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3rd Consultative Document on "Basel II"

Dear Sir/Madam,

The Austrian Federal Economic Chamber - Wirtschaftskammer Österreich - represents all businesses in Austria, the vast majority of them being SMEs, and also represents the Austrian financial services industry including banks.

We welcome the significant progress concerning the **treatment of loans to SMEs** that has been achieved in the negotiations in the Basel Committee in the last two years. The proposed treatment of loan exposures to SMEs of up 1 Mio € as **retail exposure** is an improvement for many loans to SMEs even compared to the existing capital regulations. We also acknowledge the QIS 3 results, which show a significant reduction in the banks' capital requirements for retail loans to SMEs, and in general a slight reduction of the capital requirements for loans to SMEs.

On the other hand we think that much of the advantages achieved for SMEs could be compensated by the implementation costs of Basel II in the banking sector. With regard to the fact that especially **small and medium-sized banks** are important financing partners for SMEs in many EU member states, we therefore think that further measures have to be taken that make a more pragmatic, unbureaucratic and cost efficient implementation in the banking system possible. **In the annex you find specific proposals by the Austrian banking industry which we fully support.**

From the point of view of Austrian businesses we think that there is still some work to do:

1. Retail loans

In our opinion a regulatory **preferential treatment for loans to SMEs is fully justified** since portfolio and diversification effects in a bank's loan portfolio reduce the bank's risk. This has been taken account through lower risk weights. Besides the default of a loan to a SME does not endanger the Committee's main priority, which is enhancing the stability of the banking systems.

The **granularity criterion** which was proposed for the standardised approach in the QIS 3 Technical Guidance (no aggregate exposure to one counterpart can exceed 0,2 % of the overall regulatory retail portfolio) would discriminate SME-retail customers of smaller banks and should therefore be deleted. The effect of the criterion would be a strong distortion in the competition in the banking sector. In the current proposal the "0,2 %-criterion" is foreseen as an example how granularity can be achieved in the retail loan segment; we would prefer a deletion in the final document; see also 3rd Consultation Paper by the Commission where the "0,2-criterion" has already been deleted by the Commission.

The required **use test** for retail loans (par 200) could be a hindrance for a wide application of the retail loan category to loans to SMEs. Also it is questionable that the retail segment requires an estimation of all parameters (not only PD, but also LGD and EAD) which means de facto that for the retail segment only the **advanced IRB approach** and not the foundation IRB approach is available. Since the justification for the preferential treatment of smaller loans to SMEs is the diversification and therefore lower risk in the bank's loan portfolio, we doubt whether these two restrictions to the application of the retail segment are really necessary. With respect to smaller loan amounts administrative costs in the bank are even more relevant then in the case of larger loans. We therefore think that instead of prescribing sophisticated rating systems for smaller loan amounts it would be necessary to enable bank to use **simplified rating systems** (e.g. credit scoring models, but not as a mere element of the rating procedure, but as the sole process in determining the probability of default, and without the necessity to estimate LGD and EAD.

The threshold for retail loans (1 Mio €) should be **adjusted to inflation** on a regular basis, otherwise it will decline in real terms. Already in the end of 2006 when Basel II finally gets into force, 1 Mio € will be less in real terms than now (summer 2003). See also 3rd Consultation Paper by the European Commission that foresees the possibility of adjustment.

In the standardised approach according to par 43, footnote 19, supervisors may determine higher risk weights for retail exposures. The **conditions for increasing risk weights** for retail loans by the authorities in the standardised approach should be described much more precisely. An increase in risk weights of retail loans by the authorities should happen only in exceptionally circumstances.

If the authority decides to increase the risk weights for retail loans in an economic downtrend, this could increase the pro-cyclical effects of the new framework.

Besides, if the supervisory authority is able to increase the risk weight, it should also be able to lower it, if there is a low risk and low default rate.

Taking into account the low risk of small loans to a bank's stability we would prefer a deletion of footnote 19.

2. firm size adjustment for SMEs in the corporate loan segment

We welcome the approach to prevent negative effects for SMEs whose loan volumes exceed the retail threshold by taking into account their revenues (**firm size adjustment in the corporate portfolio**; **SME-portfolio**) but we think that this firm size adjustment **should not be restricted to the IRB-approach.** We propose a special risk weight in the standardised approach for non-retail loans to SMEs with sales of up to 50 Mio €, which should be between the 75 % for retail loans, and 100 % for unrated corporates (the risk weight should be near the risk weight for retail loans; e.g. 80 %).

In the IRB approach risk weights for SMEs above the retail threshold should be lower and nearer the retail risk weights. This would also prevent a "cliff effect" (large difference in risk weights for loans of up to 1 Mio € and slightly above 1 Mio €); The lowering of risk weights for loans to SMEs above the retail loan threshold has also been demanded by the Committee on Economic and Monetary Affairs of the European Parliament (July 9th, A5-0258/2003).

It will be important that all the thresholds (for retail loans and the SME-segment) will be **adjusted to economic growth and inflation** on a regular basis.

3. Corporate loans in the standardised approach

According to par 41 supervisory authorities can increase the risk weight for unrated claims to corporates "when they judge that a higher risk weight is warranted by the overall default experience in their jurisdiction"; they can also increase risk weights for corporates in the case of individual banks.

The **conditions for increasing risk weights** for corporate loans by the authorities in the standardised approach should be described much more precisely. An increase in risk weights of corporate loans by the authorities should happen only in exceptionally circumstances.

E.g. if the authority decides to increase the risk weights for corporate loans in an economic downtrend, this could increase the pro-cyclical effects of the new framework.

Besides, if the supervisory authority is able to increase the risk weight, it should also be able to lower it.

4. Procyclical effects

We still think that the stronger focus on the creditworthiness of companies could **enforce cyclical downtrends in an economy**, but we appreciate that both the Basel Committee and the Commission have addressed these concerns (e.g. requirement of stress tests); But see also various Working Papers published by the BIS.

Work by the Basel Committee, the European Commission, by supervisory and monetary authorities on this question **has to be continued**.

5. Collateral, business creation

A wide-ranging recognition of SME-typical collateral is necessary:

Progress has been made, but the rules are still too restrictive (e.g. in the case of “commercial real estate” the term “multi-purpose” excludes many kinds of real estate that is used by businesses, e.g. factories). It is necessary that physical collateral is also recognized in the standardized approach.

The requirement of periodic inspection by the bank of inventories that are collateral (par 485, bullet point 5) could be a dis-incentive for banks to accept this kind of collateral.

6. Business Start-ups

Since **newly created enterprises** can demonstrate no rating history when applying for a loan, we think that there should be special rules for this companies, because otherwise their financing condition could worsen under Basel II:

Start-ups are crucial for the dynamic, innovation and change in an economy.

Because of the significant economic importance of business creations we therefore propose a general risk weight of 75 % for newly created enterprises (risk weight for retail loans in the standardised approach can be applied by banks to newly created enterprises irrespective whether the bank chooses the IRB or the standardised approach = *partial use*). This special “partial use” could also be applied for **entrepreneurs taking over a small enterprise**, and should be possible in the first two years after the business creation / transfer.

7. High-volatility Commercial Real Estate (HVCRE; par 195, 196)

We ask the Committee to define more clearly what HVCRE is, since this term causes some concern among our members. HVCRE should be restricted to very large and very risky commercial real estate projects.

(In the current proposal it is in the discretion of supervisory authorities to decide what commercial real estate exposures are qualified as HVCRE, par 196)

8. Default definition

According to the proposed default definition, a default takes place when the obligor is past due more than 90 days on any credit obligation. The default definition could be to the disadvantage of certain businesses since this could heighten the PD for them. We therefore welcome the more flexible approach in par 414, footnote 80 (for the retail segment supervisors can substitute a figure of up to 180 days), but think such a flexibility is also necessary for non-retail exposures to SMEs. A preferential treatment for one member country of the Basel Committee is not an ideal solution (par 414, footnote 80).

9. Equity

The proposed treatment of equity has to be improved. For instance concerning loans the proposals differ between retail and corporate loans, depending on the size of the loan exposure of the bank (1 Mio € threshold). We propose to create a **retail segment** also **for equity investments** (with more favourable risk-weights for smaller equity investments compared to larger investments) – both in the standardised approach and in the IRB approach, and to allow a **firm-size adjustment** (in analogy to the corporate loan segment)

The proposed risk weights for equity investments seem to be much too high (e.g. IRB, simple risk weight method: 300 % for publicly traded companies, 400 % for all other equity holdings, par 315)

Yours sincerely

Dr. Christoph Leitl
President

Dr. Reinhold Mitterlehner
Deputy Secretary General

Annex: comments by the Austrian banking industry

July 7, 2003

BANK+VERSICHERUNG

WIRTSCHAFTSKAMMER ÖSTERREICH

Basel II – Third Consultative Paper

As the legal representation of the interests of all Austrian banks and credit institutions, the department for the banking and insurance industry of the Austrian Federal Economic Chamber has adopted the following position on the consultative paper concerning the New Capital Accord of the Basel Committee.

BASIC CONSIDERATIONS

Even if the consultative paper shows improvement in certain areas and is certainly heading in the right direction, we continue to see a need for improvement in several areas.

Capital requirements

The new proposals have undoubtedly brought certain improvements and are moving in the right direction of reaching the same or similar capital requirements, which can also be observed from the results of QIS 3. Nevertheless, the following problems have yet to be solved:

- Volatility is very high.
- The capital requirement ranges are still too high.
- The quantitative thresholds require valorization.

Balanced cost relationship

Above all, the costs arising from the implementation of the new rules must be in a reasonable, balanced proportion to the higher-order goal of strengthening stability on the financial markets.

No disadvantages arising from the application of simple approaches

The application of simple approaches must not create any disadvantages for banks in relation to those that do not fall under the New Basel Capital Accord.

Methodologies for calculating capital requirements to be mutually recognized by regulatory authorities

It is particularly important to ensure that the regulatory authorities of the countries involved will mutually recognize the methodologies for calculating capital requirements and the supervisory procedures applied for internationally active banks.

Reduction of system costs

The new proposals are still highly complex and entail enormous effort and costs, which will ultimately also have an impact on customers. Thus, the aim has to be a cut-back in system costs. The major approaches in this context are:

- General recognition of partial use (provided that the reason for remaining within the Standardised Approach does not lie in a desire to avoid a higher capital charge).

- Decrease of the minimum requirements for the various approaches, some of which are rather strict.

Partial use

- Although the further development of risk management structures is certainly a necessity, it has nevertheless become apparent after years of preparing for the new regulations that full coverage of all portfolios and sub-portfolios under the IRB Approach is often either impossible or economically unfeasible. The facilitations that have been provided for permanent or partial use of different approaches are certainly a step forward, but they do not go far enough to provide a satisfactory solution to this problem.

  In general, it is therefore necessary not to impose the mandatory application of the IRB Approach to all material portfolios.
  Even if the approach is only employed for one single portfolio, risk management improves, consequently fulfilling the requirement for increased stability in the banking sector.

- The permanent and more comprehensive application of partial use, particularly for the asset classes banks and sovereigns, would reduce costs and is therefore of vital importance, especially for smaller banks.

- The adoption of partial use for sub-segments within the corporate asset class should be allowed within specified materiality thresholds, which should not be defined too narrowly. It should at least be clearly specified that, within such sub-segments, recognition of IRB processes will not be denied because of a weaker empirical basis.

- At the current calibration, the capital requirements for the equity portfolio constitute a particular obstacle to implementing the IRB Approach in other portfolios. This in turn hampers the development of an improved risk management framework in banks.

Unequal treatment of physical and financial collateral

Physical collateral is still not consistently placed on a par with financial collateral. This unequal treatment is out of step with current risk management processes. Moreover, it has no economic justification, since default experiences show that there are significant differences between mortgage-backed claims and uncollateralized exposures. As already demonstrated by the results of QIS 3, the fact that physical collateral is not treated equally results in additional expenditure for IT technology that is of no use to the bank’s credit risk management systems.

Physical collateral plays a major role in SME financing. Basel, however, recognizes physical collateral only in the IRB Approach. Since particularly smaller banks, which tend to opt for the Standardised Approach because of the complexity of the IRB Approach, are the main providers of SME financing, physical collateral also deserves large-scale recognition in the Standardised Approach.

The periodic reappraisal of real estate should also be in line with practical requirements and be subject to a cost-benefit analysis. The frequency of periodic reappraisal should not be fixed statically at a minimum of once a year. Especially in the case of private residential real estate, yearly appraisal would appear excessive in light of the low risk of depreciation.

The required level of over-collateralization of 140% for the recognition of CRE/RRE serving as collateral seems too high. It should also be possible to use collateral below a 30% minimum collateralization level of the exposure.

Equal treatment for collective investment undertakings as collateral
Collateralization in the form of shares in collective investment undertakings is still put at a significant disadvantage compared with direct investments. In order to ensure equal treatment, the use of volume-weighted discounts in accordance with the concrete portfolio mix of the fund (look-through approach) and not only the discount for the fund's investment with the highest risk should be allowed as an alternative.

Reconsidering the approaches for the equity portfolio

- Previous experience has shown that the capital requirements of the IRB Approach are prohibitively high. Especially the minimum capital charges are not in line with a risk-oriented approach and should therefore be eliminated or at least significantly decreased.

  The difference in capital requirements for equity portfolios when comparing the Standardised Approach and the IRB Approach is not comprehensible. Either the Standardised Approach is far too risk-oriented – in which case the capital charges of the IRB Approach are calibrated too high, and the minimum capital charges are excessive – or the IRB Approach is based on the actual risk level, which would mean that a change is required in the Standardised Approach.

  In addition, the high minimum capital requirements, in combination with the obligation to apply the IRB Approach for the equity portfolio, would be an obstacle to implementing the IRB Approach for other portfolios. This is contrary to the intention of improving risk management and prevents the dissemination of more advanced approaches.

- As a result of different methodologies, capital requirements for equity exposures are unnecessarily complex. In addition, important practical aspects of banking have been neglected.

  In addition, we would like to point out that a special arrangement has to be provided for holdings in affiliated undertakings and for ancillary banking services.

  Banks outsource certain business activities for the purposes of cost-efficiency and effectiveness. Considering the fact that a bank might also cover these activities itself and avoid equity exposure subject to capital requirements, such equity interests should be taken into account in the operational risk.

Dynamization of thresholds
Not only must all the numerical thresholds of the New Accord be regularly updated to keep up with changes in financing practices, but they should also be index-linked.

National discretion
Wherever there is meaningful national discretion, it also has to be ensured that the areas of national discretion are not exercised in a way that leads to distorted competition.

Abolition of 0.2% limit for the retail portfolio
While the 0.2% limit on the retail portfolio in this consultative paper is only provided exemplarily, it might still continue to impose a limitation on the business activities of smaller banks. Imposing a maximum limit on a single exposure as a function of the total amount of the retail portfolio means that SMEs cannot take full advantage of the special treatment of exposures to SMEs when dealing with smaller banks.

Disclosure requirements
It is necessary to further distinguish between data required for the supervisory authorities and data to be published. The scope of disclosure must reflect the size of the relevant bank, as well as its influence on the national and international financial markets.

Despite the general provision on that matter, there is still some concern that individual customer data might be disclosed in detailed tables.

Procyclical nature
Because of the higher risk-sensitivity of the Basel proposals, increased risk in periods of economic contraction inevitably leads to higher capital requirements. This may force banks to limit their loan exposures.

In addition, the process of certification of the internal rating models by supervisory authorities will lead to an extensive harmonization of borrower ratings.

The line of argument brought to bear on this problem so far does not provide a satisfactory solution. First of all, the required stress tests only reveal the symptoms of procyclicity without treating the underlying causes. Secondly, the additional capital buffers required for such cases would break the promise that Basel II would not lead to an average increase in capital requirements.

DETAILED COMMENTS

PART 1: SCOPE OF APPLICATION

3.

According to the new provisions, a group must consolidate on all levels (sub-consolidation) in order to guarantee sufficient capital adequacy. Moreover, sub-consolidation is mandatory unless the subsidiary (which itself constitutes a sub-group) deducts the full book value of any investments in non-consolidated banks and financial institutions from its capital.

We take objection to the obligation of sub-consolidation, since this provides no additional benefits in terms of banking supervision. The proposal suggested as an alternative to sub-consolidation, i.e. the deduction of investments in non-consolidated banks and financial institutions by the subsidiary, would significantly tighten the existing regulations at the EU-level. This method appears particularly unreasonable to us, since the parent entity's consolidation of all the group subsidiaries would entail full capturing of all the risks existing in that group. Therefore, it stands to reason that a second-tier parent entity should be exempted from that obligation.

5.

In order to achieve a level playing field, not only banks but also securities entities and other financial institutions must be included in the scope of consolidation of financial holding groups. To that extent, paragraph 5 is a welcome provision. However, paragraph 5 also includes an exemption, since securities entities should be included in the scope of consolidation to the extent that they are “subject to broadly similar regulation or where securities activities are deemed banking activities”.

This formulation allows the national authorities to exclude securities entities from the scope of consolidation. This procedure creates distortions of competition, and we therefore take objection to it.

17.

The requirement that significant investments which do not reach a material level must be risk weighted at no lower than 100% is not comprehensible. They should be risk weighted like non-significant investments, i.e. depending on the relevant rating.

18.-20.

Equal deductions of investments from Tier I and Tier II would increase the “severity” of the rules governing deduction of minority investments, both on a stand-alone and on a consolidated basis, and we therefore take objection to them.

In general, with regard to the scope of application, many rules are inadequately defined or their enforcement is left up to the specific countries. We are in favor of uniform regulations to ensure fair competition.

PART 2: THE FIRST PILLAR – MINIMUM CAPITAL REQUIREMENTS

I. Calculation of minimum capital requirements

23.

- The 90% floor in the first year and the 80% floor in the second year following implementation of the New Accord require a two-fold calculation (according to the old and the new provisions). It is therefore indispensable to simplify and reduce the calculational requirements (e.g. the basis is the capital requirement as per December 31, 2006, or the basis is a bi-annual calculation according to Basel I).

  For banks, this entails that in 2007 and 2008 three approaches for the calculation of minimum capital requirements will need to be used:
  1. the current "Standardised Approach"
  2. the new Standardised Approach (because of partial use)
  3. the Internal Ratings-Based Approach

  We therefore take objection to this provision.

- The new rules for calculating capital requirements should offer banks significant incentives to develop and use more differentiated risk measurement methodologies. This incentive would be diminished by limiting the potential savings on capital requirements gained by applying such approaches to 90% of the current calculation method in the first year of implementation (currently 2007) or 80% in the second year (currently 2008).

- If the temporary rule for a floor is maintained, a corresponding cap (to set the maximum increase in capital requirements) should also be established in view of the lack of statistically significant results from the impact studies and considering the problems with regard to calibration.

II. Credit risk – The Standardised Approach

A. The Standardised Approach – General rules

28.

The application of a lower risk weight should be decided generally and not at national discretion. Failing that, it will be necessary to disclose the degree of national leeway used in the risk weighting and to automatically apply these risk weights to banks incorporated in other countries under the same conditions (automatic mutual recognition of national discretionary decisions) without requiring the approval of the relevant regulatory authority.

29.

The 1999 OECD agreed methodology should not be the only criterion for regulatory recognition of country risk scores assigned by export credit agencies. At least with respect to the methodologies they employ, the same criteria should be applied as for external rating agencies.

31.
PSEs should be treated as “sovereigns” and not as “banks”. Moreover, the choice of risk scores for banks should be standardized in order to prevent distortions of competition.

32.
The comment on paragraph 28 applies.

33.
A list of “eligible” multilateral development banks would be more practical than the “catalog of eligibility criteria”.

34.
National supervisors can still choose between two options for claims on banks. We take objection to this option of choice because it could lead to distortions of competition. (See also paragraph 31).
As things stand today, we are in favor of option 1.

36.
- The second option allows for preferential treatment of exposures with original maturities of three months or less. In our opinion, the criterion for preferential treatment should be a residual maturity of three months, since otherwise administrative costs would increase, and since it is economically irrelevant whether original maturity or residual maturity is used as the basis for the three-month rule.

- Moreover, we take objection to the recommendation to the supervisory authorities set out in footnote 16 (claims which are expected to be rolled over do not qualify for the three-month rule), since, from a legal standpoint, a prolongation does not necessarily have to be granted, in which case the risk related to longer maturities does not arise, and since the business practice of a possible prolongation is not sufficiently regulated.

38.
The rule on claims on banks with an original maturity of less than three months which are funded in the domestic currency provides for preferential treatment if the national supervisor makes use of the option for preferential treatment for sovereigns set forth in paragraph 28. As in paragraph 36, we request that the residual maturity be used instead of the original maturity of three months.

40. Claims on corporates
The 50% weight should also apply to BBB corporates, since the historical default rates of BBB bonds are only slightly higher than those of bonds rated A, whereas the difference to sub-investment grade is significant.

43.-44. Claims included in the regulatory retail portfolios
- With respect to the application of partial use, the criteria for when a claim may be included in a regulatory retail portfolio should be identical in both the Modified Standardised Approach and in the two IRB Approaches. The criteria of classification established in the IRB Approaches should therefore be used in the Modified Standardised Approach as well. Please see the comments on paragraph 200 for a detailed design of these criteria.

- The maximum of EUR 1 million for claims to be included in a regulatory retail portfolio should also be subject to yearly adjustments (rate of inflation).

44.

The granularity criterion should be dropped.
Otherwise, the definition “one counterpart” should refer to one “single” customer (individual or small business) rather than to a group of companies.

45. Claims secured by residential property

- The risk weighting for claims fully secured by residential property is 35%. Partial collateralization should also be possible if the threshold value in the IRB Approach is exceeded (paragraph 264).

- Contrary to the practice in Continental Europe, the purpose of residential mortgage loans in Anglo-Saxon countries is limited to the financing of residential property for personal use. It must therefore be clarified that the purpose of residential mortgage loans extends to all types of financing secured by residential property.

45.-46.

Aside from the 35% weighting for claims secured by residential property, the maximum weighting applied to the portion of these claims that does not comply with the criteria for 35% weighting must not exceed 75%, which is a logical result of the 75% weighting of the retail portfolio.

47.

- Commercial real estate may be weighted at 50% in exceptional cases. One condition for this preferential weighting is a loan-to-value based on a mortgage-lending-value of 60% or 50% of the market value. It should be possible to set these thresholds higher. In addition, the thresholds of the two tests seem too harsh.

- Mortgages on real estate should be discussed in the section on collateral. That would allow mortgages on real estate to be designated specifically as eligible collateral in the Basel Accord.

48.-51.

The proposed rule couples, for the first time, loan loss provisions with risk weighting. The planned scaling for unsecured defaults should be reconsidered. In any case, a more favorable regulation is required.

- According to paragraph 48, “qualified residential mortgage loans” with a risk weighting of 35% are only those portions of a loan that do not exceed the value determined for the collateral. If the entire loan is past due, that portion of the loan receives a risk weighting of 100%, with any specific provisions to be deducted from that amount. This is not adequate to the risk, since the value of the portion of the loan which is secured with a mortgage (and is therefore weighted more favorably) does not undergo any change even if the overall loan is past due. We therefore take objection to the proposed higher risk weighting for the secured portion of the loan. For the unsecured portion, we request clarification to the effect that a risk weighting as stipulated by paragraph 48 should be applied.

50.

For loans that are in default but “fully secured”, the risk weighting should not be regulated in contradiction to paragraph 48. This means that in the case of fully secured loans, risk weighting should be independent of the formation of specific provisions.

51.
We suggest that here, as in the IRB Approach (see paragraph 414, footnote 80), the 180-day period should be applied.

53.
We take objection to an extension of the 150% risk category to other assets, even more so since these are not precisely defined.

54.
- We are critical of the rule in the Standardised Approach (STA) according to which "investments in equity or regulatory capital instruments issued by banks or other securities firms will be risk weighted at 100%". As an alternative, it should be possible to implement a transparency method like the one used in the IRB Approach.

- We suggest a more precise definition of the term "all other assets".

58.
The terms "self-liquidating" and "collateralised by the underlying shipment" are still too vague. In particular, collateralization by the underlying shipment is not possible for the confirming bank. The provisions laid down in the existing EU Directive should be used to define the documentary credits subject to a 20% CCF.

In addition, the expressions "short-term" and "trade letters of credit" need to be clarified in this context.

2. External credit assessments

60.-61.
To ensure the comparability of external credit assessments and internal rating approaches, it is important to make certain that the methodologies of the external credit assessment institutions must satisfy the same requirements as those of the internal rating systems.

78.
We take objection to the rule stating that national supervisory authorities may allow banks to use unsolicited ratings in the same way as solicited credit ratings.

B. The Standardised Approach – Credit risk mitigation

79. ff
We request a clarification of the fact that pledged securities will also be recognizable as eligible credit protection if they are held by a third-party institution, as long as the other requirements, in particular those regarding the frequency of valuation, are met, which is perfectly possible by duplicating third-party securities accounts in an institution's own IT system, for instance.

114.
- We request a clarification of the fact that the residual maturity relevant for a maturity mismatch explicitly refers to the maturity of the collateral arrangement itself and not to the maturity of the single financial collateral within the scope of the arrangement.

  It is customary in many national markets to pledge an entire securities account (and not just individual securities) as collateral. In such a case, the proceeds from a maturing security are either used to reduce the loan exposure or they continue to be available as collateral in another form, for instance, as an account balance or investment in another security (in which case the bank exerts a considerable influence on the choice of security). Therefore, the maturity of the collateral arrangement, and not that of the individual pledged security, is significant.

- Even securities with a residual maturity of less than one year should be eligible in principle.

116. and 117.
Collective investment undertakings may only invest in the instruments listed in paragraph 116 f. Derivatives to hedge against exchange rate losses are an indispensable portfolio management tool. For that reason, a 5% materiality threshold for investments in derivatives used to hedge against exchange rate losses is necessary.

118.
The haircut appropriate to the exposure (*He)* has not been defined yet. Given the fact that currency mismatch, maturity mismatch and market risk of the collateral are covered by various haircuts, *He* should be either defined or eliminated.

122.
To ensure the same treatment as in the case of direct investments, the volume-weighted discounts in accordance with the concrete portfolio mix need to be taken into account and not the discount for the investment with the highest risk (paragraph 122).

In this context, it has to be considered that in many countries fund investments by private households and enterprises far exceed direct investments in securities. Any regulations that put funds at a disadvantage against other types of investment will cause distortions to the detriment of the collective-investment industry and do not take account of the real situation in many investment markets.

136.
It should also be possible to meet the requirements through cross-institutional or external arrangements.

137. f
“Daily revaluation”, not “daily remargining” should be the basis for “other capital market transactions”.

141.
The definition of “core market participant” is lacking.

153.
It is unclear which risk weight is to be used for gold, equities and collective investment undertakings in the simple approach (substitution approach). For gold, we suggest, after deduction of the regulatory standard haircut pursuant to paragraph 122, a risk weight of 0% as in the Standardised Approach (see footnote 24). For equities and collective investment undertakings, we suggest, after deduction of the regulatory standard haircut pursuant to paragraph 122, a risk weight of 0%.

160.-164.
As an operational requirement for guarantees, it is specified that the lender, following default or non-payment by the counterparty, is entitled to demand the outstanding amount of the loan in a timely manner from the guarantor instead of having to continue to pursue the counterparty (paragraph 161 letter a).

This requirement is realistic in principle, but it should not be interpreted too strictly (e.g. in the case of existing guarantees, 90 days past due does not constitute default).

174.
In the case of maturity mismatches, credit protection is adjusted. As a result of the proposed formula, short periods of maturity mismatch do not require adjustment until the last few years before repayment, whereas longer periods of maturity mismatch require significant adjustments throughout the term of the exposure. Thus, if the period of maturity mismatch is five years, only 50% of the adjusted collateral amount may be recognized ten years before maturity of the exposure. The extent of the adjustment is out of proportion to the difference in market risk and must be changed.

188. ff
In practice, the differentiation between SL and corporates and also within SL is very complex and should therefore be simplified.

III. Credit risk – The Internal Ratings-Based Approach

B. Mechanics of the IRB Approach

195., 196.
It should be clearly specified that the financing of residential real estate during any of the ADC phases (land acquisition, development and construction) should not be classified as HVCRE lending, even if the source of repayment at origination of the exposure consists of future uncertain rent payments or proceeds from sale.

199. (a)
Second bullet point

- The differentiation between personal (owner is also occupier) and third-party occupation is not feasible, especially for cost reasons.

- We propose the introduction of a cap of EUR 1 million for residential mortgage loans and suggest that – as in the Standardised Approach – this category include all types of property used for residential purposes, regardless of whether the individual to whom the loan is extended occupies/will occupy the property or rents/will rent the property out.

200. Large number of exposures
The particular risk of exposures to SMEs – which justifies their inclusion in the retail approach – primarily results from the size of the enterprises or the exposures, but not from the risk management procedures employed. The use test is therefore superfluous.

211.
The criteria for the top-down approach should be flexible; they should, for instance, include receivables purchased from third parties and a residual maturity of one year.

225. ff
Extending the IRB Approach to all portfolios of a bank is in many cases either impossible or economically unfeasible. We therefore request permanent partial use for all asset classes, provided that the sole reason for remaining within the Standardised Approach is not a desire to avoid higher capital charges:

The Committee rightly points out data limitations. Such limitations, however, may also be of a permanent nature in the material portfolios of an individual bank. In that case, permanent exceptions must be allowed.

Since no Foundation IRB Approach is provided for the retail portfolio, the Advanced IRB Approach is much more costly than the Foundation IRB Approach. This also applies to the retail portfolio. The exclusive application of the Foundation IRB Approach across other portfolios is a useful step towards strengthening risk management at reasonable cost and should therefore be allowed, even if it is not accompanied by the implementation of the IRB Approach for the retail portfolio. The results of the QIS have demonstrated that if a bank does not implement the IRB Approach for the retail portfolio, it usually also foregoes the option of lower capital charges.

227.
The implementation plan, albeit being used internally, should not necessarily be binding vis-à-vis the supervisory authority. It should also be specified, when and how the implementation plan is to be produced.

228.
The criteria to determine when a bank must hold more capital under Pillar 2 need to be stated precisely and should not require the national supervisor's approval.

229.
The obligation that a bank, once it has adopted the IRB Approach to any of the corporate, bank, sovereign or retail asset classes, is required to adopt the IRB Approach for its equity exposures at the same time is unreasonable, since the national supervisory authorities have adequate tools (according to paragraph 229, inter alia) to take action against banks engaging in regulatory arbitrage through operating subsidiaries. This interdependency must therefore be eliminated.

233.
The option to apply shorter time series should not only be available to banks implementing the IRB Approach at the earliest possible time This possibility should be open to every bank, regardless of when it changes over to the IRB Approach.

C. Rules for corporate, sovereign, and bank exposures

244.
We welcome the decision to allow lower supervisory risk weights in all SL portfolios for the rating categories “strong” and “good”. Nevertheless, we still take objection to the fact that the supervisory risk weights for specialized lending, especially in the rating categories “satisfactory“ and “weak”, are too high and request that they be lowered.

264.
The methodology of calculating the fully secured portion provides for a discount of almost 30% for CRE/RRE collateral (C/C*: 100%/140%). For the portion secured by real estate and already subject to a haircut, the maximum reduction in capital charges is 22% (1-min. LGD*/LGD: 1-35%/45%=22%). Compared to financial collateral, this treatment is very discriminatory. We therefore request

- that price volatilities be accounted for by haircuts alone, and
- that financial and physical collateral be treated equal with respect to the minimum LGD of 0%.

The minimum LGD methodology described above leads to cliff effects. Up to the minimum collateralization level C*, collateral is not taken into consideration. If, however, C* is exceeded even to a slight extent, this results in disproportionately strong consequences. We therefore request that this cliff effect be reduced by lowering the minimum LGDs.

281.
It is economically illogical and unreasonable that the Standardised Approach applies a CCF of 20% or 50% to commitments, Note Issuance Facilities (NIFs) and Revolving Underwriting Facilities (RUFs), while the Foundation IRB Approach applies a CCF of 75% to such credit lines. We therefore request that the CCF levels be reduced accordingly.

288.
To minimize calculation and data administration costs for banks using the Foundation Approach we request that the “effective maturity” calculation methodology be used exclusively in the Advanced Approach.

E. Rules for equity exposures

314.
The choice of calculation method should be left up to the bank, not to the supervisor.

315.
We continue to object to the excessively high regulatory risk weights in the equities segment under the simple risk weight method (publicly traded 300%, other 400%).

317.-318.
For risk weights calculated for the equity segment under the internal model (value-at-risk), a floor of 200% must be set for publicly traded equity holdings and a floor of 300% for all other equity holdings. The use of a more sophisticated market risk model assessed and approved by the supervisor should be the exclusive basis for calculating capital charges.
The floor should be eliminated from this form of calculation.

321.
For equity exposures with shorter holding periods, an adjustment of less than five years should also be required.

323.
The risk weight for equity positions under the PD/LGD Approach is subject to a floor of 200% for publicly traded equity holdings and 300% for all other equity holdings. If it is possible to achieve a lower risk weight than the floor despite the high regulatory minimum LGD of 90% and a five-year holding period, then the lower risk weight should be recognized as sufficiently conservative.
Here, the floor should also be abolished.

G. Recognition of provisions

346.
From a practical point of view, it is not comprehensible why provisions for non-defaulted assets may not be used to cover other capital charges.

H. Minimum requirements for the IRB Approach

359.
If uniform rating is required, it is imperative to ensure that the data is consistent (including rating determinants) for each individual borrower within a banking group. Apart from the disproportionately high effort involved, many national laws would need to be changed (data protection, banking secrecy, etc.) in order to meet this requirement and enable such data pooling.

360.
The demand for a transaction-specific dimension in the rating system must be limited to the Advanced IRB Approach. In view of the EADs and LGDs prescribed by the supervisory authorities, it is not practical to include transaction-specific factors in the Foundation Approach.

All parameters listed here (PD, collateral, seniority, EAD-relevant product features, LGD) are, in the first instance, individual dimensions, which have to be observed separately, yet managed in coordination with each other. The Basel proposals, too, have initially mirrored this thought. It makes no sense to again try and integrate many of these factors into one system, since all the factors enumerated here will influence the overall system in another way (collateral -> CRM, seniority, product type -> EAD, LGD).

The Foundation Approach was created especially for those banks that cannot measure EAD and LGD regularly and consistently owing to the required volume of data or the high effort. To request the combined representation of different factors through measurement for the Foundation Approach – and it is impossible to establish a consistently structured rating system without measurement – goes against the basic concept of the two-step system design and complicates the application of the Foundation IRB Approach.

364.
It should be possible for the third dimension "delinquency of exposure" to be construed flexibly.

379., third bullet point
In view of the strict requirements with regard to model validation, it is irrelevant whether the data initially used to build the model was representative or not.

In addition, smaller banks in particular often do not have sufficient default data and will therefore be forced to use an external provider's system or a system developed by other, larger banks. In either case, it will be practically impossible to sufficiently demonstrate the representativeness of the data required by this provision.

382.
The requirements for documentation are going too far here. Of course, a basic understanding and documentation of all key parameters of the statistical model is indispensable. However, these have to remain within economically acceptable bounds. Large parts of the requirements set out in this context are far beyond this scope and could make rating systems uneconomic to such an extent that many banks might prefer to refrain from using them. Thus, small institutions in particular will no longer have the incentive to adopt the IRB Approach, which is detrimental to the intentions of the new regulation.

382., first bullet point
We propose that the documentation is limited to **<u>key</u>** assumptions, parameters, etc.

403.
Independent credit risk control is not useful as a general matter of principle. It is rather the function that seems to be important.

405.
In view of the multilevel control structure (internal audit, bank auditor, supervisory authority) and the high costs associated with external audits, the requirement of an external audit should be limited to cases in which the supervisor has legitimate doubts as to the effectiveness of the internal rating system. For the supervisory authorities to generally prescribe external audits would be a further obstacle to the implementation of more risk-sensitive approaches.

414.
Second bullet point
For the retail and PSE segments, the national supervisory authorities may define default from 90 to 180 days. This definition of default can also be used for different product lines.

Different definitions of "default" by national supervisors would make it difficult to achieve comparability among those countries. This would create additional problems for groups with holdings in foreign subsidiaries.

For that reason, a standardized definition of default should be established.

434.
The minimum data observation period should be generally set at five years.

472. Operational requirements for eligible CRE/RRE
- Here, the third bullet point stipulates that "a qualified professional must evaluate the property". We request a clarification that this qualified professional may also be a bank employee.

- *Third bullet point, continued*
  It is necessary to explain the difference between "frequent revaluation" versus "frequent monitoring". A statistical method of evaluation should suffice for the regular monitoring of the value of the collateral. If real estate price indices are used for monitoring, the arithmetic mean suffices if there are different indices for good, bad and average locations.

The requirement that a qualified professional must evaluate the property "when [...] the value of the collateral may have declined materially relative to general market prices or when a credit event, such as default, occurs" is also contradictory. It is illogical to link periodicity with the occurrence of certain credit events. We therefore request clarification on this point. The term "credit event" also needs to be defined.

473.
Fourth bullet point:
We request that this point be eliminated since it is impracticable.

477.
In this connection, it must be clarified whether established practice (fact of common knowledge) qualifies as a legal opinion. This rule must under no circumstances require an institution to obtain a legal opinion for every single case. The minimum requirement therefore needs to be changed accordingly.

500.
Failure to meet the disclosure requirements should not automatically lead to ineligibility to use the IRB Approach.

IV. Credit risk – Securitisation framework

B. Definitions

1. Different roles played by banks

506.-507.
The role of the “servicer” mentioned in paragraph 506 is not defined in paragraph 507, while the other roles are.

We request that this definition be clarified.

C. Operational requirements for the recognition of risk transference

516. (a)
“Significant credit risk associated with the securitised exposures has been transferred to third parties”.

The definition and the requirement associated therewith are not sufficiently precise.
- It must be specified what “significant” refers to: Does it refer to internal (economic) capital calculations, to the EDF and LGD of the securitized portfolio, or to the volumes of the (lower rated) tranches held on the books by the originating bank in relation to the tranches placed with investors?
- “third parties”: Does this mean from the perspective of the individual unit or legal entity of the originator, or from the perspective of the group?

We are calling for clarification of these issues.

516. (g) (iii)
“Increase the yield payable to parties other than the originating bank, such as investors and third-party providers of credit enhancements, in response to a deterioration in the credit quality of the underlying pool.”

This requirement severely limits the flexibility and efficiency of securitizations for originators. In addition, the rule is not sufficiently explicit, since it is, for instance, common international practice to include a pricing grid among the covenants in major syndicated loans, which specifies margins as a function of credit-ratings.

We therefore consider it necessary that this requirement be abolished.

517. (d)
“Banks must transfer significant credit risk associated with the underlying exposure to third parties.”

This definition and the requirement associated therewith needs to be clarified:

- Does it refer to internal (economic) capital calculations or to the EDF and LGD of the securitized portfolio? Or does it maybe refer to the volumes of the (lower rated) tranches held on the books by the originating bank in relation to the tranches placed with investors?
- “third parties”: Does this mean from the perspective of the individual unit or legal entity of the originator, or from the perspective of the group?

517. (e), first bullet point
“[...] (e.g. significant materiality thresholds below which protection is deemed not to be triggered even if a credit event occurs [...]”.

The definition and the requirement associated therewith are very vague and imprecise.

We request a more precise definition (e.g. by specifying an absolute amount or percentage rate).

517. (e), third and fourth bullet points
These requirements severely limit the flexibility and efficiency of securitizations for originators. The rule is also not comprehensible, since it is, for instance, common international practice to include a pricing grid among the covenants in major syndicated loans, which specifies margins as a function of credit-ratings.

These two requirements therefore need to be eliminated.

518. (3)
“[...] it must only be exercisable when 10% or less of the original underlying portfolio or reference portfolio value remains.”

This threshold of 10% severely limits the flexibility and efficiency of securitizations for originators. The rule also is also unreasonable inasmuch as the concerns of the banking supervisors are adequately accommodated by the stipulations of paragraphs 519 and 520. This requirement should therefore either be eliminated or, at most, provide for a provision that requires prior notification of the supervisor (see paragraph 751).

524.
The supervisor alone determines whether or not implicit support has occurred, based on criteria that have not yet been objectively defined. The risk of conflicting interpretations – especially among various regulatory bodies – therefore appears to be quite high. For that reason, the consequences of implicit support cannot be consented to until definite criteria for implicit support are available or until it can be clearly demonstrated that implicit support has been provided. For the same reasons, we also take objection to the consequences arising with regard to the disclosure requirements (see paragraph 745 f).

D. Treatment of securitisation exposures

527.-528. Risk weights
The discrepancy between the weighting of corporates and ABS tranches in the BB category has further increased in comparison to the consultative paper of January 2001. This provision is not justified since it puts banks as investors at a significant disadvantage, and we therefore take objection to it.

	Corporates (BB+ to BB-)	ABS tranches (BB+ to BB-)	Ratio
Proposal of January 2001	100%	150%	1 : 1.5
Proposal of April 2003	100%	350%	1 : 3.5

The empirical probabilities of default and the existing portfolio effects justify a risk weight of 100% for ratings from AAA to BB-. We propose a risk weight of 350% for ratings from B+ to B and a deduction for exposures rated B- and below.

530.
This requirement severely limits the flexibility and efficiency of securitizations for originators and is a change for the worse compared to the consultative paper of January 2001.

We therefore take objection to this provision since it is not justified and propose that originators should only be required to deduct exposures rated single B and below.

541.
"[...] servicers may advance cash to ensure an uninterrupted flow of payments to investors so long as the servicer is entitled to full reimbursement and this right is senior [...]"

In many cases, senior cash advance facilities or liquidity facilities in ABS structures are not provided by the servicer but rather by third-party banks.

In addition, the rule specifying the applicable CCF (credit conversion factor) and risk weights is imprecise (in contrast to "eligible liquidity facilities", where the applicable CCFs and risk weights are clearly defined in paragraphs 536, 539 and 540).

We therefore request that the definition be clarified and further detailed and call for a clear specification of the applicable CCFs and risk weights.

554.
"For a bank subject to early amortisation treatment, the total capital charge for all of its positions will be subject to a maximum capital charge (i.e. a cap) equal to the greater of (i) that required for retained securitisation exposures, or (ii) the capital requirement that would apply had the exposures not been securitised."

It needs to be clarified whether this cap rule includes the capital charge obligation for investors' interests arising from a securitization containing an early amortization feature, such as is more clearly defined in paragraphs 555 through 566, or whether the capital charge obligation for investors' interests arising from a securitization containing an early amortization feature is independent of that rule, i.e. should be considered an addition thereto.

If the cap rule is to be treated separately, then the rule in paragraph 554 should, by extension, apply to originators of all types of securitizations in the Standardised Approach (in accordance with the rule laid down in paragraph 580 in the IRB Approach).

If it is not independent, then the rule per se is counterproductive for originators (in terms of capital charge), since the capital requirement would be at least the same as if the underlying exposures had not been securitized, i.e. the capital relief for such securitizations would no longer exist.

The intent of the rule therefore requires clarification.

579. to 586.
On the whole, it should be clarified whether the applicable risk weights should generally be considered dynamic or whether the classification into "highly granular pools", "base risk weights" and "non-granular pools" can only be made at the beginning of the transaction.

596.
In the event of resecuritization (i.e. securitization of securitization exposures), the number of exposures should be based on the original pool. Otherwise, the actual degree of diversification would be significantly underestimated.

600.
This provision stipulates a general CCF of 100%. This is in contradiction with paragraph 539, which stipulates a CCF of 20% or 50% for the Standardised Approach.

The provision also states that the RBA is to be applied if the facility is rated externally. We request clarification as to whether the distinction between "highly granular pools", "base risk weights" and "non-granular pools" also applies in this case.

601.
This provision stipulates a CCF of 20%. This is in contradiction with paragraph 540, which stipulates a CCF of 0% for the Standardised Approach.

The provision also states that the RBA is to be applied if the facility is rated externally. Does the distinction between "highly granular pools", "base risk weights" and "non-granular pools" also apply in this case?

We call for clarification of the rule in this respect.

603.
This provision stipulates a CCF of 50% and 100% respectively. This is in contradiction with paragraph 539, which stipulates a CCF of 20% or 50% for the Standardised Approach.

We propose that the rule be clarified in this respect.

604.
"[...] servicers may advance cash to ensure an uninterrupted flow of payments to investors so long as the servicer is entitled to full reimbursement and this right is senior [...]"

In many cases, senior cash advance facilities or liquidity facilities in ABS structures are not provided by the servicer but rather by third-party banks.

In addition, the rule specifying the applicable CCF (credit conversion factor) and risk weight is imprecise.

We therefore request that the definition be clarified and further detailed and call for a clear specification of the applicable CCFs and risk weights.

V. Operational risk

General considerations

The development of indicators shows that further improvement is of high importance.

The Alternative Standardised Approach
The introduction of the Alternative Standardised Approach is definitely a step forward, especially in view of the problems occurring in connection with the disaggregation of gross income, particularly as far as the retail and commercial banking sectors are concerned. We also welcome the possibility of aggregating the gross income for the remaining business lines.

To provide an incentive to use the Standardised Approaches, the qualitative requirements for eligibility to apply the Standardised Approach should be lowered to a level appropriate to a standardized procedure.

Incentives for more complex systems are necessary
At any rate, a system of incentives is required for the transition from a simpler to a more sophisticated procedure.

Sound Practices for the Management and Supervision of Operational Risk
The interaction between the Sound Practices for the Management and Supervision of Operational Risk and the qualitative and quantitative requirements of the consultative paper should also be clarified.

Recognition of the risk mitigating impact of insurance in the Basic Indicator and Standardised Approaches
The failure to recognize insurance as risk mitigant in the Basic Indicator and in the Standardised Approaches is not rational, since the impact of insurance does not depend on a bank's chosen method of calculating operational risk capital charges. Therefore, it should also be possible in the Standardised Approach to take into account the risk-mitigating effect of insurance in the calculation of the minimum regulatory capital charge for operational risk.

In addition, the 20% limit for the reduction of the total operational risk capital charge through recognition of insurance mitigation is too low.

Collective investment undertakings
The indirect inclusion of collective investment undertakings that are subsidiaries of banks into the scope of the new rules creates competitive disadvantages for collective investment undertakings vis-à-vis collective investment undertakings that are subsidiaries of insurance companies or other non-banks, and also vis-à-vis collective investment undertakings that are considered to be non-banks by reason of their legal status and are therefore, if for no other reason, excluded from the scope of the new regulations.

If the Basel Committee on Banking Supervision does not change its intention of including both collective investment undertakings and asset management companies that are subsidiaries of banks into the scope of the new capital requirements, a significant reduction of the capital charge factors (alpha/beta factors) in the Basic Indicator Approach (BIA) and the Standardised Approach (STA) for operational risk capital charges in asset management will be required.

We would also welcome the creation of a separate business line “collective investment schemes management” (CIS management) in addition to the existing business line “asset-management” in the Standardised Approach.

Detailed comments

609.

A clear ranking of the individual approaches is missing. It should also be clearly specified whether the Standardised Approach and the Alternative Standardised Approach are on the same level and whether it is possible to change from the STA to the ASA and vice-versa. This seems particularly important with respect to “reverting” to a simpler approach, which would require supervisory approval as laid down in paragraph 611.

615.

The division into business lines should not be interpreted too narrowly. For instance, banks that already use segmental reporting according to IAS should also be permitted to map their business lines according to these criteria.

617.

- The weighting of the average annual gross income suggested for the Standardised Approach in the consultative paper does not give banks an incentive to meet the qualitative and quantitative eligibility requirements for that approach. That is particularly true for banks that are primarily active in business lines with a beta factor of 18%.

- In order to provide an incentive, the betas of the business lines should be set at a maximum percentage, corresponding to the level used in the Basic Indicator Approach.

- With regard to the calculation of the capital requirement as a simple sum of the amounts across all individual business lines, we would like to make a critical note that this method does not take into account the risk diversification effects of an institution that is active in various business lines. The logical consequence is that an institution that earns all its gross income in one business line has to meet the same capital requirements as an institution that earns the (same) gross income equally divided among all its business lines.

619.

The current version of the Basel Accord does not prescribe capital requirements for operational risks, so it is illogical to speak of parallel calculation using the AMA and the current Accord. The period of initial monitoring following adoption of the AMA is governed by paragraph 622.

621.

It needs to be clarified whether this formulation means that, during this period, even internationally active banks must calculate their capital charge using the Basic Indicator Approach.

622.

The rule providing for a period of initial monitoring of the implementation of the Standardised Approach or the AMA by the supervisor is defined too imprecisely, both in terms of the actual timeframe and the relevant criteria to be monitored. We therefore argue that the requirements should be formulated more clearly in order to maintain a level playing field. A definite timeframe must be specified, during which the supervisor must determine whether the quantitative und qualitative criteria are met, and, if this is the case, grant its approval.

624.

We take objection to the requirement that, in order to qualify for the Standardised Approach, institutions must build a data base to track losses. Particularly in the case of smaller institutions, this would require a huge effort with scarcely any benefit for risk management:

- The small number of defaults only permits very limited conclusions about the actual operational risk.
- Even if such conclusions were possible, they would often be meaningless, since the losses must be tracked according to the regulatory business lines rather than according to the bank's actual business lines.
- Owing to these different methods of classification, it is unreasonable to expect that such a loss database will help provide the required incentives (622; 624.(b)).

627.

- It must be clarified under which conditions a bank's operational risk measures for credit risk with "a one year holding period and a 99.9% confidence interval" are comparable to the Internal Ratings-Based Approach. Since credit risk models are based on internal ratings, the distribution assumption for the value-at-risk model is not logical. The 99.9% confidence interval in the IRB formulas is based on an assumed normal distribution. If risk-sensitive operational risk models are used, which are based on highly leptokurtic distributions (i.e. sharply peaked distributions with a larger extent of extreme values, for instance the log-normal distribution), significantly more extreme results will be taken into account, which will, in turn, lead to increased capital requirements. For that reason, the operational risk capital charge calculated on the basis of a 99.9% value-at-risk model is considerably higher than that for credit risks. In leptokurtic distributions such as the log-normal distribution, for instance, a confidence interval of 99.9% instead of 99% creates a fourfold difference, whereas in normal distributions, the difference is only 1.328.
  As a solution, the capital charge should be calculated using a 99% confidence interval and the result should then be multiplied by a factor of 1.328.

- We take objection to a confidence level of 99.9% and a holding period of one year.
  In connection with the preparation of the AMA, the term "independent model validation" also needs to be further clarified and defined.

628.

The possibility that the Committee may, if appropriate, refine its proposals after 2006 on the basis of the accumulated data causes uncertainty for the Basel II projects and creates a risk of misdirected investments for banks.
This review must not affect principles such as the permission to use Advanced Measurement Approaches.

629.

It would be worthwhile to reconsider covering the expected loss in the operational risk with capital. It is also unclear how the supervisors would expect the expected loss to be factored in order to abandon the regulatory capital charge.

The quantitative standards regarding the determination of correlations are extremely vague and therefore might be interpreted contradictorily.

634.
The use of external data may lead to an overestimation of the risk of the bank's own operational risk management results.

One possibility would be for the Basel Committee to impose minimum requirements regarding the quality and thus the providers of external data in order to ensure higher-quality information and easier integration into the evaluation processes.

637.
The limitation on the recognition of insurance mitigation to 20% of the total operational risk capital charge should be eliminated after a certain period of time (e.g. after expiry of two years) or the percentage should at least be increased.

Annex 6
Principles for business line mapping

(e): The use of mapping criteria for operational risks consistent with the criteria used for credit and market risks appears impossible in light of the complexity and inherent characteristics of operational risks. For this reason, banks should be permitted to define their own criteria subject to supervisory approval.

Footnote 155: *"Gross income should not exclude operating expenses."*
This definition is in clear opposition to all other definitions of gross income, in which operating expenses are not taken into account. (Maybe this is just a typing error, since the German translation is consistent with all the other definitions.)

VI. Trading book

A. Definition of the trading book

646.
We take objection to the obligation to determine an expected holding period in the documented trading strategy since this only increases the time and costs involved in administration.

B. Prudent valuation guidance

2. Valuation methodologies

Marking to market

652.
The consultative paper stipulates that, when marking to market, the more prudent side of bid/offer shall be used. The implementation of this provision would entail substantial one-time changeover costs and possibly increased maintenance costs for the IT systems currently used.

Even though we generally support the principle of conservative and independent valuation, we do not think that the use of the prudent side of bid/offer will automatically lead to right valuation. Market practices must be considered as well. Therefore, differing procedures between the International Accounting Standards (IAS 39 in particular) and the New Capital Accord must be avoided at any rate, and the valuation at mid-market (corresponding to the fair-value valuation according to IAS) should continue to be possible.

653.

- The consultative paper defines a comprehensive number of requirements for the application of the marking to model concept. In particular, it specifies that the valuation model has to be examined by an independent party and that prudent valuation assumptions have to be applied.
  Concerning the demand to have the valuation model assessed and approved by independent parties, we point out that the entire internal model has been assessed and approved by third parties. We therefore take objection to the partial acceptance of individual functions of the model by third parties, as it is deemed superfluous. Rather, the valuation model will be checked as part of the periodic reviews by auditors and the competent authority.

- An implemented internal model that is approved by the supervisor is subject to routine data backups, which should be sufficient. An additional backup of the model would therefore not create any additional benefit.

3. Valuation adjustments or reserves

657. ff

This paragraph requires the establishment of valuation reserves for numerous business aspects (unearned credit spreads, close-out costs, etc.). The wording does not clarify the level (individual exposures, aggregated) on which these valuation reserves are to be defined. Moreover, it has been specified that profits/losses arising from the valuation reserves shall be added to/deducted from an institution's own funds.

The section "value adjustments and reserves" has not been worded clearly enough. A correction of the valuation results on the basis of individual exposures does not seem feasible owing to the enormous effort it entails. In addition, we doubt that it helps increase the accuracy of risk weighting.

Regarding the terms "operational risks" and "model risk", we would like to point out that the operational risk is covered by other sections of this document. According to this section, the operational risk would be covered twice.

D. Trading book capital treatment for specific risk under the standardised methodology

3. Specific risk capital charges for positions hedged by credit derivatives

670.

We appreciate the option of offsetting long and short positions in credit derivative and money market instruments. However, owing to the correlations observed in the market, an offset exceeding 80% should be provided.

4. Add-on factor for credit derivatives

675.

For credit derivatives, add-on factors independent of maturity have been provided in order to cover potential future exposure. To ensure risk-adequacy, the add-on factors should be differentiated according to residual maturity. This would accommodate the fact that longer maturities carry a higher risk of future exposure than short maturities.

PART 3: THE SECOND PILLAR – SUPERVISORY REVIEW PROCESS

Basic considerations

1) Qualitative deficiencies must not be converted into quantitative capital requirements
The conversion of qualitative deficiencies into quantitative capital requirements, which is not explained in more detail, does not comply with the existing principles of the Constitution.

Until the Capital Accord Implementation Group has presented its findings, it is impossible to estimate to what extent the great number of uncertain terms, the interpretation of which will determine crucial areas of supervisory intervention.

- will result in sufficiently predictable supervisory action (legal certainty) at national level;
- will create a level playing field at international level;
- will enable an appropriate cost-benefit ratio in terms of supervisory effort;
- will maintain the autonomy of the management of banking institutions;
- will ensure that particularly the individual additional capital requirements are the exception rather than the rule (otherwise the calibration based on Pillar 1 alone would be insufficient).

2)
Section C contains a new comprehensive list of criteria to be taken into account by the supervisory authorities when reviewing the application of Pillar 1. It also includes details on risks which, as the Basel Committee admits, Pillar 1 does not address at all.

Interest rate risk in the banking book has already been included as the only specific category. This was, however, based on the following premises:
- considerable heterogeneity between banks in terms of the nature of the underlying risk and appropriate processes for monitoring and managing this risk
- limitation of regulatory intervention to clearly defined "outliers"

Neither of these two premises applies to the newly added specific issues. They refer to all banks and largely relate to matters that have already been addressed in Pillar 1. For that reason, the doubts raised in the last bulleted paragraph of point 1 above are particularly important:

There is a risk that Pillar 2 will change from a structure that only gives rise to bank-specific regulatory interventions (such as additional capital requirements) in exceptional cases into a standardized structure that triggers frequent regulatory interventions. This results in a fundamental change of the relationship between Pillar 1 and Pillar 2. We therefore urgently request that the new specific risk categories be integrated into Pillar 1 so that the calibration can take place on that basis.

Supervisory action in the context of Pillar 2 should not be subject to disclosure requirements (see, for example, paragraphs 745 and 746).

We generally take objection to new risks being added without clearly specifying how they are to be treated (e.g. credit risk concentration in paragraphs 729 through 736).

3) Minimizing national differences
We welcome the objective of minimizing the differences in national regulations as set forth in paragraph 67 of the Overview of the New Basel Capital Accord.

The minimization of such differences should allow the supervisory authority of a subsidiary bank to recognize the capital requirement rules of the parent bank. Similarly, it should be possible for the supervisor of the parent bank to recognize the capital requirement rules of the subsidiary bank on a case-related basis.

Such mutual recognition would create huge savings for the regulatory authorities without impairing the quality of supervision.

Detailed comments

B. Four key principles of supervisory review

697.
We take objection to the exhaustive enumeration of data requirements in connection with interest rate risk in the banking book, since the required data depends on the particular system used to measure interest rate risk in each individual case.

702.
We take objection to external audits of the capital assessment process, since this assessment is part of the supervisory review process at any rate and would only cause additional costs.

Principle 4:
717.-718.
Drastic measures such as prohibiting or restricting the payment of dividends seem excessive and should not be considered unless creditors are at risk. In our view, this principle may potentially lead to excessive restrictions on banks in relation to their business policy.

C. Specific issues to be addressed under the supervisory review process

729. ff
We consider these rules to be excessive and take objection to consequences affecting capital requirements arising therefrom. For instance, a large amount of data not contained in customer databases is required to identify risk concentrations such as those described in paragraph 732, bullet point 3 ("credit exposures to counterparties whose financial performance is dependent on the same activity or commodity"). In practice, obtaining and capturing such data entails a huge effort. Moreover, the requirements regarding "credit exposures to counterparties whose financial performance is dependent on the same activity or commodity" are covered by the second bullet point ("credit exposures to counterparties in the same economic sector or geographic region").

739.
In the event that the supervisory authority deems the credit risk transfer arising from a securitization transaction to be insignificant or non-existing, the supervisor has the option of imposing higher capital requirements (option 1) or may deny the bank from obtaining any capital relief from the securitization (option 2). It must be guaranteed that option 1 will only lead to higher capital requirements it these are triggered by option 2.

PART 4: THE THIRD PILLAR – MARKET DISCIPLINE

We appreciate the partial reduction of the disclosure requirements compared to previous versions. Nevertheless, we continue to see a need for change in certain areas.

The scope of the disclosure requirements is still too broad. There is still too little differentiation between data required for the supervisory authorities and data that are to be published. Despite the general provision on that matter, there is still some concern that individual customer data might be disclosed in detailed tables.

In any event, it should be ensured that the disclosure requirements under Basel II do not exceed the IAS disclosure obligations. Any information beyond that scope should only have to be disclosed directly to the supervisors.

In addition, insufficient disclosure of CRM techniques, for instance, should not lead to a refusal of lower risk weights, since this is not a cause for an additional increase in risk.

In principle, the choice of disclosure medium should be left up to the individual institution. It does not make any sense, for instance, to publish certain qualitative disclosures (e.g. table 4, table 6, table 8, etc.) in printed form every year.

Detailed comments

A. General considerations

760.-761.
The standardization of disclosure requirements and sanctions at the international level as well as concretization of the measures seems particularly necessary because otherwise consolidated group data cannot be presented. The more specific the sanctions, the more precisely must the individual circumstances be defined. This, however, currently does not seem to be the case.

The sanctions need to be specified in more detail and a standardized international procedure regarding the sanctions must be adopted. In addition, we request an international standardization of disclosure requirements. Not only banks, but also securities entities should be subject to the disclosure requirements in order to prevent distortions of competition.

Publication of detailed information on systems, inputs, and backtesting results in particular, does not create any additional benefit. In fact, publishing backtesting results even creates the risk that the general public, to whom this information is actually addressed, might derive false conclusions (see below).

767.
- It would be reasonable to scale the frequency of disclosure, especially with regard to an institution’s size and risk profile. Generally, we consider disclosure on an annual basis to be sufficient for smaller banks with a stable risk profile.

- We also request that the disclosure of data from individual subsidiaries should only be mandatory if the subsidiary is fully consolidated and the parent organization has a controlling interest.

- It is also necessary to clarify what kind of “review process” banks need to establish in order to ensure the eligibility and required frequency of their disclosures of information on the financial and earnings positions.

B. The disclosure requirements

770.
The publication of a formal disclosure policy does not make any sense and would require considerable additional resources.

771.
The regulatory scope of consolidation should be adapted to the IAS scope of consolidation (“materiality” as a criterion for inclusion in line with IAS rules).

771. / 3. / Table 2, (a)
For the purpose of focusing on material information, we propose that the word “especially” be deleted. Consequently, qualitative information will only have to be disclosed in the case of innovative, complex or hybrid capital instruments.

772.-774.
The disclosure obligations for impaired loans are still too extensive; notification of the supervisor should suffice. In general, internationally active banks, too, should only have to disclose information required by their rules of accounting.

773. ff
We request elimination of the requirement to disclose the processes (bullet point 1) and the policies for hedging and/or mitigating risk (bullet point 4). This information must be provided to the supervisor, and therefore no additional disclosure is necessary. Furthermore, the protection of confidentiality is to be given priority over the benefits of this information, which we consider to be very limited.

774. / Table 4, (a), first and second bullet points
For the purpose of focusing on material information, we propose that the obligation to disclose such information be limited to cases in which these definitions and approaches deviate from the generally valid rules or the rules imposed by accounting standards or the supervisory authorities.

775. in general
- We take objection to the disclosure of loss estimates and data on actual losses, since it is almost impossible for external market participants to interpret such data correctly, which might cause a falsification of the information.

- The optional recognition of pooled disclosures when applying internal models is not mentioned. Pooled disclosures would also be a good option for the problematic documentation concerning the number of defaults. An explanation of what is meant by sufficient time and meaningful assessment is missing in the provisions on quantitative disclosures.

- Optional recognition of pooled disclosures when applying internal models should be provided for in the form of a pool of data, since it does not make sense for each bank in the pool to repeatedly disclose information on the same system.

Operational risk
Description of the AMA seems superfluous since approval by the national supervisor is required at any rate. Investors will be able to rely on the fact that the conditions for approval have been met. Disclosure would not result in any apparent benefit for the investor, since most of the systems are very complex. The supervisors check the validity of the models, and rating agencies have the models explained to them as well.

775. / Table 6, (g)
We request that the disclosure requirement will not depend on a certain implementation date (2008). Rather, it should only become mandatory in cases where a corresponding time series (e.g. five years) actually exists.