

**Second consultation paper on
capital adequacy requirements,
issued by the Basel Committee on
16th January 2001**

Summary for Members of the BBA, ISDA and LIBA

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1. Overall Capital

Structure of the new capital adequacy framework

The global framework for assessing banks' capital adequacy remains based on three pillars : minimum capital requirements (Pillar 1), which constitute the main part of the new proposals, supervisory review (Pillar 2) and market discipline (Pillar 3). Of the three, only Pillar 1 is mandatory.

Definition of capital

The Basel Committee has kept the definition of capital unchanged, i.e. continues to require that banks hold capital against both expected and unexpected losses [para 20].

Purpose of capital

The time period for assessing banks' capital and calculating credit risk charges is set at one year. The purpose of capital is not, however, explicitly related to the minimisation of banks' default probability over a given time period.

Valuation norm

The Committee takes no clear position as to what valuation norm underpins the new framework. One would assume that the new charges are calibrated against an accruals accounting background, although in places, mention is made of the need for banks to mark to market their assets, under well defined circumstances.

Decomposition by risk type

Pillar 1 capital is meant to be held against [para 20] credit risk, operational risk and market risk. Operational risk represents 20% of the overall charge on average.

Banks' global minimum capital charge should remain equal to 8% of risk weighted assets.

Risk sensitivity

The new capital framework is significantly more risk sensitive than the 1988 Capital Accord. It is also meant to provide more incentive to use credit risk mitigation [para 21].

Question for members

Is the baseline calibration (overall/credit/OR) acceptable?

Should the existing cap on general provisions be removed in the definition of Tier 2 capital?

2. Scope of application

[Overview, paras 54-61 + Accord, paras 1-18]

Specifics

Application on a consolidated basis (at every tier) to internationally active banks but with considerable national discretion on insurance, minorities and commercial entities. **Scope extended** to include, on a fully consolidated basis, holding companies that are parents of banking groups¹. Three year transition on sub-consolidation for countries where this is not currently a requirement. Supervisors should also "test that individual banks are adequately capitalised on a stand-alone basis".

Treatment of particular types of subsidiary etc

Securities and other financial entities	Consolidation "to the greatest extent possible", generally full consolidation. Supervisors to assess appropriateness of including minority interests in consolidated capital but will adjust in the event that not readily available to other group entities. Not feasible or desirable to consolidate: temporary investments acquired through debt/equity swaps; entities subject to different regulation; or entities which must be deconsolidated by law. Imperative in such cases for supervisor to obtain "sufficient information" from supervisors responsible and holdings of capital instruments will be deducted. Supervisors will ensure that such entities meet regulatory capital requirements, monitor action to correct any capital shortfall and, if not corrected in a timely fashion, deduct shortfall.
Insurance	In principle, appropriate to deduct. Alternative approaches should include a group-wide perspective for determining capital adequacy and avoiding double-counting. Due to "issues of competitive equality" [vs insurance supervisors], some countries will retain their existing treatment as an exception. Banks should disclose the national regulatory approach. Supervisors may permit surplus capital in an insurance entity to be recognised under "limited circumstances" - criteria to be determined nationally and public disclosure required. Supervisors will ensure that insurance subsidiaries are adequately capitalised and will deal with shortfalls as above.
Significant non-insurance minority	Significance threshold to be determined by national accounting and/or regulatory practices. Deduction or, under certain conditions, pro-rata consolidation (eg joint ventures or where supervisor satisfied that only proportionate support expected and other significant shareholders have means and willingness to support their share). Deduction of deliberate reciprocal cross-holdings reiterated [but nothing on EU-style material holdings deductions].
Significant investments in commercial entities	Significance determined by national accounting and/or regulatory practices but 15% individually/ 60% in aggregate of bank's capital [ie EU thresholds] or stricter. Investments below threshold risk weighted at least 100% in standardised method with equivalent treatment under IRB based on methodology being developed for equities.

All deductions are 50% Tier 1, 50% Tier 2.

¹ Defined as "groups that engage predominantly in banking activities"; includes parents of parents so long as the bigger group is still a "banking group".

3. Credit Risk: The Standardised Approach

[Overview paras 68-79 + Accord paras 19-44]

Overview

The standardised approach remains substantially the same as proposed in June 1999 with risk weights determined by reference to the type of counterparty and, where available, a rating provided by an External Credit Assessment Institution. Standards for the recognition of ECAs and the mapping of ratings are given. Key points worth noting include:

- 1) A 50% risk bucket is introduced for corporates rated A+ to A-, down from 100%.
- 2) The sovereign floor (impossibility of a rating more favourable than sovereign) has been removed for both corporate or bank claims.
- 3) The definition of short-term claim has been lowered from a claim with an original maturity of six months to three months or less.
- 4) A carve out to the 100% weighting for commercial real estate lending is proposed. A preferential risk weighting of 50% of a specified proportion is available in markets with a low and stable loss profile.
- 5) 150% weighting for the unsecured portion of any asset past 90 days due, net of specific provisions.

Supplementary publications

The Standardised Approach to Credit Risk

Specifics

The proposed risk weighting structure for sovereigns, banks and corporates are shown below:

Claims on sovereigns

Credit Assessment	AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to B-	Below B-	Unrated
Risk Weights	0%	20%	50%	100%	150%	100%

[Accord 23]

Export Credit Agencies (ECAs) can qualify as ECAs if they apply the 1999 OECD methodology and are recognised by national supervisors.

ECA risk scores	1	2	3	4 to 6	7
Risk Weights	0%	20%	50%	100%	150%

[Accord 25]

Claims on banks

For claims on banks national supervisors will be able to apply either Option 1 or Option 2 to all banks in their jurisdiction.

Option 1

Credit Assessment of Sovereign	AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to B-	Below B-	Unrated
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Risk Weights under Option 1	20%	50%	100%	100%	150%	100%
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Option 2

Credit Assessment of Banks	AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to B-	Below B-	Unrated
Risk Weights under Option 2	20%	50%	50%	100%	150%	50%
Risk Weights for short term claims under Option 2	20%	20%	20%	50%	150%	20%

[Accord 32]

Claims on corporates

Credit Assessment	AAA to AA-	A+ to A-	BBB+ to BB-	Below BB-	Unrated
Risk Weights	20%	50%	100%	150%	100%

[Accord 32]

Other

Claims on domestic public sector entities will be treated as claims on banks of that country or, subject to national discretion, as sovereigns. Claims on multilateral development banks will be treated as banks under Option 2 except in the instance of very highly rated institutions (such as the World Bank, EBRD) which will receive a 0% risk weight. As a general rule if domestic exceptions are made then other supervisors are free to make the same approach available to banks in their own jurisdiction. [Accord 27 + 28]

Some questions for firms

- Are the proposed risk weightings now a reasonable solution in terms of weightings and granularity?
- Is the three-month benchmark for short-term claims acceptable?
- What is the reaction of members to the proposed exception to the treatment of commercial real estate?
- Bearing in mind the entry requirements to the Foundation IRB approach do members expect to make substantial use of the standard approach?
- Taking the standardised and IRB approaches together, are members generally content with the proposals in relation to their own funding?

4. Credit Risk: Internal Ratings -Based Approach

Overview

The Internal Ratings Based (IRB) Approach is the foundation of the New Accord. Two options are available: a Foundation approach open to most banks and an Advanced Approach open to more sophisticated banks with better data availability. Operational standards and data availability are the key determinants of entry to, and advancement within, the IRB approach. As expected under the Foundation IRB the only variable banks will have to contribute is probability of default². Under the Advanced IRB banks will be able to rely upon own estimates of PD, LGD, EAD and maturity. The IRB approach takes a similar treatment toward corporate, sovereign and banks exposures and a differentiated approach to retail, project finance and equity.

Key new elements include :

- 1) The introduction of a **reference definition of default**, applicable to both corporate and retail exposures;
- 2) The possibility for banks to use the foundation IRB approach, as well as the approach developed for retail, during a **transitional period** of three years, without the need to meet the requirements imposed on data quality/ experience with internal rating system.
- 3) The calibration of the IRB charge as a **continuous function of the risk drivers** (infinite granularity)
- 4) **The transitional floor imposed on advanced IRB charges**, equal to 90% of the foundation IRB charge.
- 5) A possible **downward adjustment of the charge through granularity** effects.

Supplementary publications

The Internal Ratings -Based Approach to Credit Risk

Specifics

Mechanics of IRB approach

Entry and advancement

In order to be eligible for IRB treatment, banks' internal ratings systems must conform with a number of qualitative and quantitative requirements³. In particular, the internal ratings and, if relevant, loss given default (LGD) and exposure at default (EAD) measurement systems should have been in place for at least three years when the new Accord is implemented (January 2004).

Institutions must additionally meet extensive public disclosure requirements.⁴

It is possible to move only one category of assets into the IRB approach, although purely on the condition that this approach is adopted quickly for all classes of exposures and all significant business units. It is also feasible to move an asset category straight from the standardised approach into the advanced internal ratings based approach.

²Although banks may choose to also take account of maturity

³In particular, no more than 30% of gross exposures should fall in any one borrower grade (excluding sovereign exposures) [para 242].

⁴These would include the methods of estimation of the risk drivers, the data required for estimating the model(s) used, the mapping of internal grades to external ratings, as well as the definition of default retained.

Data requirements and transitional periods

For the purpose of ensuring the comparability of IRB capital requirements across institutions, banks should use an internal definition of default which is consistent with a reference regulatory definition, according to which default is deemed to have occurred where one or more of the following events has taken place :

- “-it is determined that the firm is unlikely to pay its debt obligations (principal, interest or fees) in full;
- a credit loss event [...] ;
- the firm is past due more than 90 days on any credit obligation;
- the firm has filed for bankruptcy [...]” [para 272]

This definition applies for both corporate and retail exposures.

Additionally, probability of default (PD) estimation should be based on at least five years’ worth of data in order to be recognised [para 164-165].

However, during a transitional period of three years (starting 2004), it will be possible for banks not meeting the requirements above (5 years of data for PD or 3 years’ experience with the internal rating system itself) to avail themselves of the foundation internal ratings based treatment or of the advanced IRB treatment for retail, provided that they can demonstrate constant progress towards meeting the requirements set by the regulators for entry into these IRB approaches [para 163].

For non-retail assets, regulatory acceptance of LGD estimates is conditioned on the availability of seven years’ worth of data [para 342]. No transitional period is provided for entry into the advanced internal ratings based approach for non-retail assets.

Calibration

[Overview 48-53] “The Committee... views additional efforts related to the IRB calibration process as essential.” The foundation IRB is intended to deliver, *in aggregate*, a “reduction in risk-weighted assets of 2% to 3%” against the standardised approach and the “tentative risk weights” are a “starting point for dialogue”. On the advanced IRB, a floor of 90% of a simplified foundation IRB calculation is proposed for the first two years following implementation, during which time the results of the capital requirements will be reviewed.

Treatment of corporate, sovereign and bank exposures

The following parameters drive the credit risk charge [para 161]:

Foundation approach	Advanced approach
PD [0.03% floor except for sov.]	PD [0.03% floor except for sovereigns]
LGD (1)	LGD [refers to economic loss]
EAD (2)	EAD
Maturity (optional): If no adjustment, all assets are assumed to have a maturity of 3 yrs.	Maturity : two options: MTM- based maturity adjustment or default-based adjustment. Maturity capped at 7 years.
Granularity adjustment	Granularity adjustment

(1) set at 50% for senior unsecured, 75% for subordinated unsecured

(2) set at 75% of the nominal value of the commitment. A 0% credit conversion factor applies for unconditionally and immediately cancellable corporate overdrafts [para 232].

The capital charge is given by a continuous function linking regulatory capital to the risk drivers listed in the first part of the table above (the granularity adjustment is separate). [para 173-174]

Regulators have not yet fully finalised their proposals on the adjustment of capital charges to reflect the tenor of credit instruments. It is implied in the consultation paper that the degree of sensitivity to maturity might be a function of the underpinning definition of credit risk (both default and migration risk or default risk only) [para 177].

In addition, the Basel Committee proposes to adjust the capital charge to reflect the degree of concentration inherent in banks' corporate exposures portfolios, compared with that of a reference portfolio (granularity adjustment). Adjustments upwards as well as downwards are possible [para 503 to 515].

Regulators are considering how to integrate project finance and equity into the above framework.

Treatment of retail exposures

The Basel Committee is defining retail as including exposures to individuals, as well as small business lending where specified criteria are met (large number of exposures of a small size, certain product types) [para 156].

The same reference definition of default as for corporates is introduced [para 466].

Risk drivers retained in the calculation of the retail credit risk charge :

- PD/ LGD [defined as economic loss] or EL
 - EAD. If EAD is not specifically calculated, then LGD should be adjusted for undrawn commitments. All risk drivers to be estimated by the bank. Sufficient segmentation of the portfolio (by at least product and score) is essential [para 443 to 447].
- Maturity and granularity have no impact on the retail charge.

The function calibrated by regulators based on the risk factors above yields lower charges than that proposed for corporate assets, reflecting the higher degree of diversification present in retail portfolios. The exact calibration of this function is still under consideration [para 425].

Further work :

On retail: appropriateness of proposed definition of default, possible calibration of an EL based charge.

Development of an IRB approach for equity and project finance related exposures

Some questions for firms

- Are the transition, and final data requirements acceptable ?
- Is the risk weighting function effective ?
- Is the reference definition of default workable ?
- Are the foundation LGD and EAD values acceptable ?
- Is the proposed approach to maturity reasonable ?
- Is the inclusion of a granularity adjustment necessary or sensible ?
- Are the proposed IRB standards reasonable, in particular proposals relating to the distribution of assets across risk grades ?
- What is the general response to the proposed treatment of retail exposures ? Is there a need to introduce an EL based methodology ? Should there be further differentiation of retail exposures ?

5. Asset Securitisation

[Overview paras 135-156 + Accord paras 516-546]

Overview

The New Accord highlights the Committee's particular concern about the use to date of asset securitisation structures for capital arbitrage and puts forward standard and IRB approaches to the treatment of risk in securitisations. Synthetic securitisations are mentioned only as an area for further work. The Committee has significant concern about residual risks, such as implicit recourse which could result in the assets concerned being risk weighted as though they were on-balance sheet.

Supplementary publications

Asset Securitisation

Specifics

Treatment of explicit risk associated with securitisation under the Standard approach

The New Accord describes the treatment required for originating banks, investing banks and sponsors under the standard approach.

Originating Banks

A bank acts as an originator where it transfers assets from its balance sheet. In order for it to remove assets from its balance sheet for risk-based capital purposes it must have achieved a *clean break*.

Credit enhancement may only be provided at the outset of the securitisation and the full amount of the enhancement must be deducted from capital, using the risk-based capital charge as though the assets were held on balance sheet. [Accord 520]. *Liquidity facilities* are only permitted to the extent that they smooth payment flows, subject to conditions, or provide short-term liquidity [Accord 522]

Early amortisation clauses in revolving securitisations will be subject to a minimum 10% conversion factor applied to the securitised asset pool, although this may be increased. [Accord 525]

Investing Banks

Securitisation tranches are weighted depending on the Rating assigned to them by an eligible External Credit Assessment Institution [ECAI] [Accord 525 + 527], as follows:

External Credit Assessment	AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to BB-	B+ and below or unrated
Tranches	20%	50%	100%	150%	Deducted from capital

Unrated securities will generally be deducted from capital, although they may be accorded a look-through treatment limited by the highest risk asset in a pool. [Accord 527]

Sponsoring Banks

Sponsoring banks are not originators but may provide credit enhancement, liquidity facilities, manage the conduit vehicle and/or place its securities [Accord 531]. First loss credit enhancement must be deducted from capital; second loss enhancements are risk weighted [Accord 532]. Conditions are established under which liquidity facilities provided by sponsors may be converted at 20% and risk weighted at 100%. If these are not met such facilities will be treated as credit exposures. [Accord 534]

Securitisation under IRB

An outline of a treatment for IRB has been developed to take advantage of the greater risk sensitivity under the IRB approach. The same approach would be applied irrespective of whether a bank was operating the Foundation or Advanced IRB [Accord 537]. The IRB treatment is far less developed and further work is planned, including a consideration of the treatment of synthetic securitisations. [Accord 538]

Issuing Banks

The full amount of any retained first loss position must be deducted from capital, regardless of the IRB capital requirement that would be assessed against the underlying pool of securitised assets. [Accord 539]

Issuing banks retaining securitisations which have an appropriate ECAI rating may be permitted to apply an IRB capital requirement based on the PD/LGD framework. **Internal ratings will not be acceptable.** [Accord 540]

Investor Banks

ECAI – not internal – ratings will primarily be used and a capital requirement applied based on the PD and LGD appropriate to the tranche. A conservative 100% LGD is proposed. [Accord 541]

Implicit and Residual risks

The Committee believes that originators may be subject to moral or reputational risks even when a clean break has been achieved such that it provides implicit recourse beyond its contractual obligation. [Accord 543]

If an institution is deemed by its supervisors to have provided implicit recourse all assets associated with a structure (not just those in the affected tranche) will be treated as if they were on balance sheet. A second offence will result in a bank's entire securitised assets being brought back on balance sheet. [Accord 544]

The Committee is conducting further work on the topic of residual risks in asset securitisations and seeks full dialogue with the industry. [Accord 545]

Disclosure

Substantive public disclosure of qualitative items and quantitative data will be required in accordance with Accord paras 659-660 of Pillar 3 section, in order to obtain capital relief through the securitisation process [Accord 546]. Apply to: originator/sponsor's statutory accounts; and issuer's offering circular. [**By implication, failure to disclose by sponsor means that all assets come onto the balance sheet?**]

Further work :

Development of an IRB approach and treatment of synthetic securitisations

Some questions for firms

- What is the appropriate maximum percentage of the clean-up call under revolving securitisations?
- A minimum 10% conversion factor must be applied to revolving securitisations with an early amortisation clause. Is this appropriate? Are there circumstances in which this conversion factor should be higher?

- Are the external rating-based risk weightings that investors must assign to securitisation tranches realistic?
- Do members agree with the capital treatment of unrated tranches by investors?
- Should short-term liquidity lines attract as much as a 20% conversion factor?
- Internal ratings of retained positions under the IRB approach will not be permitted – will members oppose this?
- Do members strongly object to the over cautious 100% LGD ratio assumption for investor banks under IRB?
- Do members agree that the introduction of after-the-fact recharacterisation of securitisations, depending on a regulator's perception of residual risk, poses significant risk to asset securitisations?
- Risk weighting – does it reflect economic risk?

6. Credit risk mitigation

[Overview, paras 80-92 + Accord, paras 61-149 (standardised); 182-187 + 197-221 (foundation IRB); 188-193 + 364-365 + 403-421 (advanced IRB)]

Overview

On the positive side, a wider range of collateral is eligible in standardised/foundation IRB approaches, the 'comprehensive' approach to collateral is based on offset and banks will be permitted to calculate their own haircuts. (Advanced IRB treatment of CRM is vague, particularly on collateral.) Set against this are the following **key new elements**:

- 1) substitution approach/no allowance for 'double default' is generally retained for credit risk mitigation, except under the 'comprehensive approach' to collateral;
- 2) recognition in the standardised/foundation IRB approaches generally subject to a 'floor' [see table below], actually an additional charge rather than a minimum requirement as such. Broadly described as needed to provide an incentive for banks to monitor credit quality of the underlying and to account for legal/documentation risk, particularly on collateral and credit derivatives [double counting vs operational risk?];
- 3) collateral haircuts include an element for volatility of the underlying and are subject to scaling up if mark to market/remargining is not daily;
- 4) on balance sheet netting restricted to loans and deposits to the same counterparty [according to FSA no change on off balance sheet netting];
- 5) maturity mismatch charge is based on worst possible mismatch [so earliest step-up/call for protection purchased].

Supplementary publications

Elements of 'The Standardised Approach to Credit Risk' and 'The Internal Ratings Based Approach to Credit Risk'

Specifics

	<i>Standardised</i>	<i>Foundation IRB</i>	<i>Advanced IRB</i>
Collateral	<p><i>Minimum standards</i> [Accord 67-74]: legal certainty/opinions; no material positive correlation; robust risk management; Pillar 3 disclosures</p> <p><i>Eligible collateral</i>[Accord 76-79]: Cash deposited with the bank Sovereign/PSE securities BB- and above Bank, securities firm and corporate securities BBB- and above⁵ Equities included in a main index Other equities traded on a recognised exchange (<i>comprehensive approach</i> only) Gold Certain UCITS/mutual funds</p> <p><i>Comprehensive approach</i> [Overview 85-86, Accord 80-105] Collateral adjusted by haircuts^{6,7} for: exposure; collateral; and currency (if relevant) Net risk weighted exposure is sum of: <ul style="list-style-type: none"> ▪ risk weighted uncollateralised element; ▪ risk weight x 15% of the lower of exposure </p>	<p><i>Minimum standards</i>[Accord 198]: as for standardised plus, for real estate [Accord 316-321] enforceability, objective value, frequent revaluation, first claim, collateral management.</p> <p><i>Eligible collateral</i> [Accord 197]: as for standardised plus specified commercial and residential real estate [definitions - "targeted to collateral pledged by [SMEs]" - in Accord 312-315].</p> <p><i>Method</i> [Accord 199-221]: financial collateral as for standardised comprehensive approach. Eligible real estate: assigned LGD of 40-50% depending on LTV.</p>	<p><i>Minimum standards</i>[Accord 364-365]: as for foundation plus strategy & risk management standards.</p> <p>No specific requirements on <i>eligible collateral</i> or <i>method</i></p>

⁵ Unrated bank bonds may be treated as A/BBB under certain conditions

⁶ Standard haircuts are provided [to be scaled up if MTM/remargining is not daily]. Supervisors may permit banks to calculate their own haircuts, subject to minimum qualitative and quantitative standards.

⁷ For certain government securities repo-style transactions:

- supervisors may choose to set the haircuts at zero where the counterparty is a *core market participant*; and
- the 15% floor can be disappplied.

	<p>and adjusted collateral^{7,8}.</p> <p><i>Simple approach</i> [Overview 87, Accord 106-111] [No haircuts?] Substitution approach subject to a floor of 20% (may be reduced to 10% or zero for certain combinations of transaction type, exposure/collateral quality, documentation and operational standards).</p>	[Composite method where both forms held.]	
On B/S netting	<p><i>Minimum standards</i> [Accord 112-116]: legal certainty; monitoring/control on a net basis; monitoring/control of roll-off risks; Pillar 3 disclosures.</p> <p><i>Scope</i> [Overview 91]: loans and deposits to a single counterparty.</p> <p><i>Method</i> [Accord 115-116]: offset subject to:</p> <ul style="list-style-type: none"> ▪ FX haircut (scaled up if necessary) applied to the liability side where relevant; and ▪ maturity mismatch charge where relevant. 	No specific mention [although Accord 367 suggests that there is - presumably as for standardised?]	As for foundation [Accord 367]
G'tees & credit derivs	<p><i>Minimum standards</i> [Overview 88, Accord 117-128]: must be direct, explicit, irrevocable and unconditional; robust risk management; legal enforceability; Pillar 3 disclosures. Additional operational requirements for each: for credit derivatives these cover matters such as credit events, default events, grace periods, asset mismatches; "ability to transfer the underlying exposure ... if required for settlement"⁹.</p> <p><i>Scope</i> "Only credit default swaps and total return swaps that provide protection equivalent to guarantees will be eligible for recognition"¹⁰ [Accord 127]. Eligible providers [Accord 129]: sovereigns, PSEs and banks with better credit quality than underlying; corporates rated A or better.</p> <p><i>Method</i> [Accord 130-145]</p> <ul style="list-style-type: none"> ▪ FX haircut where necessary; ▪ substitution with additional RWA for corporate guarantees and all credit derivatives of 15% of exposure x difference in risk weights¹¹ 	[Accord 182-187] Minimum standards, scope and method as for standardised.	[Accord 188-190] Additional <i>minimum standards</i> [Accord 403-421] <ul style="list-style-type: none"> ▪ <i>guarantees</i>: recognition & "notching" criteria; rating system requirements; completeness/integrity of assessment; process/criteria for assessment; ▪ <i>credit derivatives</i>: as above plus mismatch criteria and residual documentation/legal risk. No restrictions on providers, no floor, internal assessment of degree of risk transfer.
Maturity mismatch	<p><i>Maximum possible mismatch</i> used [Accord 147]:</p> <ul style="list-style-type: none"> ▪ latest possible scheduled maturity of underlying; ▪ earliest possible effective maturity of hedge (so earliest step-up/call). <p><i>Method</i> [Accord 148]</p> <ul style="list-style-type: none"> ▪ no recognition for < 1 year residual maturity; ▪ time based sliding scale otherwise. 	<p>If no explicit maturity dimension [Accord 192]: as for standardised.</p> <p><i>Explicit maturity dimension</i> [Accord 193]: covered portion as if no mismatch. Uncovered forward charged as difference between maturities</p>	As for foundation/explicit maturity dimension [Accord 193]

⁸The purpose of this floor is: "to encourage banks to focus on and monitor the credit quality of the borrower"; and "to reflect the fact that ... a collateralised transaction can never be totally without risk" [Overview 86].

⁹ According to FSA, this relates to transferability restrictions in the documentation for the underlying not the credit derivative.

¹⁰ According to FSA, this is not intended to restrict eligibility but is simply a prelude to a later sentence. The overall intention is to prevent total return swaps where receipts are taken to income from also counting as hedges unless the corresponding deterioration on the underlying is also recognised.

¹¹ To maintain "banks' focus on the credit quality of the underlying borrower" and "to reflect the extent to which enforceability of the documentation used has been upheld in practice" [Overview 90].

Pillars 2 + 3

Extensive disclosure as a pre-condition for recognition [see section on 'Pillar 3:Market Discipline]

Further work

Additional capital for maturity mismatches where there is an explicit maturity dimension [*Accord 193*]?

Some questions for firms

- Do firms agree with the principle that there should be a floor on recognition of CRM in the standardised and foundation IRB approaches (particularly given Op Risk charges)?
- Are firms concerned that only cash which is "on deposit with the lending bank" is eligible as collateral?
- Should we argue for a wider range of eligible securities (collateral) and guarantors/protection providers? If so, what ?
- Is a haircut for volatility of the underlying consistent with non-trading accruals based values?
- Are firms concerned about the restriction of on balance sheet netting to "loans and deposits to a single counterparty with a residual maturity of one year or more"?
- Do firms agree with the very conservative (ie worst possible) definition of maturity mismatch?
- Do the proposals cast any light on how to deal with credit derivatives referenced to obligations?
- What do firms think about the failure to recognise double default (except in the 'comprehensive approach' to collateral)? [*Overview 89*]

7. Operational Risk

[*Overview, paras 157-173 + Accord, paras 547-565 and 665-666*]

Overview

As expected, a minimum capital (Pillar 1) charge based on a **3-stage evolution** [cf, credit risk], with internationally active banks expected to be at stage II and/or III. Much still to be finalised, including the indicators used in Stage I and II and calibration. The Committee warns that “without **data**, [it] will be forced to make conservative assumptions in setting minimum operational risk capital requirements.” [*Overview para 160*]. NB, many operational standards are built into other parts of Accord, viz, rules on internal ratings, credit risk mitigation, asset securitisation.

Key new elements:

- 1) a [temporary] ‘floor’ to the capital reduction available for moving forward a stage [*Overview 168*]. [Cf credit, where floor is conservatively set.]
- 2) possible development of a ‘Risk Profile Index’, for use in IMA [Stage III – see below], whereby a firm’s capital requirements would be subject to adjustment to reflect performance relative to industry-wide experience. [*This appears to include downward adjustment – if so, a major concession! – see Annex to Accord for details.*]
- 3) With regards to EL (especially in HFLI losses), provisioning and loss deduction may be recognised.
- 4) Acceptance of principle of operational risk mitigation

Supplementary publications

‘Operational Risk’

[‘Operational Risk Sound Practices’ – forthcoming]

Specifics

Definition

“The risk of direct *or indirect* [our emphasis] loss resulting from inadequate or failed internal processes, people and systems or from external events” [*Accord, 547*]. Strategic + reputational risk ‘out’, with further discussion with industry on their treatment. Legal risk ‘in’.

Three stages, for now [*Accord 552-558*]:

1) Basic Indicator Approach

fixed-percentage α {30%} x gross income (to be confirmed).

2) Standardised Approach

fixed-percentage β {one per business line} x indicator {one per business line} – see diagram below.

3) Internal Measurement Approach (IMA)

as with stage II, a separate calculation will be made for each business line *and loss type* – Exposure Indicator {EI, chosen by supervisor – banks supply data} x Probability of Event (PE) x Loss Given Event (LGE) x fixed-factor γ {to translate expected loss into capital charge}.

(In future, a **Loss Distribution Approach** [ie, true internal model approach] “may be available”.)

The Standardised Approach

Business Units	Business Lines ¹²	Indicator	Capital Factors ¹³
Investment banking	Corporate finance	Gross income	$\beta 1$
	Trading and sales	Gross income (or VaR)	$\beta 2$
Banking	Retail banking	Annual average assets	$\beta 3$
	Commercial banking	Annual average assets	$\beta 4$
	Payment and settlement	Annual settlement throughput	$\beta 5$
Others	Retail brokerage	Gross income	$\beta 6$
	Asset management	Total funds under management	$\beta 7$

α , β and γ will all be specified by supervisors. α (and/or β factors) will be set to deliver a capital charge that – on average – constitutes **20% of the overall capital requirement** as calculated under the '88 Accord [*Overview 161* – stage II may deliver the 20% and stages I/III a higher/lower charge respectively]. In stages II and III, the charge will be the simple sum of charges for individual business lines. Business lines will be defined by supervisors, with the possibility to adopt the definitions of individual institutions at a later stage [*Overview 167*]. A bank with approval for a more advanced approach, will “not be permitted to choose to revert to a simpler method” [*Overview 162*]. A bank may be on the Standardised Approach for some business lines and the IMA for others.

There will be **qualifying criteria** [*Accord 560-565*] for entry to Stages II and III. (In Stage I, banks must comply with the standards in the ‘Sound Practices’ paper.) Qualifying criteria, including a ‘use test’ and disclosure requirements [see below], revolve around ‘effective risk management and control’ and ‘measurement and validation’. Regulators will also “comment on the control environment of the institution”. Banks should “incorporate experience and judgement into an analysis of the loss data and the resulting PEs and LGEs”.

Pillars 2 + 3

No explicitly identified Pillar 2 (supervisory review) elements. Disclosure (Pillar 3) *requirements* are promised for the future, as a pre-condition for the use of IMA, [cf *recommendations* enunciated in the current paper]. In this context, ‘**core disclosures**’ are [*Accord, 665-666*]:

- the approach(es) a bank qualifies for
- key elements of the operational risk management framework
- OpRisk exposure (or, as a proxy, capital charge) by business line
- the bank’s OpRisk charge as a percentage of total minimum regulatory capital.

‘Supplementary’ disclosures are actual annual losses per business line.

Further work

Dialogue on data, ‘risk profile index’, internal models and risk mitigation [*Overview, 170-173*].

¹² A business line for agency services (including custody) is intended to be included in the final proposal. An insurance business line may also be included in both the standardised and internal measurement approach, where insurance is included in a consolidated group for capital purposes.

¹³ These factors, denoted Beta factors, will be calibrated once more data is available. One approach to calibration, based on 20% of existing minimum regulatory capital, is set out in Annex 3 of the Supporting Document *Operational Risk*.

Some questions for member firms

- Where should comment be **focused**: principle of charge; calibration; qualifying criteria...?
- Do firms accept the **evolutionary structure**, and any/all of the detail, eg, the business line breakdown?
- There remains openness to dialogue on **risk mitigation** but none on **models** – do firms accept this?
- Do the **qualifying criteria** and/or **disclosure requirements** pose any problems?
- What **data/impact exercises** would be appropriate in the light of this paper?
- How do the ideas of i) the **floor** and ii) the **risk profile index** strike member firms?
- Should the floor be EL-based or a fixed percentage of the charge under the Standardised Approach?
- In **IMA**, can PE and LGE be satisfactorily combined with regulatory-defined EI and γ ?

8. Trading Book Issues

[*Accord, paras 566 - 585*]

Overview

This section contains various piecemeal proposals: revised definitions of trading book and elements thereof; guidance on 'prudent valuation' and amendments to the standardised charge for specific risk.

Key new elements:

- 1) Explicit definition of 'financial instruments' which includes loans [will be helpful in EU debate] but financial instruments are eligible for trading book only if either free of restrictive covenants on tradability or able to be hedged completely [these conditions are presumably designed to limit the eligibility of loans]
- 2) Explicit requirements on valuation adjustments/reserves including a requirement to consider operational risks
- 3) Detailed [and unfavourable] proposals on credit derivatives specific risk offset

Specifics

Definitions of 'trading book', 'financial instrument', 'trading intent' and 'hedge'

[*Accord 566-570*]

Trading book/intent: overall effect broadly as now, except that: financial instruments must either be free of any restrictive covenants on their tradability or able to be hedged completely; and various factors evidencing trading intent are specified

Financial instrument: standard accounting definitions of 'financial instrument', 'financial asset' and 'financial liability' [so includes loans]

Hedge: "a position that materially or entirely offsets the component risk elements of another trading book position or a set of positions".

Guidance on prudent valuation

[*Accord 571-580*] Framework for prudent valuation¹⁴ should "at a minimum" include:

- 1) Various specified *systems and controls*.
- 2) Banks must *mark to market*¹⁵ "as much as possible" using the more prudent of bid/offer unless a significant market maker and can close out at mid.
- 3) *Marking to model*¹⁶ may be used in the "limited circumstances" where mark to market is not possible, provided that it can be demonstrated to be prudent ("an extra degree of conservatism is appropriate"). Various factors to be considered by supervisors in assessing prudence (eg framework, inputs, assumptions, methodology, valuation adjustments).
- 4) Banks must establish and maintain procedures for considering *valuation adjustments/reserves* including, as a minimum: unearned credit spreads; close-out costs; operational risks; early termination; investing and funding costs; future administrative costs; model risk; less liquid positions. Adjustments must impact regulatory capital.

Specific risk under the standardised methodology

[*Accord 581-585*] new capital charges "consistent with" the banking book standardised approach:

- 1) Government paper: broadly in line with banking book charges, though more favourable for BBB+ and below and for A+ to A- of shorter residual maturity (up to 24 months).
- 2) Credit derivatives: full offset only for total return swaps where exact match on reference asset, maturity and currency and taking account of fixed payouts, materiality thresholds etc. Credit default products meeting these conditions give a net charge of 20% of "the side of the transaction with the higher capital charge". Credit derivatives with asset mismatch of at most the banking

¹⁴ Described as "especially important for less liquid positions which, although they will not be excluded from the trading book solely on grounds of lesser liquidity, raise supervisory concerns about prudent valuation".

¹⁵ Defined as "daily valuation of positions at readily available close out prices that are sourced independently".

¹⁶ Defined as "any valuation which has to be benchmarked, extrapolated or otherwise calculated from a market input".

book mismatch criteria and currency or maturity mismatch get (overall) the higher of the charges for the credit protection and the underlying asset

Pillars 2 + 3

No explicit Pillar 2 issues although concerns about prudent valuation could presumably have consequences. Pillar 3 focuses on reporting results of calculations.

Further work

Application of IRB to credit risk in the trading book and the treatment of potential future exposures for OTC derivatives [*Overview 134*].

Some questions for firms

- Do firms agree with the 'no restrictive covenants'/'complete hedge' elements of the revised trading book definition?
- Is the hedge definition - specifically the "materially or entirely offsets" language - problematic?
- Is the balance between mark to market and mark to model too skewed towards the former ("limited circumstances" language)?
- Do firms agree with the list of potential adjustments/reserves, particularly operational risk?
- How should we tackle specific risk offset for credit derivatives?

9. Pillar Two - Supervisory Review + Interest Rate Risk in the Banking Book

[Overview paras 174 - 198 + Accord paras 586 - 632]

Overview

The headline commitment to the supervisory review process is confirmed and a common basis for that assessment articulated. Critically this includes proposals for supervisors to require banks to hold capital above the Pillar 1 minimum where necessary. However, Pillar 2 is not a universal requirement at implementation. No details of any transitional period for Pillar 2 are given or the impact of partial implementation on Pillar 1. Rather the Committee intends to promote information exchange as a means of promoting complete and consistent implementation.

Interest rate risk in the banking book is to be included within the scope of Pillar 2. The rationale for a Pillar 2 approach is the heterogeneity of underlying risk and management process discovered amongst internationally active banks (an argument not applied to OR). The assessment process will rely upon internal measurement systems, with supervisors able to require banks to lower their risk profile and/or hold more capital.

Supplementary publications

Various Guidance Papers (see p. 113 The New Basel Capital Accord)

Pillar 2: Supervisory Review Process

Principles for the Management and Supervision of Interest Rate Risk

Specifics

The New Accord is light on detail on the operation of the supervisory review process, much being left to national discretion and interpretation. At a high level the operation of the supervisory review process will revolve around four common principles:

The Four Principles

- Principle 1** Banks should have a process for assessing their overall capital adequacy in relation to their risk profile and a strategy for maintaining their capital levels. *[Accord 594 - 609]*
- Principle 2** Supervisors should review and evaluate banks' internal capital adequacy assessments and strategies, as well as their ability to monitor and ensure their compliance with regulatory capital ratios. Supervisors should take appropriate supervisory action if they are not satisfied with the result of this process.
[Accord 612 - 622]
- Principle 3** Supervisors should expect banks to operate above the minimum regulatory capital ratios and have the ability to require banks to hold capital in excess of the minimum.
[Accord 623 - 625]
- Principle 4** Supervisors should intervene at an early stage to prevent capital from falling below the minimum levels required to support the risk characteristics of a particular bank and require remedial action if capital is not maintained or restored.
[Accord 626 - 627]

Banks will be required to demonstrate that they have a sound internal risk and capital allocation process. The common standards which will support this assessment are contained in the various guidance published by the Basel Committee from 1996 onward covering everything from core principles to electronic banking. An additional paper on Operational Risk Sound Practices is 'in

progress'. Full detail of the approach is given in the supporting document Pillar 2: Supervisory Review Process.

The approach taken to interest rate risk will rely upon internal measurement, public disclosure (including results of standardised shock) and supervisory judgement. If considered necessary by national supervisors, this may translate into mandatory monitoring and measurement procedures [Accord 630]

Particular attention is to be paid to outlier banks. These are institutions whose economic value declines by more than 20% of the sum of Tier 1 & 2 when subject to a standardised interest rate shock (200 basis points). Full detail of the approach to interest rate risk is given in the relevant supporting document [Accord 632].

Some questions for members

- Is a delayed adoption of Pillar 2 by some national regulators acceptable?
- If Pillar 2 is not applied should this have implications for the level of Pillar 1 capital e.g. a higher minimum?
- Are the Pillar 2 standards reasonable?
- Does Pillar 2 overlap with the operational risk requirements?
- Are there practical steps which we might propose to ensure consistency of application?

10. Pillar Three: Market Discipline

[Overview, paras 199-214 + Accord, paras 633-674]

Overview

Taken together, the Pillar 3 proposals amount to the disclosure in considerable detail of virtually all (qualitative and quantitative) elements of the Pillar 1 capital ratio, mainly on a semi-annual basis. The proposals are divided into mandatory **requirements** which are generally disclosures specified as part of the entry criteria for a particular treatment under Pillar 1 (IRB, for example) and **strong recommendations**, failure to comply with which would result in supervisory action under Pillar 2. The latter category is further sub-divided into **core disclosures** which every bank should make and **supplementary disclosures** which should be made by every bank to which they are relevant (not secondary or optional).

Other key **new elements**:

- 1) An 'overarching principle' on disclosure policies by which all banks should be bound [see below]
- 2) Securitisation: disclosure requirements for originator/sponsor financial statements and issuer offering circular as a pre-condition to taking off balance sheet
- 3) Interest rate risk in the banking book: public disclosure recommendations, including the effects of standardised rate shocks [see below]

Supplementary publications

'Pillar 3: Market Discipline'

Proposed requirements on securitisation and ECAI recognition are in 'Asset Securitisation' and 'Standardised Approach' respectively.

Specifics

Overarching principle

by which every bank should be bound [Accord 634]: "Banks should have a formal disclosure policy approved by the board of directors. This policy should describe the bank's objective and strategy for the public disclosure of information on its financial condition and performance. In addition, banks should implement a process for assessing the appropriateness of their disclosure, including the frequency of disclosure".

Frequency

[Accord 637 & 638] generally semi-annual with a proper verification process at least annually. Quarterly disclosure expected "in particular for internationally active banks" for "certain categories of disclosure that are subject to rapid time decay, for instance risk exposure". Annual disclosure may be sufficient in some cases "for instance, information on an institution's risk management framework ... and banks with a stable risk profile"; banks should explain why.

Delivery mechanism

[Accord 638] Annual and half-yearly reports and accounts "but there may be cases ... where an alternative method is needed. Banks are encouraged to be flexible ... and to consider ... electronic media".

Enforcement

[Overview 202 - 206 + Accord 639] where requirements are linked to the use of internal methodologies, banks that fail to meet them on an ongoing basis will not qualify. Where banks do not comply with recommendations, "the Committee expects a supervisory response aimed at remedying the situation".

Summary of disclosures

Scope of application [Accord 642 & 643]
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<p><i>Core recommendations</i> entities included in/excluded from consolidation and how. Those subject to requirements at a sub-consolidated level. Tier 1 & 2 deductions for excluded and commercial entities.</p> <p><i>Supplementary recommendations</i>: whether entities subject to deduction meet their own regulatory capital requirements.</p>
<p>Structure of capital [Accord 644 - 646]</p> <p><i>Core recommendations</i>: detailed analysis of Tier 1, total for Tiers 2/3, deductions and overall eligible capital. Summary information on terms, conditions and main features of instruments included. Qualitative information on: accounting policies/ principles, inclusion of unrealised gains and losses in Tier 1, influence of deferred tax on Tier 1, nature/features of innovative Tier 1.</p> <p><i>Supplementary recommendations</i>: separate totals for Upper Tier 2, Lower Tier 2 and Tier 3.</p>
<p>Credit risk in the banking book: all banks [Accord 650]</p> <p><i>Core recommendations</i>: unweighted exposures (before and after CRM), weighted risk assets, cross-border distribution and sectoral or counterparty type distribution by broad instrument type. Maturity distribution. Past due/impaired loans by sector or counterparty type. Credit losses, specific & general provisions, recoveries etc. Risk management strategies, objectives, practices, techniques and methods. Definitions of non-performing, default etc. and of specific/general provisions, including estimation methods.</p> <p><i>Supplementary recommendations</i>: more detailed analysis of the core disclosures; indication of average exposures, concentrations/lumpiness, transfers into securitisation vehicles, use of credit derivatives; information about credit scoring/grading/portfolio credit risk models.</p>
<p>Credit risk in the banking book: standardised approach [Accord 651]</p> <p><i>Requirements</i>: names of ECAs etc used for which types of exposure + alignment of scales with buckets. % of each bucket covered by each agency.</p> <p><i>[Core?] recommendations</i>: significant changes in the list of agencies used; policy for mapping bond ratings to borrower ratings; comprehensive guidelines on transferring public issue ratings onto comparable assets in the banking book [what does this mean?]; average default rates by rating category + definition of default; default rates on unrated loans.</p> <p>Credit risk in the banking book: IRB approaches [Accord 652]: [see IRB section]</p> <p>Information disclosed would include the methods of estimation of the risk drivers, the data required for estimating the model(s) used, the mapping of internal grades to external ratings, as well as the definition of default retained.</p>
<p>Credit risk in the banking book: credit risk mitigation [Accord 653 - 658]</p> <p><i>Requirements</i> for banks taking advantage of CRM in standardised/foundation approaches: strategy and process for managing/monitoring CRM (exc. on-B/S netting) and for recognition of collateral. Amount of exposure covered by each CRM technique (exc. on-B/S netting) + risk weighted assets before and after CRM by bucket/grade. Type of methodologies selected.</p> <p><i>[Core?] recommendations</i>: as above for on-balance sheet netting if material. Internal risk management net exposure by bucket/grade. Quantitative data above analysed by geographical/industrial sector. Main guarantors/protection providers.</p>
<p>Credit risk in the banking book: asset securitisation [Accord 659 - 661]</p> <p><i>Requirements</i>: detailed disclosures by originators and sponsors/third parties in their statutory accounts and by issuers in the offering circular. [See Securitisation section of Pillar 1?]</p>
<p>Market risk: standardised method [Accord 663]</p> <p><i>Core recommendations</i> which portfolios covered by standardised method and, for each, measurement methodologies, capital requirements for each of IRR, equities, FX, commodities and options.</p> <p><i>Supplementary recommendations</i>: movement of portfolios between standardised and models; more detailed analysis of capital charges by risk category/portfolio (eg specific/general, points on yield curve); daily variability of profits and losses on relevant positions.</p>
<p>Market risk: models approach [Accord 664]</p> <p><i>Core recommendations</i> which portfolios are covered by models and, for each, characteristics of models used and stress test programme; scope of supervisory acceptance; aggregate level and variability of VaR and backtesting results.</p> <p><i>Supplementary recommendations</i>: movement of portfolios between models and standardised; treatment of non-linear, specific and event risk; application of stress test results; daily variability of profits and losses on relevant positions; VaR and backtest results for different regions and/or portfolios; description and quantification of important backtest outliers.</p>
<p>Operational risk [Accord 665]</p> <p><i>Core recommendations</i> will "ultimately ... be a pre-condition for the use of internal measurement approaches". [See Op Risk Section]</p>
<p>Interest rate risk in the banking book [Accord 667 - 669]</p> <p><i>Core recommendations</i>: risk management structure, nature of IRR in the banking book and key assumptions for measurement/management, use of hedging programmes, overview of measurement systems used and translation into risk measure, methodology for supervisory rate scenario. Size of standardised shock by currency and effect (absolute/percentage) on earnings, economic value and regulatory capital; internal limits (economic value and earnings), notional value of hedging derivatives. If applicable, goodness of fit of models and/or validation of assumptions.</p> <p><i>Supplementary recommendations</i>: description of any sensitivity analysis on key assumptions, use of other stress test scenarios; quantitative data on results of alternative stress tests; goodness of fit etc. for different currencies and/or portfolios.</p>
<p>Capital adequacy [Accord 670 - 674]</p> <p><i>Core recommendations</i>: capital requirements for each of: on- and off- balance sheet credit risk; market risk by component risk element (even where using models); operational risk. Total capital and capital requirements and percentage cover.</p> <p><i>Supplementary recommendations</i>: analysis of factors impacting on capital adequacy and economic capital allocation, including impact of changes in capital structure, contingency planning, capital management strategy and future plans and amount of economic capital allocated to different transactions, products, business lines or organisational units. Summary comparison of aggregate economic capital requirements vs reported capital vs regulatory requirements "is also a useful disclosure".</p>

Pillars 1 + 2

As noted above, failure to comply with requirements generally results in a more favourable Pillar 1 treatment being denied. Failure to comply with recommendations results in supervisory action under Pillar 2.

Further work

Continued investigation of possible enforcement mechanisms [*Overview 204*]. Continued work with IASC and others to promote consistency between disclosure frameworks [*Overview 207 + Accord 639*]

Some questions for firms

[If the industry is to be persuasive in opposing any/all of these proposals, it will probably need to be on the basis of the views of potential users of the data]

- Is the proposed 'overarching principle' meaningful?
- As a basic principle, do firms accept that data arising from the regulatory capital calculation can be useful to investors, analysts, lenders, counterparties etc?
- Do firms accept that regulators should mandate public disclosure at all rather than leaving it to IASC etc?
- Do firms accept the principle that the pre-conditions for certain favourable capital treatments (eg IRB, CRM, securitisation) should include public disclosure?
- Do firms agree with the proposal that disclosure recommendations should be enforced through Pillar 2?
- To what extent could these disclosures be made without disclosing proprietary information?
- Given the volume and level of detail of disclosure proposed, will users be able to make any sense of it? Could the information be summarised to a point where it would make sense?
- Do firms agree with the proposed public disclosures on interest rate risk in the banking book?
- Do firms have views on frequency and timeliness of publication (there is nothing on the latter issue in the material)?