

ANNEX 3 To

**Review of Capital Requirements
Response on Commission Services'
Third Consultation Paper
LIBA/ISDA**

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BBA/LIBA response to the Third Consultative Document on a New Basel Capital Accord

This paper presents the joint British Bankers' Association (BBA) and London Investment Banking Association (LIBA) response to the third consultative document published (CP 3), on 23 April 2003, by the Basel Committee on Banking Supervision on a New Basel Capital Accord.

The BBA/LIBA response first addresses a number of substantial overarching issues that have a special relevance to the sound and continuing implementation of the new Capital Accord (see section 1). Thereafter, the response addresses a number of specific technical concerns relating to sections of the Accord (sections 2-10 inclusive).

1 Overarching issues

1.1 Cross-border implementation: the Home - Host issue

The application of the new Accord to cross-border groups is one of the most complex challenges now facing industry and supervisors. Success in this arena is critical. Home - Host considerations remain unclear and are of paramount concern to internationally active groups. Recent discussions with certain regulators suggest a diversity of opinion on both the adoption and implementation protocols for Basel 2. Inconsistency in this area, in addition to competitive uncertainties, creates the very real possibility of duplicated regulatory calculations.

The new Basel Accord is an instruction to both banks and supervisors. BBA/LIBA regard it as essential that, as above, the Committee sets out clear principles and clear expectations in respect of the application to international groups. We strongly feel that the Committee should, through the articulation of a number of key principles, signal a strong lead to national supervisors.

The key principles on which our members are keen for a certain outcome are:

- **Consistency:** The Accord should state that regulators must strive to achieve consistency in their standards and approaches for implementation and validation, thereby avoiding distortions in the competitive landscape and additional costs of compliance and implementation.
- **Interpretation:** No institution should be subject to more than one interpretation of the Basel Accord in any jurisdiction, unless there are specific legal circumstances that make this unavoidable.

The preference of the Associations is for a pragmatic lead supervisory model. The home supervisor (defined as the main place of business) would lead on the global supervision of the consolidated group and on the approval process for the more advanced approaches. Local supervision and specific implementation rules could be delegated to the "host" supervisors.

- **National Discretion:** The Committee should also review the area where national discretion is available. Although the introduction of flexibility carries advantages, the prospect of building a system to cater for different regulatory environments is highly unattractive. We especially draw the Committee's attention to the competitive impact of

the national discretions applying to the standardised treatment of banks and maturity in the IRB approach.

The demands on both supervisory and industry resource will be considerable if clarity in this area is not achieved. Therefore, as a matter of urgency, we look forward to more guidance from the Committee (or the AIG).

1.2 Cross-border implementation: consolidation

Institutions should be able to choose how to calculate capital for the consolidated group. The Accord should allow for the capital adequacy to be assessed by either:

- **Aggregation:** summing the regulatory requirements for sub-consolidated groups, or individual institutions, if not already part of the sub group. (Adjustments would need to be made in relation to intra-group exposures to avoid double counting, which could be achieved by zero weighting intra-group exposures or by stripping them out entirely, the latter option has the benefit of avoiding any overstatement of the 0% band); or,
- **Re-calculation:** of the capital adequacy of the whole group on a line-by-line basis.

The cost of either alternative being mandatory would be prohibitively high for those groups that need to make adjustments to their current approach. We note that the Joint Forum is not prescriptive in its recommendations on the form of the consolidation required.

Further issues regarding consolidation are discussed in section 2.

1.3 Cost, complexity & flexibility

The new Accord, as currently proposed, is unduly complex and will be difficult for our members to implement and for national regulators, even in the G10, to supervise. The cost of compliance, for firms and supervisors will be high, and we question whether sufficient resources will be available within the supervisory bodies to ensure consistent application, across and within jurisdictions.

While CP3 is an improvement on previous versions of the Accord, the requirements involve a level of detail, complexity and prescription that increase the risk of inadvertent non-compliance. This is contrary to the goals of the Committee, which include commitments to maintain competitive equality and foster prudential soundness. Disagreement on methods, calculations and inputs runs the risk of making the playing field even more uneven than it is now. The wide dispersion of individual bank results evident in QIS 3 has not dispelled this concern.

The Associations have always believed that the Accord should not prescribe a "unique vision", but instead provide a guide to good practice for regulators and firms to be interpreted flexibly, to encourage continued evolution in risk management practice and the containment of cost. In this regard, the Accord's text should be structured for easy amendment in light of changes or improvements in industry practice. Even at this late date, we would urge the Committee to consider an approach more based on principles and less on rules.

Flexibility within the Accord would be significantly improved by the following changes, both of which are consistent with firms' implementation plans:

- **"Single IRB"**: The objective of creating a more evolutionary Accord would best be served by implementing a "single IRB" on the wholesale side which would be more flexible and pragmatic, allowing for the transition to the Advanced Internal Ratings Based Approach (AIRBA) on a portfolio-by-portfolio, risk factor-by-risk factor basis.

Inconsistencies between the current Foundation and Advanced methodologies (such as the different definitions of LGD, maturity) should also be removed, eliminating the "cliff effects" and perverse incentives that now exist between Foundation Internal Ratings Based Approach (FIRBA) and AIRBA. Jurisdictions choosing to implement the Accord using only regulatory inputs for LGD and EAD, in effect the FIRBA, would still be able to do so.

Such an approach would reduce the risk of the Accord stifling innovation in risk management. Institutions would be able to make prudent cost/benefit decisions with regards to portfolios advancing to AIRBA. This is particularly relevant for portfolios with low default frequency. Regulators would have the ability, through the supervisory review process, to ensure that firms justify such decisions and were not merely choosing to use regulatory inputs in order to achieve a lower capital charge.

- **Retain Basel 1 as a transitional arrangement**: We believe that the Committee could go further in creating more flexibility in the rollout provisions. We propose that Basel 1 be retained as an option throughout the transitional period up until 2010. Furthermore a firm should be allowed to progress directly to the Standardised Approach (SA), FIRBA or AIRBA (IRB if the suggestion outlined above is adopted) on a portfolio-by-portfolio basis. This would greatly reduce the costs of compliance whilst at the same time smooth the transition to Basel 2.

Without such flexibility, firms looking to implement IRB approaches would need to move all non-compliant portfolios onto the SA in 2006, possibly moving them onto IRB from, say, as early as 2007. We can see little or no prudential gain in requiring firms to take such an awkward and expensive transitional step.

To balance concerns that firms may game this capability we consider that Pillar 2 (Supervisory Review) and Market Disclosure (Pillar 3) be applied at the outset.

1.4 Calibration

- **QIS 4**

Whilst useful, QIS3 should not be regarded as the definitive calibration of the new regime. QIS3 showed considerable volatility in impact across institutions and markets and we doubt if sufficient incentives have been created to persuade our members to adopt the more advanced approaches on offer.

BBA/LIBA would support a further refinement study, if "QIS4":

- were sufficiently focused on the key remaining issues, most notably in our view the trading book, the treatment of securitisation and the creation of a single IRB;

- were to lead to further changes in the proposals if the study highlighted further areas of concern.

We would recommend delaying any future QIS's until firm's data collection techniques have become more aligned with the Basel 2 processes; the completion of QIS3 was hampered by difficulties of collecting good quality data. We would also recommend that the scope of future exercise, contrary to practice to date, include an assessment of the impact of Pillar 2.

- **Trading Book issues**

The Associations do not believe that Committee has properly addressed the effect on specialist banks and on certain business activities. In particular we do not believe that the overall calibration for the trading book is appropriate. The Committee's comments on the QIS3 results ignore the impact on specialist institutions, particularly those for which trading book capital requirements represent a material proportion of overall regulatory capital. Specific issues relating to the trading book are discussed in section 8.

1.5 Supervisory disclosure

The new Accord will have a major impact on financial markets and institutions. It is not possible to anticipate every aspect of every dynamic that is created and, because of the necessary flexibility built into the regime, the impact could differ substantially across jurisdictions. A general interest exists in monitoring the impact of the new regulations in terms of systemic stability but also to ensure competitive equality. Those with an interest in monitoring this impact include of course supervisors, but also government, legislators, industry and consumers.

Supervisory disclosure is a simple, cost efficient and potentially effective policy built upon the accepted observation that the market can inform and discipline implementation. We would propose that Member State competent authorities publish, in standard format, data in three core areas:

- the publication of national standards and rulebooks;
- the take up and the rationale for the national discretions;
- aggregate statistics on the impact of national implementation, for example the proportion of regulated businesses achieving the AIRBA or the average additional capital required under Pillar 2.

In addition to the practical benefits already discussed, such disclosures could act as a driver for supervisory convergence and support the work of the AIG, whose effectiveness will be key in ensuring a coherent application of the new Accord.

The EU Commission and EU Parliament have made a number of positive comments around supervisory disclosure and it would be beneficial if the Basel proposals were aligned. In this regard, the Associations will submit under separate cover a draft disclosure template for the Committee's consideration.

2 Scope of application

2.1 Level of consolidation

The new Accord requires firms to consolidate and meet capital requirements at all levels in the ownership chain, with a minimum 8% at the lowest level in the ownership structure. Requiring sub consolidation at intermediate sub-holding company levels create significant, additional reporting burdens for banks, but is of minimal value.

There seems to be little cost: benefit analysis in this proposal. Whilst we support the Committee's objective in having capital readily available to support risks incurred by an institution within a group, we are unsure whether any meaningful information will be obtained as a result of this new requirement.

We propose that a principle be introduced in paragraph 3 requiring the Accord to apply on a fully consolidated basis and at the highest level of a banking group within any individual jurisdiction, although we suggest that the Accord permits host regulators to waive such consolidation, (after discussion with home regulator) if such consolidation does not add to the host's supervision of the regulated entities.

In exceptional circumstances, supervisors should have discretion to require application on a sub-consolidated basis, but only where this is justified on cost/benefit grounds, not in every case and at every level.

2.2 Deduction of investments

We believe that the wording of paragraph 18, relating to the deduction of investments is unclear. We assume that deduction of investments is required 50/50 from Tier 1 and Tier 2 as they are currently determined i.e. calculating the limits on innovative Tier 1 capital and on Tier 2 capital before making the deduction. We remain unclear on the reasoning for this proposal, as the allocation of 50% to Tier 1 capital and 50% to Tier 2 capital appears arbitrary. This is one of very few changes which have been proposed affecting capital rather than the calculation of capital requirements.

3 Credit risk – the Standardised Approach

3.1 Treatment of A rated banks

The risk weights under for single A rated banks under Option 2 of the SA are arbitrary, correlate poorly with actual default experience and create significant market distortions. In particular, under Option 2, the risk weight for single A rated banks or investment firms would lead to significant distortions relative to the current accord and to the proposed Option 1 SA and IRB approaches. We do not think that either prudential risk based standards or competitive equity are served by the current proposals. The EU decision to propose a permanent opt out from the IRB approach for banks and sovereigns increases our concerns (see European Commission, Review of Capital Requirements for Banks and Investment Firms, Working Document, Article 50.)

We recommend that Option 2 be amended to ensure that A rated banks or investment firms receive the same treatment as AA or AAA firms. Default/loss data suggests that a single A banks show no discernible difference in behaviour when compared to even higher rated banks. Such an approach would reduce competitive distortions within the banking market both at domestic and international levels.

4 The Standardised Approach – Credit Risk Mitigation

We refer the Committee to comments made by the International Swaps and Derivatives Association (ISDA) and the Bond Market Association (BMA) which, in general, we endorse.

4.1 Credit Derivatives

We welcome the Committee's revised proposals for the treatment of credit default swaps in relation to restructuring risk of the underlying. We also welcome the indication of the Committee's willingness to consider offering some capital relief where control over the restructuring event does not exist.

However, we urge the Committee to re-examine the proposals for:

- **Add-ons for sellers of Credit Default Swaps.** We regret the absence of discussion by the Committee on the reason for this change. Where protection is bought, we ask that the Committee re-consider the size of the add-on where qualifying underlyings are being hedged.
- **Specific risk offsets.** The Committee is well aware of the Associations' long-standing view that these should not be limited to 80%. We understand that the Committee is anxious to reach conclusions, but we urge continued dialogue on this item.
- **Double Default.** We recognise that the Committee has sympathy for the arguments that the substitution approach (i.e. double default) is an extremely conservative approach. We hope that the Committee will consider the solution being discussed by the Federal Reserve Board regarding the treatment of Double Default and ask that any allowance by the regulatory authorities in the US be reflected in the Basel rules, to ease implementation and ensure international consistency.

4.2 Counterparty Risk

We welcome the adoption of the sampling methodology in the VaR treatment for repo style transactions, though we continue to harbour concerns that the size of the multiplier is too large (the size of multiplier used is of great importance for firms in determining whether or not it is beneficial to use the approach).

We also agree with ISDA that the VaR treatment should be allowed for counterparties without netting agreements. Quite apart from the practical implications and costs of having to develop two approaches, there are valid portfolio effects taken account of within a PE measure even where there is no netting agreement.

We further welcome the Committee's decision to review the treatment of potential exposure arising from OTC derivative transactions. Such a review should also encompass the treatment of securities financing transactions. It is imperative that the treatment of potential exposure is looked at as a matter of urgency to ensure that any changes resulting from the Committee's discussions are implemented in the final Accord - not doing so will damage the credibility and risk-sensitivity of the new Accord. This is especially important for those institutions with large OTC derivative portfolios, particularly given the overall impact on capital requirements for the

trading book, as noted above. We would ask the Committee to recognise that there would be considerable expense involved in a two transition, moving from VaR treatment to a new Potential Future Exposure framework. We ask the Committee to do what it can to mitigate this risk.

4.3 Maturity

We support the better recognition of the risk mitigation value of maturities of under one year; indeed, we believe this is key in the construction of a risk sensitive system.

However, the existing maturity formula is not appropriate. The reduction in risk weight for low maturity transactions using the current formula is insignificant when compared to the true reduction in risk that occurs in the context of very short-dated transactions.

We also question the applicability of the maturity mismatch formula to firms electing to use maturity adjustments.

4.4 Drafting and definitional issues

- To avoid confusion, we recommend that the conditions applying to the treatment of cash collateral in the Simple Approach [specifically paragraphs 116(a) and 156 and footnotes 34 and 45] are reorganised and clearly cross-referenced.
- We would wish to see full consistency between the minimum requirements applying to CRM in the Revised Standardised Approach and IRB Approaches (e.g. Legal Certainty), as there is no logical reason for firms to be subject to different criteria and standard if they were to transition between these approaches.
- We seek clarity on the activities that are included within the definition of “margin lending”. Specifically we believe that prime brokerage should be encompassed within the definition of “repo-style transactions” and thus eligible for the same capital treatment as repos. Prime brokerage involves daily marking to market of exposures and daily re-margining, and the business is risk managed in a manner consistent with repo activity.

5 Credit risk – the Internal Ratings-Based Approach

5.1 Transitional floor LGD floor for mortgages

BBA/LIBA rejects the proposal for a 10% transitional LGD floor for mortgages (paragraph 235) and its application at the sub-segment level, which greatly amplifies the negative impact. We cannot understand the logic behind this "one size fits all" solution. This proposal will penalise the highest quality mortgage portfolio (and the highest quality sub-segments within those portfolio).

BBA/LIBA believes that the Committee may legitimately have dealt with this concern within the standards expected in Pillar 1 and the potential for portfolio specific adjustment in Pillar 2. At the very least we would recommend that the transitional floor be applied at the portfolio rather than sub-portfolio level.

In this context we would also question the introduction of a 3bp PD floor within the retail approach. Whilst the logic behind this requirement is unclear, it is unfortunately clear that the

requirement creates a real incentive for banks to amend their portfolio segmentation. As above we would recommend that any floor be applied at the portfolio rather than sub-portfolio level.

5.2 Loss Given Default

The Associations do not see the relevance of the additional requirement that the firm must use “LGD estimates that are appropriate for an economic downturn” (paragraph 430 refers). We believe this is both conceptually wrong and, practically burdensome. As most defaults occur in periods of economic downturn, a firm's average recovery experience will automatically be weighted towards such periods and to require a yet more extreme 'worst case' calculation makes the calculation unreasonably conservative.

BBA/LIBA understand the concerns that the Committee is seeking to address but strongly questions whether a uniform requirement to use recession case LGDs is an appropriate or sound response. The proposal simply may not fit with the evolution of a market, may penalise firms with a longer data series, will fail to reward improvement in firm risk management practice, fail the use test and result in an overstatement of required regulatory (as compared to economic), capital.

Using recession case LGDs is a major proposal with significant consequences. On the basis of the data collected in QIS3, we would ask the Committee to make public their own assessment of the impact. We believe this requirement is far too conservative, especially when juxtaposed against the need for seven years LGD data and undertake stress testing, coupled with the supervisory review requirements in Pillar 2.

5.3 Minimum requirements for IRB Approach

Many of the suggestions that BBA/LIBA made in response to the rationalisation of the minimum requirement for the IRB approach in CP 2 have been adopted by the Committee. We welcome this.

However our members are still concerned that elements of the proposals still persist which add little value to either the stability or sensitivity of the regime but will be very costly to implement. We highlight:

- **Data maintenance:** The data maintenance requirements in CP2 have been retained, specifically the requirement that firms retain sufficient data to conduct retrospective ratings. The cost of this proposal is grossly disproportionate to any benefit. If the intention is retain a near perfect audit trail for supervisors to follow then the objective is flawed and unlikely to be realisable in practice.

The starting point should be an articulation of regulatory objectives and the requirements to fulfill them. We suspect that in the absence of any clarity, firms are being asked to bear the cost of keeping supervisory options open. It would be unfortunate if experience proved that only a fraction of this data would ever be used. Rather, we propose that the minimum standard be to hold the current rating and rating history.

- **Absolute SME boundary.** The definitions of SMEs, being based on absolute limits at the asset level, will produce operational problems and cliff effects. BBA/LIBA are of the opinion that the "use test" should lead in portfolio definition and that numeric

boundaries should be flexibly applied. For example, if a number of exposures cross the absolute boundary but are not material in the context of the overall portfolio and are part of the same risk process, then firms should not be made to treat such exposures differently, changing from very different retail and corporate risk management systems every time a firm breaches the €1m level.

If the retail/corporate SME boundary is to be defined in terms of an exposure measure, we would like to see this done in pragmatic terms, since "exposure" in this instance is a proxy for firm size, and not a risk measure. We suggest that the exposure measure in this instance should be limited to on-balance sheet drawings. To do otherwise would penalise institutions with a good capability of aggregating exposures across different business lines.

- **Cash values.** Related to the above we would wish to understand how the Committee intends to revise and compensate for inflation and exchange rate volatility when applying the Basel Accord at a national level. In the context of absolute boundaries, with no materiality concession, exposures could move from one treatment to another on the basis of factors entirely outside the control of any individual firm and irrelevant to their risk profile.
- **All relevant information.** Currently paragraph 410 requires that firms use "all relevant and available information" in the IRB approach. If interpreted literally this would be an impossible standard to apply since however much information you have you can always get more and it would be difficult to prove that such additional information would not have some relevance. We propose that the words "all relevant and available information" be replaced by "material and relevant information".
- **Good quality, low data portfolios:** The IRB model implicitly assumes the availability of default, loss and exposure data for all portfolios. In a number of markets this assumption is flawed and cannot be solved by industry data sharing. Portfolios such as banks, sovereigns, high quality corporate and specialised lending, private banking as well as the trading book all show very low levels of default and/or credit loss experience. Problems may also arise when new products or financing techniques emerge.

Our preference would be for portfolios with negligible loss history to be approved for IRB approaches, but with the clear understanding that the firm would be expected to demonstrate this to the supervisor, as and when necessary. The current IRB requirements do not permit this and implicitly create a framework whereby low-default portfolio may fail to access the IRB approaches - an outcome that would be both counter-prudential and counter-intuitive.

The inability of the framework to address this issue for a large part of firms business is, in our view, a fundamental flaw of the framework as proposed. Leaving this issue to national supervisors to address will be one of the greatest sources of inconsistency in application of the new Accord across jurisdictions and will potentially lead to misinterpretation by the market in terms of the level of sophistication that firms have or have not achieved.

- **Derivation of Risk Weights for Intra-Group exposures:** No thought seems to have yet been given to how firms are to derive risk weights for intra group exposures to connected parties. Calibration and modelling from credit data history for intra-group exposures is generally meaningless as it would be unusual for a parent bank in the group

to allow its subsidiaries to default on their intra group borrowings – borrowings are usually rolled-over as necessary. We believe that such exposures should continue to be zero weighted to avoid penalising intra-group exposures relative to 3rd party exposures. Concentrations of risk to intra –group entities, if significant, should be considered as part of the Pillar 2 review rather than be incorporated under Pillar 1.

5.4 Retail EAD

For retail exposures with uncertain future exposure, paragraph 307 requires banks to incorporate an estimate of expected additional drawings prior to default in the calibration of their loss estimates. The treatment of EAD in paragraph 307 is inconsistent with other treatments given to other uncommitted off balance sheet lines. Specifically, paragraph 56 (the standardised approach - general rules for off balance sheet items) and paragraph 281 (EAD under the foundation approach for bank, sovereign and corporate exposures) are both credit facilities that are characterised as being, "unconditionally cancelable at any time by the bank without prior notice, or that provide for automatic cancellation due to deterioration in a borrower's creditworthiness." These lines are given a 0% credit conversion factor. There is no material difference between these uncommitted off balance sheet lines and credit card lines and the treatments should be the same.

5.5 Recognition of provisions

The proposals on recognition of provisions result in the perverse outcome that a prudent firm which raises conservative provisions will be penalised if these provisions exceed EL. Once available offsets have been used, all further provisions remain as straight deductions from Tier 1 capital (as they are a charge to profit and loss) without any benefit in reduced RWAs. There is, therefore, a disincentive to raise additional specific provisions above a certain level.

This outcome is driven by the specific provision offset being limited to EL. This is an artificial threshold, as specific provisions are not intended to equate to EL and, given the difference between the accounting principles for impairment and the Basel Definition of Default, are unlikely to agree.

The offset limit and the reallocation of excess specific provisions to other assets in the same class adds a significant and unnecessary further layer of complexity to the already complex IRB calculations.

The current Accord bases RWAs on the exposure net of specific provisions. This effectively allows full offset for specific provisions. The revised Accord should similarly allow full offset of the specific provisions.

5.6 Specialised lending

Assessment of risk associated with Specialised Lending presents particular problems. Where portfolios, for example Project Finance, have low default data, estimation of PD, LGD and EAD on a statistical basis will be difficult. The "Supervisory Slotting" approaches employ a valid methodology but the resulting risk weightings are punitive. There seems to be no logical reason why weightings under IRB, which requires superior risk analysis, should be generally higher than those that apply under the Standardised approach. We request that the IRB risk weightings are re-considered to ensure that there is a suitable incentive to adopt the more advanced approaches.

5.7 Trade related guarantees

BBA/LIBA are pleased that the Committee took into consideration our comments in respect of the treatment of trade related letters of credit.

We wish to raise a similar and strongly related issue, the treatment of trade related guarantees. It is unclear whether guarantees would fall under the general treatment devoted to off-balance sheet items (see para 56), namely receive a credit conversion factor of 20% or 50% according to their original maturity date. We would also note concern that the standard supervisory CCF of 75% in the IRB approach is not applied to trade related guarantees on the basis that they are neither Letters of Credit nor unconditionally cancelable. Our preference would be to retain the current treatment with risk conversion factors ranging between 50% and 100%, according to whether the guarantee is transaction-related or financial.

Further, the taking into consideration of guarantees for credit risk mitigation purposes at paragraph 161 of CP3 runs contrary to the practice of guarantees as well. Indeed, while it is required that guarantees be “unconditional”, which we assume means “independent from the underlying transaction”, conditions (b) and (c) establish a clear link with the underlying transaction that would defeat any such independence.

6 Credit risk – Securitisation Framework

We continue to believe that the securitisation proposals are unduly complex and will be difficult for firms to implement and supervisors to validate and review. We also believe that each approach delivers highly conservative amounts of capital that could damage further developments in the securitisation market.

6.1 Definitions and legal requirements

The roles played by firms in securitisation are not mutually exclusive. For instance the same firm that has moved assets into a special purpose vehicle (some of which it may have originated, others not) can also be a provider of liquidity facilities. Whilst we understand that this is the reason for the inclusion of the phrase ‘directly or indirectly’ in para 507 their meaning is not yet clear enough to be useful to firms.

We note the specific requirement in paragraph 517(f) to obtain an "opinion...from a qualified legal counsel that confirms the enforceability of the contracts in all relevant jurisdictions". We query whether this constitutes a higher standard compared to other legal requirements, for example paragraph 89.

6.2 Liquidity facilities in the Standardised Approach

The 20% CCF for liquidity facilities is far too high and its introduction would de-stabilise a large part of the ABCP market were it introduced. Losses under liquidity facilities have rarely exceeded 0.03% as they are protected by subordinate tranches of credit enhancement. Historical experience suggests that a 1% CCF is more appropriate.

6.3 Rating Based Approach

Whilst we accept that tranche thickness is relevant to the risk profile we do not see the need for a further supervisory parameter given that this is an integral factor in the risk assessment models applied by external rating agencies.

The capital weights for securitised structures should be set at a rate only marginally above the rate used for corporates. For instance the impact of raising the capital weightings on BBB and BB tranches as compared to corporates will serve only to destabilise the underpinnings of the entire securitisation market, as the 350% capital weightings on BBs may push these tranches into unregulated hedge funds and CDOs as buyers themselves. It would be better to leave both the buyers and sellers of this risk inside the regulated financial system.

Furthermore, as there is an observable spread difference in the market for similarly rated tranches that comprise different types of assets, that the risk weight curves should be modified allowing firms to look through to the underlying type of asset to recognise that the EL/UL relationship differs depending on the asset class.

6.4 Supervisory Formula

The continued use of floor capital charges, combined with a one-for-one deduction up to K_{IRB} creates a premium that, for some classes of assets, (for instance retail-backed exposures) will require multiples of extra capital when compared to unsecuritised assets. For instance the requirements to risk weight liquidity facilities according to the highest risk weight under the standardised approach and use a CCF higher than in the standardised approach does suggest that IRB firms will be disadvantaged when compared with less sophisticated firms on the standardised approach.

7 Operational risk

7.1 Calibration – Basic Indicator vs. Standardised Approach

BBA/LIBA continues to have concerns as to the calibration of the operational risk proposal. The calibration of business line beta factors for corporate finance, trading and sales and Payment and settlement is at a level above the alpha proposed in the Basic Indicator Approach (BIA). Calibration should provide clear incentives to adopt the Standardised Approach (STA) - beta factors should not exceed the BIA alpha.

To date Basel has not issued any discussion or justification for the higher multipliers applied to corporate finance and trading and sales. We are not aware of any empirical basis for this decision and note that the loss data exercise conducted by the Basel committee did not yield results that would support the higher calibration of these lines. We also note that trading and sales addresses activities that are both high margin and are marked to market. Taking all these features together, we do not find the STA to be risk sensitive and we find the beta factor applying to investment business activities to be excessively high, and recommend that it be reduced. Moreover, as the Committee is well aware, some firms specialise in these business lines. Where the capital charge is not risk sensitive, any such firm faces a disproportionate capital charge.

7.2 Calibration - AMA

BBA/LIBA also note that the proposed calibration standard of the AMA is to a level ‘comparable to that of the IRB approach for credit risk (i.e. comparable to a one year holding period and a 99.9% confidence interval)’. It is highly likely that, simply by virtue of being specifically mentioned, the 99.9% confidence level will become a “hard-coded” standard; at least in some jurisdictions and that the ‘comparable to’ qualification will be ignored. In an environment where various types of AMA are expected to be developed in compliance with a flexible set of regulatory principles, a hard-coded standard is inappropriate.

We believe that it would be better for the Accord to focus on the objective of the standard (prudential soundness) rather than the means by which it is achieved (99.9%). Specifically, we recommend the Basel Committee place greater reliance on the language in paragraph 622 of the draft Accord, which requires a “credible and appropriate” approach and that if the 99.9% figure, is retained; it is referred to as an example.

7.3 Supervisory responsibility for AMA recognition.

The Qualifying Criteria for TSA and AMA require a bank to have an approach to operational risk that is ‘conceptually sound and implemented with integrity’. We believe this requirement provides a useful guide to the split of supervisory responsibility for AMA approval. In principle, we believe that the home supervisor should have primary responsibility for assessing the ‘conceptual soundness’ of the approach and implementation in the home jurisdiction. Once the approval of ‘conceptual soundness’ has been granted by the home supervisor, we would not, as a matter of course, expect a host supervisor to replicate this review. Rather, the host supervisor would be expected to focus on implementation of the approach in their jurisdiction. Clearly, supervisors operate in specific legal and regulatory regimes that may at times make this division of labour imperfect. However, we believe this is a principle that the Basel Committee (either in the Accord or via guidance) should adopt, to avoid wasting time and resources at both banks and supervisory agencies.

7.4 Operational risk loss data

We note that the wording in the final bullet of para 633 has been altered from previous drafts. Concern exists that the wording in this paragraph could create duplicative and costly data collection burdens because it would require flagging credit risk losses in the operational risk database even though such losses would not impact regulatory capital for operational risk. This issue could be resolved fairly easily if the penultimate sentence referred to “operational risk management” instead of “operational risk databases” and by deleting the last sentence of paragraph 633.

We believe that it is more appropriate for a firm’s management to set the loss threshold. This threshold is currently set by the Committee at Euro 10,000. The firm should be prepared to explain its approach and justify that no information that would have a significant effect on the operational risk capital requirement is being left out.

7.5 Recognition of insurance

BBA/LIBA first engaged the Committee in discussion on the issue of the recognition of operational risk mitigation insurance-based products in 1999. Over that period the BBA/LIBA message has, and remains, consistent. We believe that there is economic value in such

operational risk mitigation products and that this value should properly be reflected in the calculation of any regulatory capital charge.

We recognise that the precise means of achieving this objective is difficult to identify. At present the Committee proposes the recognition of insurance in the AMA but not under either the BIA or STA.

One unintended consequence of the current limitations on the recognition of insurance is that it could actually increase the risk to the banking system. Given the insurance haircuts and the 20% cap, a firm may prefer to reserve for a particular expected loss rather than to insure against that particular loss. The expected loss could be fully deductible against capital, where the insurance is not. Thus in the rare case of incurring losses that are substantially in excess of the expected loss, the losses will remain in the banking industry instead of being transferred to the insurance industry.

It would be preferable, and more consistent, if the Committee articulated the principles which it believes drive recognition and valuation, so that in the future these principles might be used to permit recognition of insurance in the BIA and STA.

8 Trading book issues

8.1 Definition of the trading book

A specific illustration of our concern that the Committee should be unambiguous in its usage of terms relates to the requirement that items in the Trading Book should be “free of any restrictive covenants on their tradability.”

8.2 Overall calibration issues

The overall calibration of the proposals for trading book activities needs to be considered with urgency. Trading book activities exhibit very different features from the banking book. Trading book exposures are marked to market daily, subject to risk management techniques such as robust standard documentation and (depending on the type of transaction) frequent re-margining and are typically of a low maturity or indeed may not be held to maturity. Due to the combination of these factors credit loss experience is limited. We believe these key factors are not fully reflected in the current Basel proposals that are calibrated with the banking book in mind. Therefore, we ask the Basel Committee to look at these issues and the overall calibration. In particular the use of model based potential exposure measures for OTC derivatives and secured financing transactions would greatly improve the risk sensitivity of the regime and this together with the appropriate treatment of maturity would go a long way to correctly calibrating the rules for the trading book.

8.3 Unsettled transactions

Unsettled transactions are currently excluded from the scope of counterparty risk requirements in the EU, provided that settlement occurs within 4 days of due settlement date. The Associations would welcome clarification of whether the Committee contemplates charging all unsettled transactions under paragraph 292 of CP3.

8.4 Credit Valuation Adjustments

We believe the Basel Committee should re-visit the area of trading book credit by stripping out the EL component from the Trading Book calculation so that it is calibrated against UL only. BBA and LIBA would be willing to supply more information to the Committee if this would be of value.

8.5 Impact of Credit Risk Mitigation

Much of the impact of the revised capital framework in the Trading Book, as the Committee is well aware, is achieved through the application of the comprehensive approach to Credit Risk Mitigation to the Trading Book. Therefore the treatment of credit derivatives, counterparty risk, the maturity dimension and the need for definitional clarity are crucial to achieving a reasonable outcome in the overall treatment of the Trading Book.

9 The Second Pillar – Supervisory Review Process

The BBA and LIBA share the view of the Committee that the Second Pillar of the new Basel Accord will be critical in determining the impact of the new regime for individual firms and the global banking industry. In its initial form, the Basel 2 Pillar 2 concept suggested that it was the responsibility of the firm to assess its own capital needs with the supervisor's role being to review and challenge this process, and intervene promptly where necessary by, among other remedies, being able to set higher than minimum capital standards for an individual firm. We support this approach.

BBA/LIBA are concerned that there is now a divergence from this original Pillar 2 philosophy, caused by a blurring of the boundary between Pillars 1 and 2 which has occurred because of the introduction into Pillar 2 of elements that are intended to have "teeth" and to be applied in a robust, structured, prescriptive and quantitative manner. Instead of encouraging firms to assess whether capital derived from a largely transaction based approach in Pillar 1 is appropriate in the round, Pillar 2 is thus increasingly forcing firms and supervisors to examine certain defined categories of risk prescriptively and mechanistically.

There is an urgent need for debate on the interpretation and implementation of Pillar 2. BBA/LIBA, who support the recent letter written to the Committee by the G-10 Banking Associations in this regard, believes that a top-down, whole-firm approach should be adopted. The following principles should also apply:

- **Capital.** Additional capital requirements under Pillar 2 should be the exception not the rule as Pillar 1 will on average deliver an adequate capital charge and require firms to conservatively meet high qualitative and quantitative standards.
- **Objective benchmark:** Pillar 2 should be orientated toward the achievement of a general and objective standard of soundness. For example, *firms should seek to identify material divergence that threaten to crystallise and thereby undermine continued compliance with the minimum requirements firms would either take action to restructure their business or hold capital above the minimum.* So a firm with significant risk concentrations, or better than average diversification, would reasonably be expected to assess the impact on their future Pillar 1 requirements.

- **Individual risk issues.** The introduction of specific risk issues in Section C sits awkwardly in the context of Pillar 2. These issues should be re-integrated into the general framework.
- **Net adjustment within Pillar 2:** Any additional capital requirement should be calculated on a net basis. For example, banks should be allowed to net any diversification benefit at the group level against any additional demands for capital to cover concentration risk. Pillar 2 should not simply sum the negatives and disregard the positives.
- **Firm and supervisory dialogue:** The output of Pillar 2 should be the basis of dialogue between firm and supervisor to determine what, if any, action is required. This action may include adjustment to risk profile, improvements in risk management practice or additional capital.
- **Level of application:** Pillar 2 should be applied to the consolidated group by the home supervisor, taking into account the views of the host supervisors. It should not be applied, except in exceptional circumstances, by host supervisors. For example, as in the general case, unless there are specific legal circumstance that make this unavoidable.

BBA/LIBA would be pleased to take work forward in this area with both the Basel Committee and the Accord Implementation Group.

10 The Third Pillar – Market Discipline

The BBA and LIBA refer the Committee to previous comments on this subject, in particular earlier to the draft Pillar 3 proposals. We would note the following key points:

- the centrality of international accounting standards;
- the need to avoid requiring overlapping disclosure obligations;
- the level of prescription in Pillar 3;
- the need to keep the Pillar 3 disclosure requirements under review.

The BBA has responded as a member of the European Banking Federation (EBF) on this subject and support the response of the EBF.