the extent to which the bank considers them in its internal assessment of capital adequacy under Pillar 2. Such assessments should include reviews of the results of a bank's stress tests. Supervisors should take appropriate actions where the risks arising from a bank's credit risk concentrations are not adequately addressed by the bank.*
Potential Ambiguities	It is unclear how APRA will decide what constitutes a concentrated credit risk, if it is not the same definition as applied in APS 221 and 222.
Recommended Alternatives	APRA should indicate that banks that conform to APS 221 and 222 will not be required to hold extra regulatory capital for credit concentration risk
Resolution Priority	High – there is a surprisingly widely-held belief that the Australian major banks are more exposed to credit concentration risk than their international peers. Standard & Poor's reviewed the issue last year and found that, contrary to their expectations, Westpac's credit concentrations were well within international standard practice.
International Consistency	Low

Issue/Problem	Westpac is awaiting confirmation from APRA that disclosing New Accord information via the bank's website will be permitted by APRA
Paragraph Reference	April 2003 Consultative Document: The New Capital Accord, paragraph 764
Accord Requirement	*764 For those disclosures that are not mandatory under accounting or other requirements, management may choose to provide the Pillar 3 information through other means (such as on a publicly accessible internet website or in public regulatory reports filed with bank supervisors), consistent with the requirements of national supervisory authorities. However, institutions are encouraged to provide all related information in one location to the degree feasible. In addition, if information is not provided with the accounting disclosure, institutions should indicate where the additional information can be found.*
Potential Ambiguities	Some guidance on APRA's preferred means of disclosure would be useful. In 2002, mention was made of a transition period for risk management disclosure in order to avoid a sudden change-over on Jan 1st 2007. Has APRA's thinking on the transition period developed in the last 12 months?
Recommended Alternatives	Allow banks to meet their New Accord disclosure requirements by publishing information on their websites
Resolution Priority	Medium – the sooner APRA's transitory disclosure requirements are clarified the better. A final decision on the nature of New Accord disclosure (website, risk management document, addendum to financial statements, etc) is not yet time critical
International Consistency	Low

Issue/Problem	The statement that Pillar 3 information need not be audited is consistent with Westpac's intention to use the Bank's website as the mechanism for disclosure. It is recognised that APRA will need to satisfy themselves as to the quality of Westpac's verification processes in order for this option to be pursued. Will certification to use the most sophisticated approaches in the New Accord include certification to release Pillar 3 information electronically
Paragraph Reference	April 2003 Consultative Document: The New Capital Accord, paragraph 765
Accord Requirement	*765 The recognition of accounting or other mandate disclosure in this manner is also expected to help clarify the requirements for validation of disclosures. For example, information in the annual financial statements would generally be audited and additional material published with such statements must be consistent with the audited statements. In addition, supplementary material (such as Management's Discussion and Analysis) that is published to satisfy other disclosure regimes (eg listing requirements promulgated by securities regulators) is generally subject to sufficient scrutiny (eg internal control assessments, etc) to satisfy the validation issue. If material is not published under a validation regime, for instance in a stand alone report or as a section on a website, then management should ensure that appropriate verification of the information takes place, in accordance with the overarching principles set out below. Accordingly, Pillar 3 disclosures will not be required to be audited by an external auditor, unless otherwise required by accounting standards setters, securities regulators or other authorities.*
Potential Ambiguities	Westpac first raised this issue (and the previous one) when commenting on the December 2002 draft of Pillar 3 in the bank's letter of January 21st. No response from APRA has yet been received.
Recommended Alternatives	APRA should provide some guidance on how Australian banks may satisfy them as to the quality of their verification process. Will internal audit sign-off of the disclosure process be sufficient?
Resolution Priority	Medium – it is in the bank's interest to produce reports of as high quality as possible. There are cost implications if APRA require external sign-off of the verification process.
International Consistency	Low

Issue/Problem	The quantitative disclosure requirements for market and operational risk are ambiguous
Paragraph Reference	April 2003 Consultative Document: The New Capital Accord, paragraph 771, table 3
Accord Requirement	*771 Table 3* *(d) Capital requirements for market risk:* *Standardised Approach; and* *Internal models approach – Trading book* *(e) Capital requirements for operational risk:* *Basic Indicator Approach;* *Standardised Approach; and* *Advanced Measurement Approach (AMA)*
Potential Ambiguities	It is unclear whether capital requirements need be disclosed under all approaches or just the ones the bank uses
Recommended Alternatives	Since disclosing results for multiple approaches would increase the cost of compliance, it is proposed that capital requirements for market and operational risk be disclosed for the most sophisticated approach a bank has been certified to use
Resolution Priority	Medium – this is a minor point
International Consistency	Low