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Comments of the Zentraler Kreditausschuss on the Basel Committee's Consultative Document of 29 April 2003 on a New Capital Adequacy Framework for Banks ('Basel II')

Preliminary Remarks

On 29 April 2003, the Basel Committee on Banking Supervision published the Third Consultative Document on a revision of the 1988 Capital Accord. A comparison with the two preceding Consultative Documents reveals that important improvements of key points have been achieved. We would like to highlight particularly the inclusion of loans to small companies under the retail portfolio, the firm-size adjustments for small and medium-sized enterprises (SME's), the waiver of the mandatory consideration of the explicit maturity for credits under the internal rating approach, the extension of the range of eligible collaterals along with the dispensation of the 'w factor' as well as the streamlining of the information which has to be disclosed under the Third Pillar.

We would, however, also like to point out that at the current stage, the practical implications of Basel II on the credit institutions' capital requirements cannot yet be fully gauged since the QIS 3 results presently do not lend themselves to comprehensive conclusions. Last but not least for this reason, we see an urgent need to leave Basel II open for revision even after the finalisation stage scheduled for autumn 2003.

Generally speaking, also after the adoption of Basel II, there needs to be an ongoing debate on an improved prudential supervision assessment of risks. In this context, we deem it of paramount importance that internal credit risk models will be recognised as soon as possible. The regulatory framework should include a commitment to this effect. Talks on credit risk models between the Basel Committee and the banking sector should be taken up immediately.

Key requests

In the view of the German banking industry, the following adjustments in particular are going to be necessary before the final adoption of Basel II:

- Close analysis of Basel II's procyclical effect and possibly measures for mitigation thereof.
- Establishment of suitable measures for a partial application of the complex prudential supervision methods ('partial use').
- Dispensation of the envisaged maximum threshold for capital relief ('floor').
- Safeguarding sufficient incentives for a transition to more advanced approaches for risk measurement (credit risk and operational risks) and implementation of further impact studies.
- Mutual recognition of supervisory decisions by the Basel II nations.
- After securitization, the sum total of the capital requirements of all banks involved in an ABS transaction must not be higher than before securitization.
- Lowering the risk weights for specialised lending and deleting the exposure segment 'high volatility commercial real estate'.
- Deleting the provision according to which – under the IRB retail approach - loans to corporates have to be treated as retail exposures ('use test').
- Deleting the separate risk weight function for private housing loans under the IRB retail approach.
- Reduction of the capital requirements for equity exposures under the IRB approach.
- Creation of uniform, appropriate, transitional regimes for the data histories of all IRB risk parameters.
- Appropriate resolution of the numerous issues that still persist with a view to the provisions on 'operational risk':
- No mandatory capital requirements for stress scenarios under Pillar II.
- Compliance with the disclosure obligations must not be a *conditio sine qua non* for the application of the supervisory procedure under Pillar I. The disclosure obligations must be of such a flexible design that an adjustment to meet changing accounting provisions is possible at any later point.

Procyclicality

The outcome of the impact studies, promulgations of the German Bundesbank as well our own investigations into the issue of procyclicality have demonstrated that the procyclical effects of Basel II are indeed far greater than had been assumed up to now. In the event of realistic fluctuations of the probability of default by 100%, a 40% capital fluctuation is therefore to be expected. Hence, in order to reduce negative macro-economic impacts, Basel II should provide for a mitigation of the procyclicality. It is therefore of paramount importance that the effects be further analysed and that a dialogue is taken up on the potential for reduction of the procyclical impacts of the new Capital Accord. In this context, the debate also needs to cover the issue of portfolio effects. Furthermore, an

elimination of expected losses from the risk weight functions would similarly reduce the procyclical impacts.

Partial Use

In order to provide them with incentives to 'grow into' more complex supervisory methods, banks must be afforded adequate possibilities for a partial use of the procedures. This applies to both the credit risk area and to the area of operational risks.

Contrary to the opinion held by the Bundesverband Deutscher Banken¹, other associations under the umbrella of the ZKA advocate exempting certain sub-portfolios (sovereigns or banks) or collaterals (partial recognition of internal LGD estimates), legally independent (domestic/foreign subsidiaries) as well as legally dependent units of the banking groups/of the bank (field establishments, branches, branch offices either domestically or abroad) on a permanent basis from the IRB approach/from the AMA. A corresponding 'partial use' should also be possible under the IRB with a view to the 'foundation approach', respectively with a view to the 'advanced approach'.

Overall capital adequacy requirements

The Basel Committee plans to introduce a floor for possible capital reliefs. Under this new provision, in year one after the introduction of the new provisions, a bank's overall capital adequacy requirement must not drop below 90% of its current level and in year two, it must not drop below 80% of the current capital requirements. In this respect, the Committee reserves the right to continue this limitation also in the subsequent years.

First, a regime of this kind would reduce the incentives for a transition to more sophisticated methods of risk measurement and thus for an enhanced risk management. Apart from this, such a regime holds the danger of being counterproductive with a view to enhancing the risk-sensitivity of regulatory capital requirement. Through the introduction of the floor for capital adequacy requirements, e.g. banks with a low-risk portfolio which – without the floor under Basel II - could achieve a significant reduction of their capital adequacy requirements under the new regime, would clearly overstate the real risk.

In our view, in order to ban the danger of an unwelcome, strong slump in banks' overall capital, it is sufficient to analyse the potential impact of Basel II before its first application; such an analysis might take place within the framework of ongoing quantity impact studies as well as under the parallel reporting regime envisaged for the so-called 'parallel use' period 2006. Potentially required adjustments should be carried out on the basis of these findings. We do recommend, however, to dispense with the floor.

¹ Since the risk weights of the internal rating are regularly above those of the standardised approach, the Bundesverband deutscher Banken holds the view that a lasting exemption of material asset classes from the IRB approach is profoundly at odds with a capital adequacy regime that reflects real risk and is equally in stark contradiction to a level playing field as far as competition is concerned. Therefore, there is no backing for a permanent 'partial use' for material asset classes.

Incentives for a transition to more advanced approaches/implementation of further impact studies

The New Basel Capital Accord's key objectives include heightened risk-sensitivity of capital adequacy requirements as well as the creation of incentives in order to implement and further develop an effective risk management system. These objectives are neither met in the field of credit risk nor in the field of operational risks (cf. comments under 'Treatment of operational risks'). In the summaries of the QIS 3 results published by the Deutsche Bundesbank and the Basel Committee (cf. annex I for a more detailed discussion) there are various examples for disincentives among the individual approaches in the field of credit risks – particularly after an analysis of the individual asset classes.

We would also like to point out that the final impact of Basel II on the capital requirements cannot yet be fully gauged. Banks applied utmost diligence in the collation of the data for last year's third Quantity Impact Study (QIS 3). However, under the Basel framework, a number of factors that are of fundamental importance with regard to the level of the overall capital adequacy requirements were still only of a provisional nature at that time (e.g. the full application of the Basel default definition as well as the recognition of credit risk mitigation techniques). What is problematic in our view - apart from the lack of data and the range of the working assumptions that need to be made - is the concentration of the QIS evaluations on average values, which largely ignore the fact that – far from being homogenous - there tends to be a lot of variation among individual results, with individual results partly being dramatically different.

We therefore think that the QIS 3 results cannot be accepted at face value but require a closer analysis and we regard the implementation of further impact studies as indispensable in order to secure an internationally homogenous high standard of the collated data as well as a calibration of the Basel regulations that is compatible with incentives. Unless this is guaranteed, Basel II – even beyond its finalisation stage scheduled for this coming autumn – needs to remain open for adjustments, particularly but not exclusively with a view to the prudential capital calibration.

Home host issue

Due to the ample room provided for national discretion, an internationally uniform interpretation/handling of the provisions on the authorisation and monitoring of the supervisory procedure appears unrealistic. Hence it is likely that banks with subsidiary companies that are based abroad will be facing divergent, contradictory or even incompatible requirements in the host country, respectively in the home country. This might lead to a situation where a procedure which has been approved in the home country may not be allowed for use abroad and/or the capital requirements which have been determined on the basis of a procedure that has been authorised abroad may not be acceptable for consolidated purposes. In order to receive the authorisation of home-

supervisors for an IRB/an AMA, in the extreme case it may even become necessary to apply two approaches in parallel, i.e. a foreign subsidiary would have to apply one approach that is requested by its home country and one approach that is requested by the host country. For this reason, the responsibility for the group-wide recognition of internal methodologies should lie with the home-country's supervisor.

Treatment of asset securitizations

In order not to jeopardise the securitization market, safeguards must be provided so that, under the new rules, the sum total of the capital requirements of all banks involved in a transaction does not exceed that level, that would result if the assets were not securitized. An increase of the systemic capital requirements through a securitization would be inconsistent with the methodology since the securitization is not associated with an increased credit risk.

The existing discrepancies between the approaches for investors and originators as well as between standardised and IRB approach give rise to different capital adequacy requirements for securitization exposures with identical risks. This creates significant incentives for regulatory arbitrage. In order to ensure equal treatment of equal risks, there is a compelling need for an identical level of capital requirement.

We would welcome publication of the QIS 3 results on the issue of securitization. From our point of view, the findings might also yield precious information for the establishment of the provisions on determining the level of regulatory capital that needs to be provided. If, in addition to this, further empirical studies would appear useful, the German banking industry would certainly be more than willing to lend its renewed support to such studies.

Treatment of specialised lending facilities

The risk weights provided under the slotting criteria approach for specialised lending are too high and fail to reflect the true risks. Particularly in the field of specialised lending, banks adopt special risk management measures that limit the risk involved in such financing. Therefore, the risk of a specialised lending facility is generally not higher than the risk involved in any other form of corporate credit. Hence, the risk weights should be reduced.

There is neither empirical evidence nor are there any accepted quantitative and qualitative categorisation criteria for a further differentiation of the field of specialised lending into the lending sub-class 'high volatility commercial real estate'. We therefore recommend deleting the lending sub-class 'high volatility commercial real estate'.

Treatment of claims on medium-sized enterprises

We object to the 'use test' envisaged for treatment of corporate exposures under the IRB retail approach. The envisaged treatment of corporate customers as retail customers is not warranted by the true risks. The peculiar risk spread of loans to medium-sized companies

– which justifies the coverage by the retail approach – results particularly from the size of the borrowers/credits, yet it does not result from the deployed risk management approaches. What is more, the ‘use test’ creates supervisory incentives to deploy risk management approaches that are inappropriate for corporate customers. Therefore, the ‘use test’ should be dropped and be replaced by risk based, verifiable and clear-cut definition criteria.

In addition to this, the retail curve and the SME curve should be adjusted in a way that avoids a sudden leap when an SME customer no longer meets the retail definition and is thus covered by the SME curve.

Treatment of residential property loans

The Basel Committee’s intention to introduce a separate risk weight function for private residential property loans under the IRB retail approach not only add to the IRB’s complexity, but also fails to reflect the true risks. The higher risk weights for private residential property loans result, above all, from the imputed higher asset correlation. In our view a differentiation of this kind would be unjustified, since there are essentially identical customers behind the exposures of individual subportfolios. Therefore, the risk weight function for ‘other retail’ claims should be applied to private residential property loans, too.

Treatment of equity exposures under the internal ratings-based approach

The planned treatment of the equity exposures under the so-called PD/LGD approach, leads to an overstatement of the risks of such assets. First, this applies to the 90% LGD for equity exposures proposed under the IRB approach which is clearly excessive when compared to the 45% LGD for unsecured exposures to corporates. In lieu of this, due to the comparable risk, we therefore suggest applying the same LGD as for junior loans (i.e. 75%) under the PD/LGD approach. Furthermore, we feel that the fixing of minimum risk weights is unjustified because this would overstate the risk of equity exposures in companies with excellent credit ratings. The requirement of having to distinguish three different equity exposure types within the approach would become superfluous after a drop of the minimum risk weights. This requirement should therefore be deleted as it only adds to the complexity of the IRB approach.

Data history

The transitional provisions agreed to by the Basel Committee for the respective length of the data history is, in principle, to be welcomed. Yet, with a view to the streamlined data history under the IRB foundation and retail approach, there need to be safeguards in order to prevent an increase in data requirements during the transitional period.

Furthermore, the transitional provisions should safeguard that after the New Capital Accord has been passed, banks will be capable of using any of the approaches at the point of first application of the Accord. In order to achieve this, it will be necessary to expand

the transitional provisions to include the estimates for PD, LGD and EAD under the advanced IRB approach.

According to the Basel Committee, internal estimates of LGD and EAD should be based on a minimum observation period of seven years. This means that, in terms of the data history, the requirements for LGD and EAD would be higher than for PD. There is no economic reason for this and it also lacks any explanation in terms of the inherent model theory. It is therefore essential that the length of the required minimum data history for LGD and EAD estimates be brought into line with that stipulated for PD estimates.

Treatment of operational risks

The capital relief promised by the Basel Committee with regard to the transition to a more complex method is still not assured. The capital requirements under the basic indicator approach and under the standardised approach continue to be equally calibrated to an average of 12% of total regulatory capital. The extremely high quality requirements of the standardised approach are thus only matched by capital savings if there is a concentration of the bank's transactions in business lines that are particularly low-risk. Nor are there, to date, any guaranteed incentives for a transition to an AMA.

In order to secure an efficient incentive structure, we suggest limiting the capital requirement under the AMA, at least for an interim period, to 80% of the capital requirement under the standardised approach whilst the capital requirement under the standardised approach should be limited to 80% of the capital requirement under the basic indicator approach. Concerning the transition to the standardised approach, it may alternatively be worth to consider fixing the highest beta factor at the level of alpha.

The selected OpRisk measurement approach does not prejudice the efficiency of an insurance product. In order to create powerful incentives for the reduction of operational risks, the Basel Committee should recognise suitable insurance tools in all measurement approaches.

In order to allow banks the gradual adoption of an AMA, the exemption of material areas/units from the AMA (partial use) should be possible on an interim basis for 10 years as of the date on which Basel II becomes effective. An appropriate clear-cut delimitation of immaterial areas and units which, under the Basel proposals, may be exempted from the AMA on a permanent basis, will be equally crucial.

Capital requirements under Pillar 2

Under the Second Pillar, the Basel Committee plans to stipulate that banks – in addition to the capital requirements under the First Pillar - also have to meet those (additional) capital requirements which result from the credit risk stress tests. We strongly reject this request. Collateralisation of the ‘worst case’ would lead to a drastic overstatement of the institutions’ true risks.

We reject the Pillar II provision on the supervisors’ discretion according to which the supervisor may request from banks a capital level that exceeds the minimum capital adequacy requirement. In our view, the bank’s appropriate capital adequacy is entirely safeguarded by the prudential provisions on regulatory minimum capital. This is particularly true given the further enhanced risk-sensitivity of the forthcoming provisions.

Increased capital requirements are not a constructive tool that would help overcome the deficits in risk management identified during the supervisory review process. Supervisors should first and foremost attempt to remedy the deficits in a dialogue with the bank’s management by means of qualitative requirements. Additional capital requirements shall only serve as an ultima ratio sanction, provided that the bank permanently fails to remedy identified deficits in its risk management.

Market discipline

The Third Pillar disclosure provisions require that the use of lower risk weights/the use of collaterals as well as certain discretionary powers will be tied to certain disclosure obligations. There is no sound business case for such a correlation. Hence we strongly oppose any such package-deal.

We welcome the fact that the consistency of the Pillar III disclosure obligations with international accounting standards has been explicitly enshrined as a principle. Here, we feel it is necessary that the disclosures are also based on homogenous consolidation rules, measurement principles and shared nomenclature. The International Accounting Standards Board (IASB) together with the Financial Activities Advisory Committee (FAAC) is currently, inter alia, reviewing the disclosure obligations concerning risks associated with financial instruments. Against this backdrop, we feel it is necessary that the Basel Committee designs its disclosure provisions in a manner flexible enough to allow potential adjustments to IASB standards, the standard benchmark in this field, at any later point.

The continued immense scope of the disclosure obligations leads to an information overkill for the reader which is counterproductive in terms of the required intelligibility and ultimately also proves to be counterproductive for transparency reasons. It is therefore our firm conviction that a further reduction of the disclosure obligations in terms of content is absolutely vital.

We would like to comment on the Third Consultative Document as follows:

Part 1: Scope of application

Preliminary remarks

Given the growing integration of financial markets, internationally diverging consolidated capital requirements have increasingly evolved into a competitive factor. We therefore firmly support the Basel Committee's present intention of harmonising the Capital Accord's scope of application at an international level. Its proposal to extend application of the scope of consolidation to include, on a fully consolidated basis, holding companies that are parents of a banking group, is a first step in this direction.

To allow full harmonisation of the coverage of supervisory rules, we suggest that the scope of consolidation provided for in Basel II be brought completely into line with the rules applying in the European Union. Besides their proven effectiveness, a further advantage of adoption of the EU rules would be that they are already applied by a majority of the countries represented on the Basel Committee.

Definition of a 'banking group'

The proposed definition of a 'banking group' as a 'group that engages predominantly in banking activities' is unclear and allows room for national discretion. To allow harmonisation of the scope of consolidation, a more precise definition is required. A clear-cut and thus competitively neutral definition of holding companies that are parents of banking groups could be ensured by using the definition of 'financial holding company' contained in Article 1, no. 21 of the EU Codifying Banking Directive 2000/12/EC².

Scope and method of consolidation

According to the Basel Committee, majority-owned or majority-controlled securities entities 'should' generally be fully consolidated if they are subject to supervision that is 'broadly similar' to that to which banks are subject or if the activities they conduct are deemed by national supervisors to be banking activities.

Moreover, formulating the provision on the consolidation of securities entities in the Consultative Document as a 'desired' provision ('should') and using the vague legal term of 'broadly similar regulation' seriously dilutes its regulatory thrust. To create a risk-focused, internationally uniform scope of application of the Capital Accord, the Basel Committee must stipulate on a binding basis those activities which qualify undertakings that need to be included in consolidated supervision. For this purpose, the list of activities applying to 'financial entities' set out in Annex I of the Codifying Banking Directive (2000/12/EC) should be adopted as a tried and tested guideline. To establish a level

² Under the provisions of Art. 1 No. 21 of the EU codifying Directive "financial holding company" shall mean a financial institution, the subsidiary undertakings of which are either *exclusively* or *mainly* credit institutions or financial institutions, one at least of such subsidiaries being a credit institution; "

playing field, the circumstances which trigger mandatory full or pro-rata consolidation of a financial entity need to be stipulated on a binding basis (pursuant to Articles 52-56 of the EU Codifying Banking Directive 2000/12/EC).

One major difference to the EU regulations also consists in the fact that the Basel provisions are not directly applicable to securities entities. To ensure an international level playing field, the differing scopes of consolidation should be aligned, i.e. the New Basel Capital Accord should apply directly to securities entities as well. In order to achieve this, the Basel Committee should, if necessary, bring its influence to bear on IOSCO.

The Basel Committee admits that there may be ‘instances’ in which consolidation of ‘certain securities and other regulated financial entities’ is not feasible or ‘desirable’.

This vague wording could be understood to mean that the Basel Committee provides for broad national discretion in this connection. The Committee should only waive inclusion in consolidated supervision in exceptional and clearly defined cases. The provision under Art. 52, para. 3 EU Codifying Banking Directive could serve as a blueprint.

The Basel Committee also states that majority interests in securities and other financial subsidiaries that are not consolidated are generally to be deducted from the capital of the group. If the subsidiary fails to meet its minimum stand-alone capital requirement, the capital shortfall will be deducted from the capital of the group.

In this connection, the exemption from a mandatory deduction from capital allowed under Article 34 (2), no. 12 of the Codifying Banking Directive 2000/12/EC (short-term acquisition, acquisition for the purposes of financial assistance designed to reorganise/save such an entity) should be adopted. An exemption from mandatory deduction from capital should also be granted for capital investments of subsidiary parent banks whose holding company already includes the investment in group consolidation.

Level of consolidation

To ensure adequate capitalisation and distribution of capital within a ‘banking group’, the Basel Committee feels it is necessary that subsidiary and internationally active banks consolidate, in turn, their investments in financial entities (sub-consolidation). Sub-consolidation can be waived if the Capital Accord is applied to the stand-alone bank (subsidiary and internationally active bank) and the book value of the investments is deducted from the bank’s capital.

The obligation to provide for sub-consolidation must be rejected. Sub-consolidation would impose a considerable burden, without bringing any additional supervisory insight or benefit. Due to respective considerations in the framework of the Europea banking law harmonisation, a binding obligation for sub-consolidation was abandoned (Art. 52, para. 7 of the EU codifying directive, Art. 7 para. 7 CAD).

If its parent bank consolidates an investment on a mandatory or voluntary basis, for a subordinate parent company in a three tier group structure, this should give rise to a waiver for deduction from capital. Under the current supervisory regime, banking groups or financial holdings are regarded as a single entity, i.e. only the group is subject to consolidated supervision. The consolidation of all group banks that is to be effected via

the group parent ensures that the risks incurred within the group are captured fully and matched against the capital effectively available within the group. Exemption of a subsidiary parent bank is thus appropriate.

We also assume that proof of application of the Capital Accord to the stand-alone bank is deemed to have been furnished in Germany when the bank makes a Principle I compliance report.

Third-party minority interests

Under the Basel Committee's proposals, supervisors are to be free to decide whether and to what extent third-party minority interests in financial entities may be included in the regulatory capital of the group.

Third-party minority interests should continue to be counted in full towards group capital. The risks of subsidiaries should be fully included in the group by way of full consolidation. To assess the capital adequacy of the group, it is vital, for systematic reasons, that these risks be matched in full against the entire capital of the group. It would be inappropriate to unilaterally reduce the capital available to cover these risks.

Through the controlling relationship between parent and subsidiary third-party minority interests can also be used in full for the purposes and the benefit of the entire group (e.g. for investments in other group entities). The capital of the subsidiary is available in full to cover any losses that may arise.

The deduction from capital of third-party minority interests would also be inconsistent with the aim of treating the group as a single entity for consolidation purposes.

Allowing national supervisors discretion in connection with the recognition of third-party minority interests should be avoided in any event as it would lead to significant distortions of competition if such discretion was applied in a heterogeneous fashion. If the EU were to stipulate tougher treatment of third-party minority interests than that possible under the discretionary powers granted by the Basel Committee then this would jeopardise a level playing field in particular. Any discretionary powers granted to national supervisors by Basel would have to be incorporated into the corresponding EU rules.

Significant minority-owned equity investments in financial entities

For the treatment of 'significant minority-owned equity investments' in non-insurance financial entities, the Basel Committee proposes pro-rata consolidation or, alternatively, deduction from capital of the book value of the investment. The threshold for a significant minority-owned equity investment is to be left to the discretion of national supervisors.

To create a level playing field, the adoption of the relevant EU rules is required here, too.

Cross-holdings

The Basel Committee underlines its view that reciprocal cross-holdings 'designed to artificially inflate the capital position of banks' should be deducted from group capital for the purposes of capital adequacy assessments.

We assume in this connection that in Europe bank cross-holdings are already covered adequately for prudential purposes by the relevant EU rules (deduction from capital in each case of the investment on a stand-alone basis/non-inclusion at group level of positions resulting from legal relationships between group banks). Any rules issued in Basel should be based on the European model.

Because of the vague wording used by the Basel Committee, it is, moreover, unclear whether specific rules on the treatment of cross-holdings are planned. Also unclear is how cross-holdings 'designed to artificially inflate the capital position of banks' should be identified.

Insurance subsidiaries

The Basel Committee is 'currently of the opinion' that majority interests in insurance entities need to be deducted from the capital of the bank holding the interest.

A unilateral obligation for banks to deduct their interests in insurance entities must be rejected, first, for competitive reasons. Conversely, insurance entities are not required to deduct majority interests in banks.

Second, the Basel Committee's proposal is also inappropriate from a risk angle. The nature of insurance risks is completely different from that of credit and market risks to which banks are typically exposed. They consequently lie outwith the scope of prudential rules. The deduction from capital of interests in insurance subsidiaries from capital envisaged by the Basel Committee would be the equivalent of a risk weight of 1,250%. The risk resulting from an interest in an insurance subsidiary would thus be grossly overstated. Full deduction from capital of an investment in an insurance subsidiary would imply under the prudential risk management regime that the subsidiary uses the capital made available by the investment to conduct 12 ½ times as much business carrying banking risks. This assumption is unrealistic. The volume of business carrying credit risk and market risk that is conducted by insurance entities is still low compared to the volume of actual insurance risks. Insurance entities should, at most, be required to meet the prudential requirements applying to their 'banking activities'.

Under current regulatory capital rules, an investment's probability of default is covered – like credit risk – by the 8% capital charge. The Basel Committee's intention to set higher capital charges for 'higher-risk' investments would be taken into account by the forthcoming provision on the treatment of equity.

In order to prevent underestimation of risks resulting from an investment in an insurance entity as a result of a potential deduction of the investment's book value from group capital, the Basel Committee intends to ensure that subsidiary insurance entities be adequately equipped with regulatory capital on a stand-alone basis.

In this connection, it remains unclear, however, how the capital adequacy of insurance subsidiaries is to be assessed for the purposes of prudential capital evaluation. Equally unclear is how insurance enterprises and their supervisors are to be covered by the New Capital Accord for banks.

By proposing that possible 'risk aggregation' be limited to corresponding supervisory requirements for insurance enterprises, the Basel Committee on principle recognises the importance, in a competitive context, of measures that unilaterally burden banks. This is to be welcomed. An inconsistency is, however, that the Basel Committee only fears distortions of competition in connection with the proposed 'risk aggregation'.

The Basel Committee proposes that any surplus regulatory capital available to an insurance subsidiary may be included in the group 'under certain circumstances'. Under the deduction approach, the amount deducted would be reduced by the amount of surplus capital. The 'certain circumstances' for assessing the amount and the eligibility of said surplus regulatory capital for such an inclusion are to be determined at the discretion of national supervisors.

The Basel Committee leaves all the crucial points on this question to the discretion of national supervisors. This appears to be due mainly to a lack of acceptable concepts for prudential recognition of equity investments in insurance subsidiaries for capital adequacy purposes. Important questions concerning measurement of the consolidated capital of banking groups have considerable competitive implications and call for in-depth contemplation. They should not be addressed under an apparently still unbalanced approach providing for broad national discretionary powers.

Significant investments in commercial entities

The Basel Committee proposes that investments in non-financial entities which exceed 'certain materiality levels' of liable capital of the investing bank should be deducted from the bank's capital. Such materiality levels are to be determined at the discretion of national supervisors. As a 'guideline', the Basel Committee refers to the currently applied European thresholds of 15% for a single investment and 60% for the aggregate of all significant investments in non-financial entities.

Second, it should also be made clear that determination of how thresholds are used should be based in each case on the book value of the investment. To avoid any distortions of competition, the Basel Committee should, finally, set mandatory thresholds on the lines of those applying at European level.

Part 2: The First Pillar – minimum capital requirements

I. Calculation of minimum capital requirements

Procyclicality

The outcome of the impact study, promulgations of the German Bundesbank as well as our own studies of the issue of procyclicality have demonstrated that the procyclical

effects of Basel II are indeed far greater than had been assumed up to now. In the event of realistic fluctuations of the probability of default by 100%, we therefore need to expect a capital fluctuation of 40%.

Increased capital requirements due to declining customer ratings in an economic downturn have *ceteris paribus* negative implications for banks' ratings. It will be difficult for an individual bank to increase its capital during a period of economic downturn. The banking sector as a whole will not be capable of providing sufficient input of capital. The bottom line would be that the entire banking sector would be compelled to reduce the loan portfolios, primarily by means of a squeeze on the extension of new loans.

Therefore, in order to reduce negative repercussions for national economies, Basel II should provide safeguards for a mitigation of the procyclical effect. It is of paramount importance to further analyse the effects and to take up a dialogue on ways in which the new Capital Accord's procyclical impact can be reduced. The discussion should involve different solution strategies.

In this context, the discussion also needs to cover portfolio effects as well as the recognition of internal credit risk models. Furthermore, the elimination of the expected losses from the risk weight functions would also reduce the procyclical impact.

'Floor'

The Basel Committee plans to introduce a threshold for possible capital relief (para. 23). Under this new provision, the overall capital adequacy requirements of a bank must not be allowed to drop below 90% in year one after the introduction of the new rules and must not drop below 80% of the current capital requirements in year two. In this respect, the Committee reserves the right to continue this limitation in subsequent years as well.

First, a regime of this kind would reduce the incentives for a transition to more sophisticated methods of risk measurement and thus to enhanced risk management. Furthermore, it entails the danger of being counterproductive with a view to the aim of enhancing risk-sensitive capital requirements. Apart from this, such a regime holds the danger of being counterproductive with a view to the aim of enhancing the risk-sensitivity of regulatory capital requirement. Through the introduction of the floor for capital adequacy requirements, e.g. banks with a low-risk portfolio which – without the floor under Basel II - could achieve a significant reduction of their capital adequacy requirements over the status quo, would clearly overstate the real risk.

In addition to this, the regulatory capital necessary for the loan is taken into account when fixing the loan terms. If the floor were to become a binding provision, then - via the calculation of the floor - this would result in a *de facto* obligation for banks to use the Basel I methodology. First, this would signify that favourable capital requirements could not be passed on to customers with a good credit rating in the form of favourable loan terms. Furthermore, the banks have an incentive for the extension of loans to customers whose capital requirements under the IRB approach exceed the level stipulated under Basel I. The Basel Committee would thus thwart one of the key objectives under Basel II.

In order to avoid the danger of an unwelcome, strong slump in banks' overall capital, we hold the view that it will be sufficient to analyse the potential impact of Basel II before its first application; such an analysis might take place within the framework of ongoing quantity impact studies as well as under the parallel reporting regime envisaged for the so-called 'parallel use' period 2006. Potentially required adjustments should be carried out on the basis of these findings. Any plans to introduce a floor should be abandoned, however.

If the performed impact studies should fail to allay the Basel Committee's concerns over calibration issues, then the continued existence of a floor should also be accompanied by the introduction of a respective cap. This is because, e.g. faulty calibration, along with other issues, may not only cause a considerable drop in banks' capital but it may also lead to considerable capital hikes.

II. Credit risk – the standardised approach

A. The standardised approach – general rules

1. Individual claims

i) Claims on sovereigns (paragraphs 27 – 30)

In connection with the national discretion for supervisors to allow lower risk weights for banks' exposures to their sovereign (or central bank), provided that these are denominated in domestic currency and funded in that currency, it must be ensured that such national decisions are published and made transparent and – to avoid any distortions of competition – that such risk weights may be freely adopted by banks domiciled in another country without the need for any further decision having to be made by the foreign national supervisory authority (automatic mutual recognition of national discretionary decisions in this area).

ii) Claims on non-central government public sector entities (PSEs) (paragraphs 31–32)

Under the Basel Committee's proposals, it should be left to the national supervisors' discretion to decide on derogations from the basic rules and whether exposures to PSEs should be treated like exposures to sovereigns. To create the required transparency, countries granting such a privilege should be required to list those PSEs that are treated like sovereigns, and – in order to avoid any distortions of competition – it should be stipulated that such risk weights may be freely adopted by banks domiciled in another country without the need for a further decision having to be made by the foreign national supervisory authority.

(iv) Claims on banks (paragraphs 34 – 38)

Given paragraphs 28 and 38, it is not clear why, under option 1, short term bank exposures are not granted the same privileges as envisaged under option 2. Furthermore, the risk weight of 50% for unrated banks under option 2 is unjustified both from the point of view of the methodology and from the point of view of increased risk-sensitivity. Since this may result in considerable competitive disadvantages for individual banks, the risk weight for unrated banks should be brought into line with the other risk weights of the modified standardised approach for unrated exposures and needs to be raised to 100%.

(vi) Claims on corporates (paragraphs 40 - 42)

Paragraph 42 should be dropped completely, since there is no objective justification for the national discretion to assign a 100% weighting to all corporate loans, overriding existing external ratings.

(vii) Loans which are assigned to the retail portfolio (paragraphs 43 – 44)

We explicitly welcome the envisaged option that loans to small and medium-sized companies - provided certain conditions are met, may be treated under the retail portfolio. Furthermore, it ought to be favourably mentioned that the 0.2% cap is now no longer a mandatory granularity criterion, but only constitutes one possibility for assigning loans to the different categories. Particularly for smaller banks, a percentage limit would have significantly complicated the inclusion of loans to small and medium-sized enterprises under the retail portfolio.

For consistency reasons and in order to prevent distortions of competition between banks using different approaches for the calculation of the regulatory capital for credit risk purposes, the criteria for an assignment of credits to the retail portfolio should be identical both under the modified standardised approach and under the two IRB approaches. The criteria of the two IRB approaches established for the assignment of exposures to the different definitions should therefore be adopted under the modified standardised approach, too. With a view to the conception of the criteria we should like to draw attention to our comments on paragraph 200.

Finally, we assume that the upper ceiling of EUR 1m stipulated in paragraph 44 and defined thereunder as ‘aggregated exposure’ be applied at the level of the individual bank. A pooling of all exposures of a customer at group level would be highly cumbersome whilst its supervisory benefit would be fairly moderate.

(viii) Exposures secured by residential property (paragraphs 45 – 46)

We welcome the reduction of the risk weight for residential property loans from 40% to 35%. However, the definition of residential property loans needs to be revised. First, and this is in line with the current provisions under the Basel Accord, it needs to be sufficient if the property is owner-occupied. This owner may be identical with the borrower or may be a third-party collateral provider. Furthermore, the future rental should be equally included. We therefore suggest the following wording for the first sentence of paragraph 45: 'Lending fully secured by mortgages on residential property that is or will be occupied by the owner, or that is or will be rented, will be risk weighted at 35%.'

(x) Past due loans (paragraphs 48 – 51)

Unsecured exposures past due for more than 90 days should receive a special risk weighting. In our view, the definition of those customers whose loans have to be weighted in such a way should not only be based on the fact that such loans are past due for more than 90 days. To ensure that the rules are applied in a manner consistent with that under the IRB approach, the basis should instead be the reference definition of borrower default provided under the IRB approach. At the same time, our remarks on the reference definition should be taken into account in this context (see paragraphs 414-419).

According to the remarks contained in paragraph 45 'qualifying residential property loans' with a risk weight of 35% are only those parts of a credit which do not exceed the determined value of a collateral. If there is an event of default of the entire credit, then this portion of the credit will receive a risk weight of 100% whereby the created specific provision has to be deducted from said credit amount (paragraph 51). This 'upgrading' is not risk adequate since also in the event of a default of the overall loan no changes occur with regard to the value of the collateralised (and therefore privileged) portion of the loan because this portion of the loan remains fully and comprehensively collateralised through the real security. We therefore reject the envisaged 'upgrade' of the qualifying portion of the loan. We take it that the uncollateralised portion of the loan receives a risk weight under the provisions of paragraph 48.

(xi) Higher-risk categories (paragraphs 52 – 53)

Any additional extension of the 150% category beyond the envisaged cases must be rejected, as any classification in this category which was exclusively based on the type of investment would be inappropriate. The sole criterion for classification should be the individual quality of the exposure. Moreover, giving national supervisors discretionary

powers to decide on the application of higher risk weights to certain assets would imply distortions of competition and jeopardise a level playing field.

(xiii) Off-balance sheet items (paragraphs 55 – 59)

We gather from paragraph 57, that securities lending/borrowing transactions and repurchase/reverse purchase transactions qualify as off-balance sheet transactions for the purposes of the Consultative Document. Clarification to the effect that the rules for off-balance-sheet transactions – in particular the unchanged prudential requirements with regard to off-balance-sheet netting – are applicable to these transactions as a whole, irrespective of national accounting rules, would be desirable. This would also constitute a consistent adaptation of the existing Capital Accord, which has already been opened to the whole spectrum of futures, swaps, options and similar derivatives contracts by way of the Basel Committee's announcement on the international convergence of capital measurement and capital requirement standards³.

2. External ratings

(i) The recognition process (paragraph 60)

Under the Basel Committee's proposals, the decision on whether an external credit assessment bank (ECAI) satisfies the eligibility criteria is to be left to national supervisors. In order to prevent national discretion leading to distortions of competition, in our view ECAs which are recognised in one country need to be equally recognised in any other country (mutual recognition). In addition to this, in order to increase transparency, the Basel Committee ought to publish a list of the officially recognised rating agencies.

(ii) Eligibility criteria (paragraph 61)

To qualify for recognition by supervisors, an ECAI must satisfy certain criteria. In this connection, it should be ensured that ECAs meet at least the same requirements as internal rating systems. We note for instance that the standards concerning the disclosure of information on ECAI assessment methodologies and time horizons are less detailed and thus lower than the disclosure standards for the use of internal rating systems. Safeguards need to be established, so that disclosure requirements are not used to make external ratings more attractive than internal ratings.

Generally speaking, the criteria listed in the Consultative Document require further specification. Supervisors will need to monitor compliance with the criteria on an ongoing basis.

³ Last amended by the Announcement of 7 April 1998; see in particular the remarks on currency and interest-rate-related contingent liabilities therein.

1. Implementation considerations

(i) The mapping process (paragraphs 62 – 65)

According to the Basel Committee, national supervisors shall be responsible for deciding which ECAI assessment categories correspond to which risk weights. To avoid any distortions of competition, we believe that for each type of exposures (sovereigns, banks, corporates) the Basel Committee should provide an international, uniform master scale with default probability intervals instead of assessment category intervals. The assessment categories of officially recognised ECAIs should be slotted into this master scale by means of the (average) default probabilities determined by the agencies. The default probabilities determined by the ECAIs should be reviewed annually (by supervisors) and the mapping process should be corrected where necessary.

The requirement that ECAIs' ratings must be applied consistently, i.e. the ratings of the same ECAI must be used for risk weighting and internal risk management purposes, appears reasonable to prevent 'double counting'. However, the requirement of consistent application of ratings should not mean that the same pre-determined ECAI(s) must always be used for certain exposures. The exclusion of other rating agencies from assessing certain types of exposure would seriously restrict the applicability of external ratings under the standardised approach and be a barrier to market access for new rating agencies. Such an arrangement would also be unnecessary to prevent 'cherry picking', as, First, all rating agencies have to be officially recognised by supervisors and, Second, there are clear rules for cases where a borrower is rated by several agencies.

(iii) Issuer versus issues assessment (paragraphs 69 – 71)

The Basel Committee proposes that for investments in (securities) issues that have an issue-specific assessment, banks shall use this assessment (issue rating). This appears an appropriate solution. The use of the issue-specific assessments should, however, remain confined to this specific case. The arrangement proposed by the Basel Committee concerning the use of issue-specific assessments for other exposures where there is an absence of an issuer assessment, would impose an unreasonable monitoring burden on banks and should therefore be dropped.

(vii) Unsolicited ratings (paragraph 78)

Under no circumstances should unsolicited ratings be recognised for prudential purposes. In our opinion unsolicited ratings should not be accepted. Among other reasons, this is due to their lower quality resulting from the fact that they are based on far less information.

B. The standardised approach – credit risk mitigation

2. Collaterals

It should be clarified that any risk assets (i.e. on-balance sheet and off-balance sheet transactions) may be collateralised by means of securities and guarantees.

(i) Suitable financial securities (paragraphs 116 – 117)

The list of eligible collateral should be expanded to include precious metals and precious metal certificates (in addition to gold).

Besides gold, – also silver, platinum and palladium are suitable as collateral without any qualifications, as their immediate availability is ensured by the existence of commodity markets. For supervisory purposes a further breakdown is not necessary – cf. table in article 11 (a) of the Capital Adequacy Directive (CAD II), which refers to ‘precious metals’ in general. Appropriate haircuts to reflect existing price volatility should ensure a more sophisticated treatment of this collateral in the comprehensive approach compared to the simple approach.

It appears inappropriate that debt securities issued by sovereigns ought to be recognised up to a BB rating, yet debt securities issued by banks and companies only ought to be eligible for recognition up to a BBB rating. If a suitable haircut is applied, bank and corporate debt securities rated BB should be equally eligible for recognition as collateral.

The Basel Committee proposes that the recognition of the collateralisation effect of debt securities and the level of the haircut to be applied to these instruments should be linked to their respective issue rating. However, unrated issues, with the exception of unrated bank debt securities, are generally not to be recognised.

In conjunction with the issuer rating, we advocate to equally recognise unrated, first-rank debt securities as collateral. In the case of corresponding debt securities, the issuer rating cannot possibly be better than the issues rating.

Unrated debt securities issued by banks may only be recognised as collateral if, inter alia, no other issue of the issuing bank is rated below BBB or A3/P3 and if the supervisor is sufficiently confident about the instrument’s market liquidity.

For the bank extending the loan, this policy creates a major information burden and should be dispensed with for practical reasons.

(ii) The comprehensive approach (paragraphs 125 – 126)

We are of the opinion that internal estimates on the basis of externally calculated or pooled data should also be permitted, as long as this means that the internal estimate is likely to have a greater degree of accuracy, and thus reliability.

Conditions for an H of 0 (paragraphs 141 – 143)

For repo-style transactions, the supervisors may waive the application of a haircut under certain circumstances (Paragraph 141f.). In order to prevent national room for interpretation, we suggest the following wording for sentence 1 paragraph 141:

‘For repo-style transactions where the following conditions are satisfied, and ... may choose not to apply the haircuts specified in the comprehensive approach and may instead apply a zero H.’

The introduction of a disclosure obligation for the respective home-supervisor is required so that supervisors of other countries - in line with the provisions of paragraph 143 – may adopt the derogations specified in paragraph 141.

The principle alluded to by paragraph 141 (g), i.e. that collateralisation is linked to specific transactions, does not take adequate account of current banking practices. As a rule, collateral is provided for a portfolio; even in the case of third-party collateral, this holds true at least to some extent. This circumstance affects the common practice relating to OTC derivatives, securities lending transactions and repurchase agreements which regard any individual transactions covered by the relevant master agreements as one aggregate business transaction and conclude close-out netting agreements to cover termination. The net market value or non-performance loss describes the credit risk of the counterparties; this is also recognised by the supervisor. Furthermore, the portfolio approach allows a reduction of the collateral exchanged and the resulting cost savings are also in the interests of customers. Therefore, paragraph 141 (g) ought to refer to ‘the business’.

Furthermore, we consider it neither appropriate nor useful to allow banks to use only one of the outlined methodologies. Banks must be able to apply different methodologies to their treatment of collateral, depending on the portfolio or sector involved. Regulatory arbitrage would be excluded by the fact that the Basel Committee rewards the different methodologies with escalating capital relief according to their degree of complexity. Banks opting to operate the simple approach in certain sub-sectors, for example, could therefore gain no advantages whatsoever in terms of capital relief. Moreover, allowing a bank to apply different methodologies would facilitate the transition to the next higher approach, thus providing further incentives for the development of more sophisticated risk measurement systems, i.e. an effect that would be in line with the Basel Committee’s mission statement. What is more, under the framework of the disclosure requirements (Pillar 3), the objective justification for the application of different methods would become subject to market scrutiny.

Treatment of repo-style transactions with netting master agreements (paragraphs 144 – 148)

Limiting the collaterals merely to those of the banking book (paragraphs 145, b) is inappropriate for capital market products. On principle, all collaterals covered by the master agreement (or covered by the collateral annex) should be accepted. Whether the basic transactions are assigned to the trading book or to the banking book does not prejudice the collateralising effect of the master agreement and/or the collaterals

exchanged thereunder. Potential losses are taken into account by way of the calculation of haircuts, VaR etc.

Use of VaR models (paragraphs 149 – 152)

We explicitly welcome the intention behind the provision envisaged in paragraph 149ff. i.e. modelling market related fluctuations in the exposures of repo transactions covered by a netting agreement also by means of a VaR-based modelling, and not only by means of the haircut approach. However, what appears inconsistent in this context is the fact that the calculation of the capital requirement for the counterparty's risk from collateralised transactions with OTC derivatives – following the Basel I methodology – should remain based on the replacement costs plus an add-on (paragraphs 157 f).

It is a well-known fact that banks are currently attempting to develop multi-product master agreements for financial transactions. For instance in May this year, a derivative annex for the European Master Agreement (EMA) to round off the existing product annexes for securities lending/borrowing transactions and for repurchase agreements has been prepared. So as not to obstruct these developments and in order to allow banks a further convergence of regulatory and economic capital, the methodology designed with a view to repo transactions should be equally permitted with a view to collateralised OTC derivatives transactions (cf. also our attached position paper).

The difference between the haircut approach and VaR based approach for determining possible risk increases is, that under the haircut approach the add-on to the exposure and haircuts applied to the collateral market value are added at the level of the individual exposure. Here, only risk element variations observed on the market play a role, correlations (co-variances) observed on the market are not taken into account. Contrary to this, under the VaR approach an aggregated risk ratio is calculated on the basis of sensitivities. Risk aggregation takes place via correlations between risk elements observed on the market. Therefore, the VaR approach requires more advanced risk management than the haircut approach and thus allows a more precise determination of the add-on value.

However, in the current version, the provisions envisaged under the Third Consultative Document do not provide any incentives for an implementation of the VaR approach, since the following reasons lead to a discrimination of the VaR approach over the haircut approach⁴.

1. Under the haircut approach; a zero haircut may be applied to so-called 'core market participants' (paragraph 141 ff). A comparable general privileged treatment of certain counterparties must also be permissible under the VaR approach.
2. When implementing the VaR approach under Basel II, a backtesting procedure is required. On the basis of the backtesting quality, Basel II requests that the VaR add-on factors are increased by means of multipliers if the forecast performance of the used VaR model is insufficient. The following remarks need to be made in this context:

⁴ Here and in the following sections we refer to that approach under which the haircuts may be estimated by the bank itself.

- The application of the VaR approach is subject to the supervisory recognition of an internal market risk model. Within the framework of the current prudential supervision process, the market risk model is already being tested by the banking supervision with a view to its performance. Further backtesting in addition to Principle I backtesting does therefore not yield any additional insight into the performance of the market risk model. Without information on the correlation between counterparties' exposure, backtesting at the level of the counterparties does not yield any additional information with regard to the performance of the deployed risk model. For instance, main index shares, government bonds etc. are typical securities of repo/lending transactions which - in the course of such transactions - are exchanged between the bank and the customer. In the extreme case, counterparties will be subjected to a backtesting procedure where the bank holds exposures that will be based on identical risk elements (e.g. interest risk in the case of government bonds) and any such exercise would therefore produce identical backtesting data series. In terms of methodology, there is essentially an equivalence between haircut approaches and VaR models, as haircuts can be derived from sensitivities, e.g. BPVs (basis point values of typical securities) and variations of risk elements. Hence, the exclusive application of multipliers to the VaR approach is discriminatory.

The backtesting requirement for the VaR approach should therefore be deleted. We hold the view that the approach of a model validation under Pillar II is sufficient in order to verify the exposure assessment of repo-style transactions.

Exposure determination for capital market products

There are different methods featuring different degrees of risk-sensitivity for determining the counterparties' risks resulting from capital market products. The coarsest method is the haircut approach. The VaR approach provides a higher degree of risk-sensitivity. Quantification of the credit risk equivalence amount/EAD on the basis of expected price volatilities across the contemplated transaction's risk horizon promises an increased risk-sensitivity. The methodological implementation of these concepts is realised by way of the so-called EPE (Expected Positive Exposure) approach.⁵ This methodology allows the equal treatment of commercial loan transactions and capital market transactions for prudential supervision purposes. We therefore call for an admission of internal bank EAD estimates on the basis of the EPE methodology for all capital market products, regardless of the risk horizon of the transactions/regardless of the type of master agreement.

⁵ By means of detailed Monte-Carlo simulations, the 'Counterparty Risk Working Group' coordinated by the ISDA has demonstrated that (under the Basel II methodology) the counterparty risk can be estimated on the basis of a credit equivalence amount if the EPE method is applied (cf. ISDA 'Counterparty Risk Treatment of OTC Derivatives and Securities Financing Transactions', scheduled for publication in June 2003).

(iii) The simple approach (paragraphs 153 – 154)

Collateral must be revalued at least every six months and must be ‘pledged’ for at least the life of the collateralised exposure in order to be recognised under the 'simple approach' proposed by the Basel Committee.

It is generally requested, that collateral which is not revalued every six months, but merely, e.g., on an annual basis is also recognised. By and large, collateral instruments which are not subject to major market fluctuations should not have to be revalued more frequently than once a year unless there is a relevant reason to do so and said revaluation intervals should not have an adverse effect.

Due to the rule that collateral needs to be furnished for the entire loan term, collaterals featuring maturity mismatches are excluded from the simple approach.

In our estimation, limiting the recognition of collateral involving a maturity mismatch to the comprehensive approach cannot be justified. The credit risk mitigation effect of a collateral instrument does not depend on how this is counted for regulatory purposes. Collateral with a maturity mismatch should therefore also be recognised under the simple approach using the system described in paragraphs 172ff. of the Basel paper.

The Basel Committee proposes that the portion of a claim collateralised by the market value of recognised collateral be weighted by the risk weight applicable to the collateral instrument. In this context, there should be a general minimum risk weight of 20%.

The introduction of a 20% floor is to be rejected. This rule would be an unjustifiable change for the worse. Collateralisation by eligible collateral, which in turn receives a zero risk weighting, should, in general, result in a risk weight of 0% for the collateralised portion of an exposure. The provisions stipulated in the Basel paper concerning cases below the 20% floor (paragraphs 154 – 156) would have to be deleted.

(iv) Collateralised OTC derivatives

The rules on the treatment of OTC derivatives under the standardised approach/under the two IRB approaches are inconsistent and incomplete.

In order to secure uniform application of the new provisions we suggest the following adjustments.

Standardised approach (paragraphs 157):

- Deleting the term ‘collateralised’ in the heading so that this section covers the treatment of derivative transactions in their entirety.
- Complementing the maximum function as well as changing the right term into

$E^* \times r \times 8\%$ in the equation for counterparty charge. Apart from this, the definition of $E^* = RC + \text{add-on} \pm C_A$ should be supplemented. Both changes help to create a link to the presentations under the IRB approaches.

- Contrary to the presentations made in paragraph 157, C_A itself is not explicitly defined in paragraphs 118 to 143, hence $C_A = C \times (1 - H_C - H_{fx})$ should be defined in paragraph 118.
- Additional explanation of the parameter definition concerning C_A so that collateralised and uncollateralised transactions as well as received and furnished collateral are also taken into account.
- At the level of individual transactions, the credit equivalence amount (CEA) results as $E^* = \max[(RC + \text{add-on}) \pm C_A; 0]$, i.e. if the collaterals are taken into account, the adjusted (reduced) collateral amount is deducted from (RC + add-on) if the provision of the collateral requires capital backing i.e. if it leads to an on-balance sheet claim then the adjusted (increased) collateral amount needs to be added to the (RC + add-on).
- The establishment of the CEA for an uncollateralised derivative transaction (or for several such transactions under a netting agreement) takes place on the basis of the foregoing equation, the only difference being $C_A = 0$.

IRB approaches

- In order to ensure consistency across all approaches, paragraphs 260 or 262 on the simple IRB approach and paragraph 287 on the advanced IRB approach should be complemented in such a way that paragraph 157 specifies E^* for derivatives as well as further requirements for the establishment of the CEA.

We Furthermore, refer to our comments on paragraphs 149 ff. (roll out of the VaR based, recognised determination of future risk increases to OTC derivatives).

4. Netting of balance sheet items (on-balance sheet netting) (paragraph 159)

We welcome the proposed broadening of the scope of application of bilateral on-balance sheet netting agreements with regard to and deposits vis-à-vis any other counterparty.

However, the Basel Committee makes the recognition of such netting agreements subject to certain conditions. The bank must, for example, possess a sound legal basis for the netting or offsetting which must be enforceable in any relevant jurisdiction in whatever case, including events of insolvency proceedings (paragraph 159 (a)) One further prerequisite is for instance, that the bank should also be able to determine at any time those exposures and liabilities vis-à-vis a counterparty covered by the netting agreement (paragraph 159 (b)).

As far as the enforceability of the netting agreement ‘in each relevant jurisdiction’ is concerned, it should be clarified that it is sufficient for the bank to prove that the agreement is enforceable in the counterparty’s home country. The request that the items covered by the netting agreement must be identifiable at ‘any point in time’ in our view

means that the bank must at any time be in a position to name the respective transactions in a timely manner.

Until further notice, the Basel Committee plans to limit the (on-balance sheet) netting to exposures and liabilities. Such a blanket restriction is inappropriate in our view. If the legal enforceability of a netting agreement has been proven, netting should be permitted with regard to all eligible on-balance sheet and off-balance sheet transactions (risk assets) in the banking and in the trading book.

5. Guarantees and credit derivatives

(i) Operational requirements (paragraphs 160 – 164)

Under the Basel Committee's proposals, guarantees and credit derivatives shall only be eligible for supervisory recognition if the instruments constitute an immediate exposure to the protection provider, if they are explicitly linked to specific credits and if they are, on principle, irredeemable on principle (paragraphs 160 ff.).

Guarantees and credit derivatives – in line with the portfolio approach - are not necessarily undertaken for one single liability of an obligor. It is also quite usual to guarantee, up to a certain maximum amount, the fulfilment of all present and future liabilities of an obligor to a bank. Against this background, we understand the requirement that guarantees and credit derivatives have to be 'explicitly linked to specific credits' to mean that although the bank accepting the guarantee must be in a position to clearly define the extent of existing protection by a guarantee for every exposure with a particular borrower, a guarantee may be accepted for various obligor facilities that fluctuate during the term of the guarantee without prejudice to regulatory recognition. The Basel Committee should clarify this point.

Furthermore, with a view to the irredeemability, we assume that for credit derivatives concluded for a revolving asset pool, so-called early amortisation clauses, giving the protection provider the right not to admit any new assets to the pool if the quality of the collateralised pool deteriorates significantly, will not be considered a cancellation clause preventing recognition; in this case, the assets contained in the pool are already completely covered.

As an operational requirement for guarantees, the Basel Committee wishes to stipulate that in the event of default or non-payment of the obligor, the lender must be able, in a timely manner, to claim payment from the guarantor of the amounts outstanding under the loan instead of having to continue demanding payment from the obligor (paragraph 161 lit. a).

The requirement that it must be possible to demand payment of outstanding amounts without delay is appropriate, in principle; however, it should not generally be made contingent upon the 'default/non-payment of the obligor'. The scope and content of a guarantee may differ depending on the terms of the contract. A guarantee normally only covers the default of the obligor. Under the terms of such a guarantee, the non-payment of the obligor has no relevance. A condition for payment may also be the loss of a primary security (e.g. under the terms of indemnity bonds). In order to take account of the way

guarantee contracts are usually formulated in practice, the Basel Committee should refer more broadly to 'the occurrence of contractual conditions for payments to be made' as a triggering event. If the Basel Committee stipulated, as a precondition for the regulatory recognition of guarantees, that the guarantor may be pursued for payment on grounds other than contained in the contract, then this would have a considerable, adverse effect on guarantee transactions.

Moreover, the second sentence of paragraph 161 (a) should be deleted as the guarantor's right to pursue the obligor for outstanding payments on a loan is a matter concerning the relationship between the guarantor and borrower only and has no conceivable relevance for banking regulators.

Regarding paragraph 161 (b), there needs to be clarification that not only obligations (voluntarily) assumed by the guarantor are to be covered, but also those obligations which arise from e.g. statutory provisions.

As a further eligibility criterion for guarantees, the Basel Committee also plans to require the guarantor to cover all payments which the obligor is expected to make under the loan. 161 lit. c).

Up to now, supervisory regulations on the backing of risk assets have only covered the loss of the book value. The requirement that a guarantee must cover not just the loss of the risk asset, but all claims associated with the loss would therefore be inconsistent and should be dropped. It should continue to be up to the parties to the contract alone to decide whether a guarantor shall be obliged to guarantee not only the repayment of the loan, but also the bank's entitlement to interest. Furthermore, the envisaged requirement would render invalid existing guarantees which cover repayment only.

The requirements set out in paragraphs 162 ff., which must be met for credit derivatives to obtain capital relief, are too narrow. It is doubtful that they will promote the market for credit derivatives, which, particularly in continental Europe, is just beginning to develop and expand. Instead, the requirements are more likely to prove a constraint on the market.

Paragraph 162 (a) of the Consultative Paper sets out those credit events which must be specified in the collateral agreement.

The proposed minimum credit events do not adequately reflect current market practice (e.g. ISDA master agreements). The restructuring⁶ credit event mentioned in paragraph 162 (a), for example, is highly controversial in practice, and is often excluded under the terms of individual contracts. The credit events listed in paragraph 162 (a) should therefore be limited to the failure to pay contractual amounts due according to the reference asset specified in the contract.

Along with credit default swaps and total return swaps, the Basel Committee does not want to recognise any other types of credit derivatives in the immediate future (credit linked notes issued by the bank are, quite rightly, to be treated as cash collateralised transactions).

In our estimation, recognition should be given to all products satisfying the conditions listed in paragraphs 160 and 162 for credit derivatives. The Basel Committee should

⁶ Restructuring refers to the credit events listed in paragraph 161.

delete paragraph 163 f. in its entirety, so that other types of credit derivatives may also be integrated into the regulatory framework, depending on the development of the market and the products themselves.

(ii) Range of eligible guarantors/protection providers (paragraph 165)

Under the Basel Committee's proposals, the scope of eligible guarantors/protection providers will generally comprise sovereigns, PSEs, banks and corporates (including insurance companies). The Committee will always consider guarantees eligible if they are given by sovereigns, PSEs and banks with a lower risk weight than the obligor. Guarantees given by corporates, however, will only be recognised as risk reducing if the guarantor company is rated A- or above.

The methodology does not justify this envisaged discrimination against corporate guarantees. Also guarantees provided by corporates rated below A- reduce the default risk of the protection taker and should thus be recognised. The fact that the Basel Committee considers the guarantees provided by such corporates potentially less valuable is adequately taken into account by the guarantee provider's credit assessment, which needs to be assigned to the covered credit.

(iii) Risk weights (paragraph 166 – 169)

The Basel Committee considers it necessary to fully deduct from the bank's capital those materiality thresholds that were fixed under a collateral agreement and below which – in an event of loss - no payments will be made. The Committee regards such thresholds as equivalent to retained first loss positions (paragraph 167).

It is inappropriate to deduct these thresholds from the bank's capital. We suggest treating the portion of the exposure below the materiality threshold as uncovered. Treating this portion of the exposure as a first loss position could lead to the absurd situation whereby - regardless of the level of the materiality threshold - more regulatory capital would have to be set aside for this kind of 'incompletely' covered exposure than for a completely uncovered exposure because of this position's deduction from capital.

(v) Sovereign guarantees (paragraph 171)

For a discussion on the issue whether the assignment of lower risk weights to those credits where a sovereign is the guarantor should be left to the discretion of national authorities, we refer to our comments in relation to paragraph 32. We also request that such national decisions be published allowing banks in other countries to adopt the reduced risk weights.

6. Maturity mismatches

(ii) Risk weights for maturity mismatches (paragraph 174)

The Basel Committee clarifies that maturity-mismatched collateralisations with less than one year residual maturity shall not be recognised.

This arrangement would make a maturity-mismatched collateralisation in terms of short-term products (less than one year) impossible. This would be unfair discrimination against these products. The Basel Committee should provide regulatory incentives for prudent risk management of short-term exposures, too. The equation for calculating the risk weights for positions featuring maturity-mismatched collateral with maturities in excess of one year should be applied in an analogous fashion to residual collateral maturities below one year.

III. Credit risk – the internal ratings-based approach

B Procedure of the IRB approach

1. Categorisation of the assets

(i) Definitions of corporate exposures

High-volatility commercial real estate (paragraphs 195 and 249 ff.)

There is a lack of empirical data as well as a lack of generally recognised qualitative and quantitative criteria for assignment to the exposure segment ‘high volatility commercial real estate’. Therefore, any further differentiation of the segment of specialised lending is inappropriate and we reject any such undertaking.

The classification of a commercial property financing into the HVCRE risk category should be left to the discretion of the national supervisor. The applicable criterion is that the financing must be secured through real property featuring a higher volatility than the portfolio default rates. In order to limit repercussions for international commercial property financing, the prudential supervision authorities should not only publish their decision on the assignment of certain financing transactions to the HVCRE risk class (cf. paragraph 196), but should also publish the basis on which this decision was taken.

In addition to this, scenarios are also conceivable where certain commercial property financing would be classified as HVCRE abroad, whilst in the home country they could be privileged (e.g. IPRE). Therefore, at least before the first-time application of Basel II, a sufficient transitional period should be set in order to buffer the negative consequences for capital backing of inventory financing abroad.

(iv) Definition of retail exposures (paragraph 199 – 201)

a) Nature of borrower or low value of individual exposures

In this context, too, it needs to be ensured that the proposed exposure ceiling of EUR 1m be applied at the level of the individual bank; this requirement is in line with our comments concerning the regulatory scope of the standardised approach. A group level aggregation of any exposures of an individual customer would significantly add to the administrative burden, whilst from a supervisory point of view the added value would be rather limited.

b) Large number of exposures (paragraphs 200)

With a view to the required risk adequacy, the issue of equal treatment for corporate customers and retail customers alike, requested under the so-called ‘use test’, does not make any sense. The specific risk of loans to medium sized companies – which justifies the inclusion under the retail approach – mainly results from the size of the borrowers/of the loans, but it does not result from the risk management approach adopted.

What is more, the procedures adopted in retail business are not always appropriate, particularly when it comes to larger SMEs: First of all, for such customers, an assessment on an individual borrower basis will frequently be preferable to a portfolio assessment. Moreover, it is doubtful whether retail staff are sufficiently qualified to deal with larger corporate customers in particular. Since the banks - given the comparatively low capital adequacy requirements for retail loans - have very strong incentives to include SME customers under the retail segment, the ‘use test’ eventually leads to supervisory incentives for inappropriate risk management strategies with regard to corporate customers.

In order to achieve a consistent and risk adequate, clear-cut definition of corporate exposures which may be treated like retail exposures, the use test should be deleted. Alternative definition criteria would be one possible solution in order to safeguard a sufficient degree of granularity. It would, for instance, be possible to introduce a ceiling of EUR7.5m sales per annum for corporate customer loans. In addition to this, it would be possible to treat only those corporate customers in the same way as retail who do not constitute a large exposure for the credit institution.

(v) Definition of qualifying revolving retail credits (paragraphs 202 – 203)

Under the provisions of paragraph 202, a credit shall only be qualified as a revolving retail credit if, for instance, it is uncollateralised. We recommend deleting this requirement. First, the collateralised exposures bear a lower risk when compared to uncollateralised exposures. Hence, there is no obvious reason why a collateralised loan

should not be allowed to fall under the more favourable risk weight function for qualifying revolving retail credits. In addition to this, the retail approach does not differentiate between collateralised and uncollateralised loans. Therefore, it is unclear, which credit is regarded as uncollateralised. Furthermore, under this regime it would become possible to treat overdraft facilities, which are widespread in many countries and for which frequently far-ranging collaterals have to be assigned to the category of qualifying revolving retail loans.

(vi) Definition of equity exposures (paragraphs 204 – 207)

The definition includes both direct and indirect ownership interests. Even in connection with footnote no. 51 concerning indirect ownership interests it remains unclear, to which extent for instance the corporate ownership interests held by an associated company need to be assigned to the credit institution, at least on a pro rata basis in the segment of equity exposures, if such credit institution in turn possesses capital shares in said associated company. This indirect assignment ought to be rejected because the credit institution's risk is merely limited to the share in the associated company.

Definition of purchased receivables (paragraph 208 – 212 and 332 – 337)

Under certain conditions, purchased receivables can be treated as a block 'top-down'. In the retail segment this is generally true, in the corporate segment this applies to 'origination on arm's length basis' (paragraph 209 ff.). Yet, an additional capital requirement for the 'dilution risk' will be necessary – i.e. inter alia for the risk that the borrower will enter into agreements with the initial lender, which shall be binding for the purchaser of the receivables and impair realisation. There needs to be clarification that this provision shall generally not apply to those cases where legal risks are handled appropriately or – always under the same precondition – that it shall at least not apply in those cases where only individual exposures are sold or where the pool is not treated top-down but on the basis of stand-alone loans.

One prerequisite for the application of the top-down approach is that the receivables must be purchased by a third party with which there are no relations under company law. Yet, a relation under company law exists in any kind of participation, regardless of the level of participation. In the event of low-volume equity exposures, the exclusion from using the top-down approach is not necessary in terms of risk aspects and would, in practice, lead to difficulties. Therefore, the use of the top-down approach should only be ruled out if there is a significant investment in the purchasing party or if the purchasing party holds a significant investment.

3. Adoption of the IRB approach across asset classes

Partial use (paragraph 225 – 231)

Permanent partial use

If a bank uses the IRB approach for a portion of its exposures, the Basel regulations require that the approach be applied to all exposures of the banking group (225). The exemption of significant asset classes/business units should only be possible for a transitional period (226).

With the exception of the Bundesverband Deutscher Banken⁷, the associations under the umbrella of the ZKA advocate for a lasting derogation for certain sub-portfolios (e.g. sovereign or banks) or collaterals (partial recognition of internal LGD estimates), legally independent (domestic/foreign subsidiaries) as well as legally dependent units of the banking groups/of the bank (field establishments, branches, branch offices either domestically or abroad) from the IRB approach. A respective 'partial use' regime should also be possible within the IRB in terms of the 'foundation approach'/the 'advanced approach'.

The Basel Committee should take account of the fact that certain minimum requirements (e.g. with regard to the data history) in certain sub-areas/sub-portfolios of a bank or also within legal entities of a banking group – will not be sustainable in the long run or can only be sustained if there is an inappropriately high input of resources. Therefore, it should be left to the bank's discretion to exempt certain areas – which ought to be clearly defined in conjunction with the supervisor – on a permanent basis from the scope of the IRB approach.

4. Transitional provisions

(ii) Claims on corporates, sovereigns and banks as well as retail exposures (paragraph 233 – 235)

The transitional provisions agreed to by the Basel Committee for the required length of the data history is generally to be welcomed. This approach facilitates the early adoption of the internal ratings-based approach and is therefore in line with the Basel Committee's mission statement of providing banks with incentives for continuous improvement in their risk management. Yet, with a view to the streamlined solutions for the data history under

⁷ The Bundesverband deutscher Banken does not subscribe to such a wide-ranging scope for derogations with regard to the consistent use of the selected approach in the calculation of capital requirements. The Bundesverband deutscher Banken is of the opinion that – with the exception of the authorised exemption for "immaterial portfolios", a permanent exemption of material asset classes from the IRB approach would be profoundly at odds with the objective of a regulatory capital requirement that is more strongly geared towards the actual risks as well as in strong contradiction to a level playing field as far as competition is concerned. In the case of those portfolios suggested for exemption (sovereigns, banks), risk weights of internal ratings regularly tend to be lower than those used under the standardised approach. A "growing into" more complex prudential supervision approaches will only warrant the – authorised – transitional application of the partial use.

the IRB foundation and under the retail approach, there need to be safeguards in order to prevent that the data requirements increase during the transitional period.

Furthermore, after adoption of the New Capital Accord, the transitional provisions should safeguard that banks will be capable of using any of the approaches at the point of the Accord's first-time application. In order to achieve this, it is required that the transitional provisions be expanded to cover also the estimates of LGD and EAD under the advanced IRB approach.

We reject the minimum LGD of 10% for private residential property loans envisaged under the provisions contained in paragraph 235. Particularly in the case of loans which have already been largely repaid and which are collateralised by residential real estate, there is evidence which suggests a 0% LGD. This is an area where no losses have been recorded. The risk for these credits would be significantly overstated through the envisaged minimum LGD.

C. Rules for corporate, sovereign and bank exposures

(i) Formula for derivation of risk weights (paragraphs 240 – 241)

The agreed maturity adjustments calculated on the basis of the 'mark to market' method, clearly overstate the impact of the maturity. The calculation of the maturity add-ons were performed on the basis of a model where the parameters had been set by the US supervisor. It can easily be demonstrated that the maturity adjustment would be significantly lower in the event of a different parameter setting.⁸

The envisaged capital requirement for expected losses is equally unwarranted from the point of view of risks. In the opinion of the ZKA, the expected loss is invariably covered through FMI (future margin income). Therefore, for said losses, it is possible to dispense with a regulatory capital requirement and the risk weight curves – in all IRB approaches – may be calibrated to the unexpected loss.

However, even if the Basel Committee made the recognition of FMI contingent upon the bank's proof that the FMI shall sufficiently cover the expected losses, then it would only be consistent to make this option available across all portfolios.

(ii) Firm-size adjustment for small and medium-sized companies (SME) (paragraphs 242 – 243)

The ZKA welcomes the Basel Committee's proposal to make the capital requirement for corporate exposures under the IRB approach dependent upon corporate size. Even when there is an identical probability of default, from the point of view of risks, lower capital requirements for loans to smaller companies are justified, since a smaller borrower's

⁸ Kalkbrener, Michael/Overbeck, Ludger, The maturity effect on credit risk capital, in: Risk, Vol. 15, No. 7, London, July 2002, pp. 59-63.

probability of default primarily hinges on the individual properties of these borrowers and not so much on the economic cycle.

Yet, in order to prevent jumps in the capital requirements and thus distortions of competition between banks treating loans to SMEs under the corporate resp. the retail scheme, the link between capital requirement and corporate size should become a criterion for all companies. This means particularly that companies with a turnover of less than EUR5m p.a. will become eligible for further capital relief. Due to this, we suggest expanding the firm-size adjustment continuously up to the 'other retail' curve.

The SME curve should also be applicable to credits to natural persons financing residential property with more than a certain number of residential units, the exact quantity of which still needs to be specified by the supervisory authorities; to such cases, the weighting function for corporations with an annual turnover in excess of EUR 50m shall be applicable. We advocate in favour of the application of the SME curve to natural persons in an analogous fashion taking as a basis the annual income of such natural persons.

iii) Risk weights for specialised lending

Risk weights for other SL exposures (paragraphs 244 – 249)

We explicitly welcome the planned inclusion of specialised lending under the corporate exposure class.

The suggested risk weights for those banks which do not meet the minimum requirement for the estimation of probabilities of default for corporate lending under the IRB approach are, however, too high. For instance specialised lending ranked in the category 'weak' should receive a risk weight of 350% whilst under the standardised approach for corporate credits, a maximum weight of 150% is stipulated. Specialised lending with an excellent credit assessment will not be eligible for the 20% risk weight envisaged under the standardised approach for first class corporate loans; similarly, a 50% risk weight will only be possible under the conditions described in paragraph 246.

The proposed high risk weights are unwarranted under risk aspects. On principle, the risk for a specialised lending is not higher than the risk involved in any other form of corporate credits. Furthermore, particularly in the field of specialised lending, banks adopt special risk management measures limiting the risk involved in such financing.

- In the field of specialised lending, banks have far greater influence on the borrower's behaviour than in the case of 'normal' corporate lending. Possible interventions may even include replacing the management.
- Furthermore, such financing can usually draw upon covenants, i.e. special contractual clauses serving as 'early warning indicators', the breach of which provides the bank with comprehensive rights to stave off the possible event of loan loss (termination, subsequent request for additional security etc.).
- The collateral agreement has a risk mitigating impact on the risk level of the entire financing structure. This applies particularly to the field of real estate financing, but

also to asset financing. Such financing transactions feature a high degree of fungibility of the collateral asset, minimising the loss in the event of borrower's default. This applies in particular to finished property for which there is a sufficiently broad market of potential tenants as well as to multi-use commercial property. Vacancies may indeed result in a default of the borrower. Yet, provided that – under the principles of a prudential calculation of the lending value - rental income is imputed at a level which can be achieved on a sustainable basis by any owner with an average level of expertise, it may be assumed that the property can be rented again at any future point in time. On this basis, even in the event of borrower default, there will be no devaluation of the collateral asset. For this reason and according to an almost representative survey on the average for the period between 1988 and 1998, even the real estate exposures which are not granted privileges under the standardised approach feature an expected loss of 0.19%. The same effects apply to the financing of capital goods such as ships and airplanes for which there are sufficiently functioning markets. It is difficult to understand why, for instance, a loan to an airline for the purposes of financing an airplane should feature a lower risk than a respective asset financing of said airplane.

In addition to this, continued adherence to the proposed risk weights would lead to a further competitive disadvantage for banks using the IRB approach for the calculation of the capital requirement when compared to those banks using the modified standardised approach for their entire portfolio. This is due to the fact that banks using the IRB approach need to base their calculations on high risk weights, whilst banks using the modified standardised approach for their entire portfolio may use the lower risk weights even for specialised lending under the corporate exposure class.

We therefore deem it necessary that the risk weights in the category 'strong' be reduced to 50% and that they be reduced to 150% in the category 'weak'. A 20% risk weight should be set for a financing transaction which can be rated in a clearly more positive way than is envisaged for the category 'strong' specified in the Annex 4 classification criteria.

2. Risk components

(i) Probability of default (PD) (paragraph 254)

The proposed floor of 0.03% for the PD is unfounded and must therefore be rejected.

(ii) Loss given default (LGD)

Treatment of impersonal securities in the internal ratings-based approach (paragraph 264)

The different extent to which financial and physical collateral is counted in the calculation of the risk assets appears problematic. This leads to clear discrepancies in the capital relief effect of impersonal security on the one hand and financial security on the other hand. Whilst in the case of financial securities, provided there is a sufficiently high degree of

collateralisation, banks can reduce their capital requirements virtually to nil, the scope for relief is a priori limited in the case of impersonal securities. This is particularly unjustified in the case of real estate liens. Both types of collaterals are assets in which the bank – in the case of default in payment – has a right of sale. Therefore, depending on the degree of over-collateralisation, also for impersonal security, the supervisory fixing of a 0% LGD ratio should be permissible.

(iv) Effective maturity (M) (paragraph 288 – 295)

The suggested maturity regime creates disadvantages for those banks which have to carry out an explicit maturity adjustment in the area of repo-style transactions with an initial maturity of more than three months. Whilst for such transactions in the case of an implicit treatment of the maturity, a generic effective maturity of 6 months is imputed, banks taking the maturity into account explicitly shall apply a minimum maturity of one year. This is primarily due to the fact that the application of the ‘carve outs’ for the one year floor with regard to the effective residual maturity shall only be possible if the exempted exposure features an original maturity of less than three months. Instead, we therefore suggest tying a maturity carve-out (paragraph 291) to compliance with the conditions of an effective maturity of less than one year.

D. Rules for retail exposures (loans to retail customers in the broadest sense)

1. Risk weighting of assets for retail exposures

(i) Residential mortgage exposures (private residential property loans) (paragraph 298)

The Basel Committee’s plans for the introduction of a separate risk weighting function for private residential property loans under the IRB retail approach not only adds to the complexity of the IRB but also lacks risk-sensitivity. The higher risk weights for residential property loans to private individuals mainly result from the imputed higher asset correlation. In the view of the ZKA, such a distinction is unwarranted since, on principle, the customers behind the exposures of the individual subportfolios tend to be identical. On these grounds, the risk weight function for ‘Other Retail’ exposures should be applied to private residential property loans, too.

(ii) Qualifying revolving retail exposures (paragraphs 299 – 300)

From the point of view of risks, the envisaged treatment of future margin income (FMI) is equally unwarranted. In our view, the expected loss is invariably covered through FMI. It is therefore possible to dispense with the regulatory capital requirement for these losses and the risk weight curves – in all IRB approaches – may be calibrated to the unexpected loss.

In each case, even if the Basel Committee should decide to make recognition of the FMI contingent upon proof by the banks that the FMI will cover all expected losses, then it would only be consistent to apply this across all portfolios and not exclusively to the retail approach. The proposed differential treatment of future margin incomes in the various retail sub-portfolios, where a respective proof is only possible for revolving exposures, lacks any objective explanation and would thus unduly discriminate against non-revolving credits.

2. Risk components

(i) Probability of default (PD) and loss given default (LGD) (paragraph 302)

There are no plans to provide an IRB foundation approach with regard to the retail area. We believe this to be inaccurate and that it lacks justification. Also for this area, in order to promote the transition to the IRB approach in general, an exclusively PD-based approach should be allowed. As in the IRB foundation approach for the corporate customer segment, we equally suggest using an adequate standard LGD for such a foundation approach, too.

E. Rules for equity exposures

1. Risk weighted assets for equity exposures

(ii) PD/LGD approach (paragraphs 321 – 325)

In our view, the envisaged treatment of the equity exposures under the so-called PD/LGD approach overstates the risks of such assets. First, this applies to the 90% LGD suggested for equity investments under the IRB which is inappropriate when compared to the LGD of 45% for unsecured claims on corporates. In lieu of this, due to the comparable risk, under the PD/LGD approach we suggest applying the same LGD as for subordinated loans (i.e. 75%). What is more, we regard the fixing of minimum risk weights as unjustified since this would overstate the risk of investments in commercial entities with excellent credit assessments. The requirement of having to distinguish three different equity exposure types within the approach would become redundant after a drop of the minimum risk weights and it should be eliminated, since it only adds to the complexity of the IRB approach.

H. Minimum requirements for the IRB approach

3. Rating system design

(i) Rating components (paragraphs 358 – 364)

The requirement that there needs to be a special, transaction specific rating component (paragraph 360) should, – in our view, only apply to the advanced IRB approach. Under

the IRB foundation approach the LGD ratio is set by supervisors; therefore, including an additional transaction-specific rating component in this approach would make no sense.

4. Risk rating system operations

(v) Stress tests used in assessment of capital adequacy (paragraphs 396 – 399)

The implementation of stress test procedures ties up a considerable amount of the bank's resources. Since the rating procedures are approved by supervisors, we feel that there is no compelling need to make stress-test procedures available as early as during the first application of the internal ratings-based approach. Transitional periods for the implementation of the requested stress-test procedures should therefore be allowed.

According to the provisions of paragraph 398, banks should consider the transitions of the assessments of external rating agencies when implementing stress tests. In order to achieve this, the banks' ratings classes should match those of the agencies. In view of the fact that the internal rating systems' definition of default will frequently be different from that of the external rating agencies and due to the fact that the given rating categories of external rating agencies do not have to be a benchmark for banks' rating categories, this requirement might – in practice – lead to considerable problems. It should, therefore, be eliminated.

5. Corporate governance and oversight

(i) Corporate governance (paragraphs 400 – 402)

With a view to the required supervision of the board of directors and senior management, there should be clarification that the approval of material aspects of the rating and PD estimation process by the board of directors and senior management should be limited to overrides, new measures or changes that are the equivalent of a new measure.

It should be borne in mind, when determining the frequency of reporting on the risk profile by rating grade, by migration across grades, by quantification of loss estimates per grade and in any comparison of realised default rates against expectations, that changes in banks' loan portfolios take place more slowly than in their trading portfolios.

7. Risk quantification

(ii) Definition of default (paragraph 414 – 419)

In order to prevent banks from overstating their risks when applying the default definition in the internal rating approach and in order to safeguard feasibility thereof – particularly within banking groups – the following issues of the Basel proposals are in urgent need of revision:

- The default definition should be applied at the level of individual borrowers. Under the Basel requirements, default of any group institution will lead to a corresponding rating change for the other group institutions. Hereby, the risk correlations within the group are adequately taken into account.
- The default definition should be applied at the level of the stand-alone bank. An application at group level would potentially lead to a clear overstatement of the actual risk. Customers who - as far as their liabilities to one group institution are concerned - meet one of the default criteria, do not necessarily have to have defaulted in terms of the liabilities *vis-à-vis* the parent company or *vis-à-vis* other subsidiaries. In addition to this, group-wide application would imply the need for group-wide supervision of each individual customer of the group, resulting in a significant increase in the administrative burden that would be unwarranted under risk aspects.
- For feasibility reasons, the application of the suggested indicators for low likelihood of repayment should, on principle, be left to the banks' discretion. A binding stipulation would require substantial adjustments on the part of many banks, potentially endangering the first-time application of the internal rating approach once the new Basel Capital Accord comes into effect.
- With a view to the envisaged period of default (90 days past due) we suggest introducing a relative floor, below which the customer shall not be regarded as having defaulted. The introduction of such a kind of materiality threshold should prevent those cases, for instance, where customers engaged in an active credit relation with a bank suddenly fail to service a minor exposure (e.g. a rental payment guarantee) and will automatically be treated as if they had defaulted. More specifically, we suggest that customers shall only be regarded as having defaulted if they have defaulted on at least 5% of the outstanding exposures or if their late payments amount to more than EUR 50,000.

Yet, for exposures to sovereigns, the nominal threshold is clearly too low. On feasibility grounds, exclusively and limited to this segment, we therefore suggest the application of the relative threshold in this instance.

This materiality threshold should also be applied to the time at which the default event was triggered 'renunciation to the ongoing charging of interest'.

- We furthermore, suggest dropping the default criterion 'sale of credit exposures with a significant loss motivated by credit assessment', since this default criterion is associated with a host of problems.

First, distinguishing between losses driven by credit assessments and losses driven by other parameters is encumbered with significant problems. Apart from hinging on individual credit assessments, the market value of a loan/bond is also contingent upon the general interest rate level, the market's liquidity situation as well as on the general structure of the loan spread for different credit assessment categories. Accordingly, there is a danger that this default criterion will frequently indicate an event of default although the affected borrower – economically speaking – has not defaulted (no insolvency, no excessive debt)/is not threatened in his existence.

Furthermore, it does not appear appropriate to regard a customer, whose credit is sold at a loss due to the respective credit assessment, as having defaulted. An example will illustrate this point: A bank extends a loan to a company with an AAA rating. This loan is extended at fair value i.e. LIBOR + 20 bps with a 5 year maturity, meaning that the credit's market value at the time of the loan decision is in line with the book value. In the meantime, the borrower is downgraded to A (average spread = 60 bps). Due to the exposure's long maturity, the market value responds very strongly and ends up at 94% (duration effect). For IRB purposes, all of the borrower's exposures would qualify for default, although – unless a sale takes place – it would not even be necessary to set up provisions.

Ultimately, during/after the sale of a loan exposure – also and particularly during rescue operations – there would anyway have to be a reassessment of the remaining exposure, so that the mere instance of selling an exposure at a loss driven by credit assessment does not prejudge the future rating and treatment of said exposure.

(iv) Treatment of overdrafts (paragraph 421)

The default criteria for overdrafts need to be accompanied by the introduction of an adequate materiality threshold. In our view, the introduction of a floor is particularly meaningful for accounts where no credit facility has been approved. In the case of such accounts, minor overdrafts are frequently tolerated on the grounds of cost/benefit considerations; sometimes this toleration may even last for an extended period of time without immediate action being taken in order to collect the outstanding amount or similar proceedings. If the default criterion for overdrafts was rigorously applied, then Customers who overdraw their accounts by one cent for a period of 90 days would have to be regarded as defaulted. We propose the introduction of an absolute materiality threshold of EUR 5.000.

This materiality threshold should also be applied to the time at which the default was triggered 'waiver to charge ongoing interest'.

(vii) Requirements specific to own-LGD estimates (paragraph 430 – 435)

The Basel Committee holds the view that internal LGD estimates should be based on a minimum data observation period of seven years. This would mean higher data history requirements for LGD estimates than for PD estimates. There is no economic justification for this and it also lacks an explanation in terms of the inherent model theory⁹. It is, therefore, urgently required to adapt the minimum history necessary for the estimation of LGD to that period required for the estimates of the probabilities of default

⁹ During periods of low macro-economic performance there will be a higher incidence of defaults. The data points for the LGD determination will thus cluster around 'stress' times. Thus, longer observation periods than under the PD would be warranted.

As, generally speaking, hardly any banks will already have the data samples of the required duration at hand, the requested minimum data history of seven years would also greatly reduce the number of banks able to use the advanced approach.

For the same reason, the transition period allowed for estimation of PD, applicable across all approaches should be applied to the estimation of LGD in the advanced IRB approach as well.

The requirement to use the 'economic' loss and not the loss recording in accounting records may impose a considerable extra burden on banks that would not be justified by any new, meaningful insight. The respective definition of default and loss should therefore be brought into line with existing accounting standards. For the same reason, the requirement that banks should be able to compare the economic loss and the loss recorded in accounting records must also be rejected.

In addition to this, using average values over a credit cycle for an estimation of LGD is not in every case useful, since other risk factors such as e.g. changes in insolvency law/improvement of internal loan processing ('workout') are likely to have a significantly stronger impact on the LGD level. Also with regard to LGD estimates, there is the concern that rigid regulatory provisions would hinder the continuous improvement of internal rating systems. Furthermore, where the LGDs are subject to stronger gyrations in the course of the economic cycle, banks have to prove the appropriateness of their LGD estimates within the framework of the validation. One further requirement which should be abandoned completely, is that the bank should use the LGD of an economic downturn for loans. Particularly with regard to the field of SMEs, the Basel proposals stipulate that, in an event of identical PD, the capital requirements be made contingent upon corporate size (SME component). These proposals have been made against the background that smaller companies regularly tend to be subject to a lower endemic risk and that such risk is less likely to be affected by fluctuations in the economic cycle. Instead, the specific risk of such exposures is to a larger extent determined by individual factors. This results in lower 'risks of contagion' to other companies. This is – at least in part – reflected by the risk weight formula for a variable structuring of the asset correlation.

If credits where the LGD estimation is subject to certain economic gyrations had to additionally apply a so-called stress LGD, then this would lead to the unjustified effect that, without any obvious reason, their susceptibility to cyclical influences would be considered twofold.

(viii) Requirements specific to own-EAD estimates (paragraph 436 – 441)

The minimum data observation period for estimating EAD has been fixed at seven years. Thus, in terms of the data history, the requirements that have been fixed concerning the EAD estimates are higher than those which have been fixed with a view to the probabilities of default. There is no sound business case for this, nor is it warranted by the underlying model theory. It is therefore urgently required to adapt the minimum history for the estimation of EAD to that term stipulated for the estimates of probabilities of default (i.e. five years).

Furthermore, initially there will be hardly any banks that will already have the data periods of the necessary duration at hand, that will be required for such analyses. For this reason, the transition period allowed for the estimation of PD in all approaches should be applied to the estimation of EAD in the advanced IRB approach as well. With a view to the shaping of the transitional period we should like to draw attention to our comments with regard to paragraph 233 ff.

As EAD is a secondary risk parameter, this parameter should also be eligible for random statistical sampling.

8. Validation of internal estimates (paragraphs 463 – 468)

To ensure adequacy of an internal rating system in the course of time, the assignment of PDs to rating grades needs to be reviewed on a regular basis. There are various methods for validation of the adequacy of the internal rating system.

The results of validation methods must be assessed against the background of the segment that needs to be rated, the available population and the chosen definition of default. To allow an assessment of the ability of ratings with regard to risk differentiation, validation methods must therefore accurately reflect circumstances specific to individual banks and customer groups. Any supervisory straitjacket should be avoided. Especially counter-productive would be rigid cut-offs that may not be under- or overshoot in validation (e.g. for the size of the Gini coefficient).

The general requirements for the use of ‘other quantitative validation tools’ should be dropped. Yet, banks should be allowed to use such techniques as an alternative to the back-tests described in paragraph 664. Since it is in their own interests, banks will, in any case, try to use that validation method that is suited to both their own needs and the nature and complexity of their rating system.

9. Supervisory LGD and EAD estimates

(i) Definition of eligible commercial real estate (CRE) and residential real estate (RRE) (paragraphs 470 - 471)

The requirements, under which the CRE and the RRE may only be recognised as collateral if the borrower’s risk is not materially dependent upon the performance of the underlying real estate or of the project, should be deleted. A collateral can only develop a risk mitigating effect if it can be realised by the lender within an appropriate window of time generating proceeds that exceed the realisation costs. Here it is, however, immaterial if the borrower can only service the loan from the proceeds of the asset or from other sources; at most, this factor will play a role in the calculation of the borrower’s probability of default. The value of the asset and thus also the value of the collateral will not be affected by this factor.

(ii) Operational requirements for eligible commercial real estate/residential real estate 472 – 473)

In our view, the operational requirements with regard to the eligibility of residential and commercial real estate exposures are largely appropriate. In order to prevent misunderstandings, in paragraph 472, 2nd indent, consistent use should be made of the term ‘objective market value’ and the term ‘fair value’ should be deleted. Our understanding of paragraph 472, 3rd indent is, that the valuation report may also be prepared by a qualified in-house expert.

An appropriate insurance policy covering the building against any kind of conceivable damage or deterioration (paragraph 473, 2nd indent) will not be possible at all or only possible at prohibitive insurance premiums. An insurance policy covering standard risks such as damage caused by fire, storm and mains water, should be sufficient.

10. Requirements for recognition of leasing (paragraph 486 f.)

Under the provisions of paragraph 487, 2nd upstroke, banks have to count the leasing asset’s residual value estimated at the beginning of a lease period with a 100% risk weight, provided the bank assumes the risk for a loss in an event where the market value will ultimately be below the residual value of the leasing asset.

In our view, this requirement is inappropriate and should be eliminated. A bank’s acceptance of the ‘open’ residual value (i.e. without a right to tender performance) does not have any influence on the value of the leasing asset. On the contrary, an open residual value is accepted exclusively in the case of leasing assets with a particularly stable value. Furthermore, by charging conservative haircuts, potential value losses of the leasing asset are already appropriately taken into account. For instance, in the event of real estate leasing, the residual values of the financing transaction are clearly below the real estate lending level. Repayment of the asset’s residual value is safeguarded in any case. A capital requirement would, therefore, not be in line with the actual risks.

In order to promote an economically meaningful risk reflection, banks furthermore strive for an integrated view of leasing transactions, i.e. only an overall probability of default is estimated for a given transaction. Apart from the credit assessment of the lessee/of any potential intermediate leasing entity (e.g. an SPE), the estimate of the overall probability of default also takes account of the open residual value. In order to prevent double recording and provided that the bank applies a respective procedure, no additional explicit consideration of the residual value should be required.

12. Disclosure requirements (paragraph 500)

In order to become eligible for the IRB approach, banks must meet the disclosure requirements set out under Pillar 3. If they fail to meet these requirements, they will be ineligible for the IRB approach. We definitely reject these eligibility criteria. It should

suffice if banks explicitly demonstrate to supervisors that their rating system is adequate and suitable. For further details, note our remarks on Pillar 3 – Market discipline.

IV. Credit Risk – Securitization Framework

B Definitions

2. General terminology

(v) Implicit Support (paragraph 513)

The definition of ‘implicit support’ appears too far-reaching, particularly with a view to the harsh sanctions listed under the Second Pillar. First, supervisors should only sanction those supports which qualify as ‘material’ under forthcoming materiality criteria. Accordingly, only that support should lead to supervisory action where an economic assessment reaches the conclusion that such support has significantly impaired the risk transference (in line with the aforementioned criteria, cf. our comments on paragraph 516). Furthermore, only those support measures should qualify as ‘implicit support’ that have been fully and knowingly granted by the bank.

C. Operational requirements for the recognition of risk transference

1. Operational requirements for traditional securitizations (paragraph 516)

The requirement under 516 (a) according to which a significant portion of the credit risks regarding securitized exposures must have been transferred to third parties, should be deleted. The decision as to which portions of a securitization transaction the securitizing bank keeps for itself and which portions are passed on to third parties, constitutes an important corporate decision and should, therefore, be exclusively left to the discretion of the securitizing bank. The minimum capital requirement for retained securitization exposure guarantees that a sufficient degree of loan loss reserves is set up for such exposures.

We also refer to our comments on the more comprehensive requirements proposed under the Second Pillar regarding the significance of the risk transference (notably paragraph 740).

Under (e) it is pointed out, that the transferor’s retention of servicing rights to the transferred credit risk exposures will ‘not necessarily’ constitute indirect control of the exposures.

In our view, this paragraph should be worded in a less ambiguous way, clarifying that the servicing rights to the exposures ‘*per se*’ do not constitute an indirect control of the exposures.

Both, for traditional and synthetic securitizations, the servicing rights to the exposure held by the originator constitute a fundamental element; against this backdrop, the wording used in the draft provides an inappropriate scope for interpretation.

2. Operational requirements for synthetic securitizations (paragraph 517)

In order to prevent redundancies/disadvantages that cannot be justified from an economic viewpoint, the qualitative requirements regarding synthetic securitizations should generally be further harmonised with the qualitative requirements for credit derivatives (cf. criteria under the standardised approach).

The ABS framework distinguishes between cases where a guarantee/credit derivative (a) is used within the framework of the synthetic securitization transaction (e.g. as a tranching credit derivative) or (b) used in order to protect securitization exposures. In this context, different criteria are stipulated so that – as opposed to case (b) - the scope of the protection providers in case (a) is narrowed down (e.g. concerning legal persons with a minimum rating of A-). From the point of view of risk-sensitivity, this is difficult to comprehend. First, the risk of guarantor default is already reflected by the corresponding risk weight assigned to the guaranteed portion of the exposure. Second, and this is motivated by their own vested interests, banks already subject the guarantor's risk to a comprehensive review. On these grounds, this unequal treatment should be abandoned.

As has already been pointed out with regard to traditional securitizations, we reject the requirement according to which a significant portion of the credit risks regarding securitized exposures must have been transferred to third parties. For this reason, paragraph 517 (d) should be eliminated as well.

Under the provisions of paragraph 517 (e), first upstroke, clauses which significantly limit the credit protection or the credit risk transference, shall not be permissible. Yet, in the case of quality criteria for credit derivatives, there is a different regime again for the use of materiality thresholds. We therefore request a harmonisation of these provisions and explicitly refer to our separate comment on paragraph 167.

3. Operational requirements and treatment of clean-up calls (paragraphs 518-520)

We believe that the heading and the conception of this section (paragraphs 518-520) is too narrow, since all termination options (clean-up call, time call, regulatory call) have to be treated with a view to risk aspects. Otherwise, a presentation of capital market risk transference from certain pools of exposure will not be possible.

In addition to this, a limitation only to clean-up calls is also inconsistent with the provisions contained in paragraphs 749—751, 753. For a regulation of the permissibility of the various termination options, explicit reference should be made to the provisions contained in paragraphs 749-751, 753.

Accordingly, paragraph 518-520 should also contain time call and regulatory call, in addition to clean-up call. Paragraph 518 (3) should stipulate a differentiated regime for the three following termination options:

- Clean-up call: The earliest point at which it may be exercised is when only 10% or less remains of the initial value of the underlying exposures or of the reference portfolio value.
- Time call: The provision contained in paragraph 753 should be applied together with the requested forthcoming specification of the average effective maturity.
- Regulatory call: exercising of calls prompted by regulatory or other sovereign measures need to meet the requirements contained in paragraph 751.

In paragraph 518 (2), the loss shall be limited to a ‘material loss’. Otherwise, also minor amounts could potentially limit the right to exercise a call; this is an effect that cannot be within the regulators’ intention. We would therefore ask for a more specific wording.

D. Treatment of securitization exposures

1. Minimum capital requirements (paragraph 521)

At this juncture, we should once more like to underline our key request that, under the new provisions, the capital requirements of all banks involved in the transaction must, systematically not be higher than those capital requirements which would result if the exposures were not securitized. Under the SFA approach, this request is not met, because the capital requirement calculated by means of the supervisory formula exceeds K_{IRB} (and thereby also EL and UL). An increase of the systemic capital requirements through a securitization transaction cannot be justified in terms of methodology since the securitization exercise itself is not associated with an increased credit exposure.

The fact that, to date, there have been no reliable studies into the expected impact of the Basel proposals with regard to systemic capital requirements, is a matter of particular concern in this context. In our view it is therefore of paramount importance that the outcome of the Third Quantitative Impact Study (QIS 3) on the area of securitization of exposures be disclosed as soon as possible. Should this not be possible, then the supervisory authorities should at least publish sample calculations for representative portfolios (e.g. building finance, SME lending, larger corporate loans or credit card receivables) as well as structures (synthetic, traditional and early amortisation securitizations).

In addition to this, there are several instances where the current proposals, depending on the selected approach or function of the bank in the securitization transaction – lead to different capital requirements with regard to securitization exposures with identical risks. This would create strong incentives for regulatory arbitrage. We describe this below in greater detail.

(ii) Implicit Support (paragraph 524)

As has been noted earlier (cf. comments on paragraph 513), we view the sanctions on implicit support as generally too harsh. Banks should only be under the binding obligation to deduct the securitized exposure as unsecuritized assets if, in the last analysis and after an economic assessment, the support is actually found to have had a significantly limiting impact on risk transference (cf. our remarks on verifying such materiality in paragraph 513). In the case of a one-off non-compliance, we do not think that a publication would be justified. Here, supervisory treatment of the individual bank should suffice.

2. Operational requirements for use of external credit assessments

Under the provisions contained in (b), contrary to the standardised approach, external ratings shall not be recognised whenever such ratings are only accessible for banks in the home country and banks abroad with legitimate interests, or, moreover, may only be accessible under similar conditions. With a view to the fact that, on the one hand, an external rating agency will only be recognised by the supervisor if it meets certain quality criteria and furthermore, owing to the fact that there are no grounds to believe that a rating will be of a lower quality if its access is limited exclusively to a certain target group, then, with regard to the rating, no requirements should be stipulated which exceed those requirements contained in paragraph 61. Therefore, the requirement contained under (b) should be deleted.

In our view, paragraph 525 stipulates contradictory requirements in (d) and (e). Given the fact that it is easier for the bank to handle if, in the case of several ratings for one tranche, it may use that rating which corresponds to the higher risk weight, and since the described approach is also commensurate with industry practice, (d) should be eliminated.

3. Standardised approach for securitization exposures

(ii) Risk weights (paragraphs 527-530)

The existing discrepancies in the approaches for investors and originators as well as between the standardised approach and IRB approaches, still leave significant scope for arbitrage. The respective capital requirements share external/derived ratings as a common basis. In line with the principle 'same risk, same regulation' and given the absence of economic differentiation possibilities, there should hence also be a mandatory rule stipulating identical capital requirements for identical risks (cf. also our comments on paragraph 585).

The Basel Committee suggests that a 350% risk weight may be chosen by investors holding a 'subinvestment grade' securitization exposure (BB+ to BB-), whilst originators would have to deduct such positions from their capital. The associated unequal treatment of investors and originators is not justified from the point of view of risks. The tranche has

the same risk, regardless who holds this position. Therefore, identical external ratings for securitization exposures should lead to identical capital requirements for originators and investors alike. The envisaged unequal treatment additionally incurs the danger of regulatory arbitrage. In order to become eligible for the same preferential capital treatment as investors, originators could swap their 'subinvestment grade' tranches amongst themselves.

Furthermore, we would like to point out that a rating between BB+ and BB- would not justify deductions from capital because this would clearly overstate the risk.

Furthermore, so as to ensure that no bank will have to provide more equity after securitization than before securitization, an upper limit of regulatory capital requirements should be guaranteed for originators and investors, as is also the case under the internal ratings-based approach. In line with the provisions on the internal ratings-based approach, this may be designed in such a way that for those originators and investors who are capable of determining their capital requirement *ex-ante*, i.e. prior to securitization, said capital requirement may be taken as a cap.

(iii) Exceptions to general treatment of unrated securitization exposures (paragraph 531-536)

Paragraph 535 should focus not on the facility, but more generally on the securitization exposure. Furthermore, an adequate risk reflection would require not the maximum risk weight but the average risk weight.

(iv) Credit conversion factors for off-balance sheet exposures (paragraph 537-541)

The quality test set out in paragraph 538 (b) should be premised on the definition of default under the internal ratings-based approach (paragraph 414 ff.). Note that the default definitions used in the securitization transactions are not necessarily identical with the Basel definition of default. The default definition for exposures in the framework of customer transactions (bank as a sponsor) is rathermore geared towards the specific characteristics of the transaction (e.g. short-term trade receivables) and the customer-related collection processes. In conjunction with the rating agencies, for instance, a specific time limit for overdue exposures is defined. This may significantly deviate from the 90-day rule of the Basel default definition. Therefore, the Basel default definition, as an element of the criterion set out in paragraph 538 (b) for customer transactions, is a requirement that cannot always be met. We hence suggest supplementing the reference to paragraph 414-419 with an opt-out clause in the event of transaction-specific deviations with regard to the default definition.

Furthermore, with a view to the analysis of potential credit enhancement components, there is an overlapping of the minimum requirements for 'recognised liquidity facilities'. The respective requirements contained in criteria 538 (a) and (b) are redundant.

Criterion (a) already verifies the absence of credit enhancement components ('no use for losses which have already occurred'). It should be left to the bank's discretion to decide how this objective is to be met, i.e. whether via the asset quality test or via a suitable definition of the borrowing base. An additional requirement with a view to the asset quality test is, therefore, dispensable/not applicable in the case of liquidity facilities which are not structured as an asset purchase agreement.

Requirement (c) is methodologically inconsistent. The criteria proposed in paragraph 538 serve the purposes of a quality assessment of the liquidity facility and thus help establish the credit conversion factor. However, the drawing probability of the liquidity facility as a prime determinant for CCF is not contingent upon the residual credit enhancement level. The trigger reasons for a liquidity facility, in our view, are not geared to the credit enhancement level. A reduction of the credit enhancement level would rathermore indicate a significant deterioration of the pool quality and thus would either lead to an early termination of the structure or – as has already been requested under criterion (e) – to a termination of the liquidity facility. The seniority of the availment should thus not have an impact on the CCF but on the risk weight. In terms of the methodology, this has already been taken into adequate account. For instance in the SFA, credit enhancements that have been largely exhausted give rise to a significant increase in capital requirement. We therefore suggest deleting criterion (c).

Concerning criterion (e), we note that the qualification 'in the event of default' is confusing. In the version of the 2nd Working Paper, the reduction or the termination of the credit facility was tied to pool quality. The new wording is ambiguous. We would appreciate an amendment or note clarifying the motivation for this language. We refer to our earlier remarks with regard to the suitability of a reference to the general Basel definition of default.

Furthermore, we note that the treatment of liquidity facilities is inconsistent with the hierarchy of the ABS approaches. Whilst for 'recognised liquidity facilities (for disturbances of the market)' an optional use of the RBA is envisaged, such use becomes mandatory in the event of 'other liquidity facilities'. Furthermore, the 'fall back approach' is not available for 'other liquidity facilities', yet it is available for 'recognised liquidity facilities (for disturbances of the market)'. One further example for inconsistencies is the treatment of derived ratings, which is not applied in an even manner across the various categories of liquidity facilities. This unequal treatment, in our view, should either be revised in terms of content or have to be explained in greater detail.

(v) Recognition of credit risk mitigants (paragraphs 542-549)

In our view, contrary to the provisions contained in paragraph 545, it should be permissible to accept special purpose entities (SPEs) as guarantors if their creditworthiness has been proven beyond any doubt.

With a view to the treatment of maturity mismatches (paragraphs 548-549) we refer to our comments concerning paragraph 172-174.

4. Internal ratings-based approach for securitization exposures

(i) Scope of application (paragraph 567-569)

The provision contained in paragraph 568 discriminates against originators compared with investors and should therefore be rejected. It needs to be safeguarded that also the originator shall be entitled to opt for an RBA.

(ii) Definition of K_{IRB} (paragraph 570-574)

In the new Consultative Paper, the scope of application for the top-down approach has been narrowed down to the role of liquidity provider (paragraph 574). This exclusion of all other potential securitization exposures of a bank is too restrictive. Whenever KIRB for the sponsor cannot be derived in a bottom-up fashion, this would have an impact on all other risk positions of a bank within the framework of customer transactions: for instance derivative transactions (swap counterparty) mezzanine financing as well as credit enhancements would then invariably be affected by a deduction from capital. In our view, there is no sound business case for such an outcome and for such an inconsistency under the ABS regulatory framework. As a result, we request that the top-down approach's scope of application be expanded to include all relevant securitization exposures.

Furthermore, application of the top-down approach is, for instance, made contingent on proof that applying the bottom-up approach would result in being 'unduly burdensome' (paragraph 574). This criterion hardly appears practicable, neither is it envisaged under the Basel II segment 'purchased receivables'.

For customer transactions (bank as a sponsor), application of the top-down approach is frequently the only meaningful/viable option in order to quantify portfolio risk. Use of the bottom-up approach may, for instance, not be possible due to data protection issues or because there may be a prohibitively high number of (from the point of view of the sponsor) non-customers for trade receivables. Exceptions on the grounds of undue burdens will become the rule. Therefore, the top-down approach for customer transactions (bank as sponsor) should be allowed, provided there is compliance with the listed minimum requirements, and it should not be made contingent upon the subjective assessment of an 'undue burden'.

In the present draft versions, it remains unclear as to which extent also retail portfolios will require supervisory approval. If - by way of a derogation from the Basel II segment 'purchased receivables' - an explicit, mandatory approval was also planned for retail portfolios, then we reject such plans.

Furthermore, we should like to point out that in the case of customer transactions, the generic one year horizon of the expected loss assessment under the top-down approach may lead to inconsistent results under the SFA. This is due to the fact that rating agencies determine the loss horizon on the basis of the asset portfolio's maturity (worst case weighting of the permissible maturity bands) which they then take to determine the credit

enhancement level necessary for the target rating. This results in a transaction structure's expected loss period which – depending on the underlying exposure – may considerably deviate from the regulatory one year horizon (e.g. in the case of trade receivables such period will be much shorter). Based on the short maturity, the rating agency then establishes the necessary credit enhancement level for the target rating. This results in inconsistencies between KIRB and SFA waterfall, since the latter is geared towards the credit enhancement level required by the rating agencies. In the case of the extremely short default horizons for securitisations of commodity trade financing, for instance, this may result in a considerable increase in capital costs (high KIRB in relation to the existing credit enhancements). We, therefore, suggest publication of the corresponding international ABS QIS 3 results and to adjust the existing generic requirements currently contained in the top-down approach. In our view, this may take place in the form of a rescaling of the applicable credit enhancements aimed at establishing comparability on the basis of a one year observation period.

(iii) Hierarchy of approaches (paragraph 575-579)

The suggested hierarchy of approaches creates a disadvantage for originators which is not warranted through any different degree of risk. Whilst, regardless of the approach that has to be chosen (RBA or SF), originators have to deduct from capital those retained or repurchased positions with a credit enhancement and volume level of less or equal value than KIRB, investors shall be entitled to use the ratings-based approach for these positions, too. In this respect, in order to prevent regulatory arbitrage, a 'level playing field' would have to be established.

(v) Ratings based approach (RBA) (paragraphs 581 – 588)

Within the framework of ratings-based approaches, banks should use the external ratings of these positions for the risk weights of the securitization exposures under the internal rating approach. Clearly higher capital requirements should apply for sub-investment grade tranches than for corporate debt securities with the same rating. The proposed unequal treatment is unwarranted under risk aspects. Therefore, the risk weights of securitization exposures should be geared towards the risk weights under the modified standardised approach envisaged for those exposures on which the securitization is based. A gearing towards the risk weights under the standardised approach would additionally solve problems currently resulting from the different risk weights between the internal ratings-based approach and the standardised approach. Whilst for tranches with a weak rating (BB or less), the internal ratings-based approach generates clearly higher capital requirements than the standardised approach, particularly with a view to the risk weights for securitisations of high-granularity pools, the internal ratings-based approach is more favourable for tranches with a very good rating. This may lead to a transfer of high-risk tranches from developed to less developed banks and vice versa, which is an effect that cannot possibly be welcomed by supervisors.

With regard to the computing of N for the purposes of determining RBA risk weight, please note the definition contained in paragraph 596. Yet, under the RBA, the simplified method for computing N contained in paragraph 599 will not be available. The exact computing of N requires a major information effort which, we feel, will frequently not be feasible for, e.g., the investor and which, as a consequence, often leads to the adoption of RBA calculations in lieu of SFA. In terms of the methodology, there are no obvious reasons for this unequal treatment; after all, the simplified SFA calculation frequently constitutes the only possibility for the calculation of N. We therefore request that the simplified computing of N be made available under the RBA as well.

(vi) Supervisory Formula (SF) (paragraph 589-609)

The 'floor' under the SFA approach still appears inadequate. It uses a 0.015% value which is comparable to the PD and it uses a 45% LGD for most senior positions in securitization transactions. Contrary to this, under the advanced IRB approach for corporate exposures, there is no minimum LGD. Since they are based on a minimum PD of 0.03%, this leads to a 'floor' of a limited number of basis points for such positions. The securitization of such positions would thus generate a significantly higher minimum capital requirement, without being justified by corresponding higher risks. The floor should therefore be reduced.

Exposure-weighted, average LGD (paragraph 597)

With regard to paragraph 597, we should like to point out that we think that the proposed 100% LGD for resecuritization appears too high. The fact that lower LGDs should be possible, is also reflected in the presumed LGDs contained in footnote 4 of the 'Working Paper on the Treatment of Asset Securitizations; October 2001' (e.g. 80% for a Ba3 rating). We therefore request that this LGD may always be used in those cases where the bank is capable of independently computing this LGD. If a determination of the LGD is not possible, then a 75% LGD should be taken (this is in line with the LGD for subordinate, uncollateralised credits under the IRB foundation approach).

Liquidity facilities (paragraph 600-603)

We welcome the fact that, along with the bottom-up and the top-down approach, banks now also have a third method to choose from in order to determine KIRB (paragraph 603). Yet, the use of this method should be a permanent option and should be exclusively left to the bank's discretion.

Recognition of credit risk mitigants (paragraphs 605)

For RBA and SFA, the same requirements should apply as for the recognition of the credit mitigant approaches. It is particularly difficult to understand why, under the RBA approach, it should not be possible to use the guarantor's risk weight determined in line with the IRB approach. When a guarantee is furnished for a securitization position, then the presence of the ratings, the granularity and the seniority of the position are not relevant

for such an undertaking. What will be relevant, is the quality of the guarantor as well as the bank's permission and capacity to determine the risk weight under the IRB approach. Paragraph 605 only contains a brief reference to the fact that the methods applied under the SFA are similar to the RBA methods; only the annex clarifies that the IRB approach is, for instance, used to determine the guarantors' risk weights. In order to prevent any potential doubts, this information should absolutely be included in the main document.

With a view to the methodological inconsistencies contained under the entire Basel II derivatives regime (e.g. components of credit equivalence amount, maximum function, treatment of collateral), we refer to our comment on paragraphs 1 – 143, 149 – 152, 157 – 158 and 160 – 164. These inconsistencies have now also been transferred to the securitization approach (paragraph 595).

V. Operational risk

Generally

- Banks are expected to move along the spectrum of approved methods as they develop more sophisticated opRisk measurement systems and practices. The implementation of new systems and practices creates high investment costs.

The capital relief promised by the Basel Committee with regard to the transition to a more complex method is still not ensured. The capital requirements under the basic indicator and under the standardised approach continue to be calibrated to an average of 12% of regulatory total capital. The extremely high quality requirements with a view to the standardised approach are thus only offset by capital savings if the institution's transactions are concentrated on business lines that are particularly low-risk. To date, there is also still no guarantee for incentives with regard to a transition to an AMA. Currently, estimates of the level of regulatory OpRisk capital resulting from an AMA are hardly possible; based on income situation, the simple approaches generate extremely volatile comparative requirements.

In order to secure an efficient incentive structure, we suggest limiting – at least for a transitional period - the capital requirement under the AMA to 80% of the capital requirement under the standardised approach whilst the capital requirement under the standardised approach should be limited to 80% of the capital requirement under the basic indicator approach. The appropriate level/the necessity of the cap could be reviewed after a 2-year transition period. Where the transition to the standardised approach is concerned, as an alternative, it may be worth considering fixing the highest beta factor at the level of alpha.

- What appears problematic, is that transactions within a banking group can increase gross income and, therefore, will also generate a higher OpRisk capital requirement (basis indicator adjustment, standardised approach) whilst the underlying operational risk will not have changed at all in such instances. This applies to transactions such as

transaction settlement or consultancy. In order to prevent double counting, the definition of 'gross income' should only take into consideration external transactions. However, for reasons of simple data transmission, banks should also be able to determine gross income inclusive of internal transactions.

- Particularly for banks which are internationally active, there is an urgent need for mutual recognition of prudential supervision decisions.
- The proposed provisions contain a number of terms that are not clearly defined. In order to facilitate one standard interpretation and a shared understanding, we suggest preparing a 'glossary of operational risk terms' containing an explanation of the individual terms which shall be attached to the final Accord. Proposals for definitions which may serve as a basis for such an annex, will be attached to this letter of comments as attachment 2.

General remarks

B The measurement methodologies

1. Basic indicator approach (paragraph 612-615)

Under the proposed regulatory framework, gross income shall be, on principle, calculated by national supervisors or, respectively, in line with international accounting practices. Yet, with regard to those items that should not be covered, it says that 'it is intended' to calculate gross income gross of any provisions/reserves, that such gross income shall exclude realised profits/losses from the sale of securities in the banking book, that it shall exclude realised profits/losses from securities which have been classified as 'held to maturity' and 'available for sale' and that it shall exclude extraordinary or irregular items as well as income derived from insurance. It is our understanding that gross income will not have to be subsequently adjusted for the costs of claims cases, especially since it is unclear which is the right approach in this area (book value, replacement value etc.).

In addition, on practical grounds, it must be possible to adopt that gross income directly which is reported in P & L statements prepared on the basis of nationally uniform accounting rules.

2. Standardised approach (paragraph 615-617)

Beta factors, at most, can serve as a rough proxy of the risk for individual business lines and should therefore be regarded as preliminary. In the regulatory text, the Basel Committee should provide clarification that, once more data becomes available, the determination of betas will be put on a sound and transparent footing as far as the methodology is concerned and that it shall be subject to regular reviews.

C. Minimum conditions

1. General requirements (paragraph 620-623)

The inclusion of scenario analyses, bank-specific business environment and internal control factors mentioned as a quality criterion is not always helpful in estimating unexpected losses. In order to prevent distortions and statistical errors, it may make sense to deliberately renounce the use of one or several of these methods. Therefore, banks need to be granted the necessary discretion in this respect.

2. Standardised approach (paragraph 624-625)

Paragraph 624 a) (and similarly in 626 a)), there should be clarification saying that the 'operational risk management function' does not necessarily have to be an organisational entity.

In paragraph 624 b), the wording that has been contained up to now, should be kept, i.e. that loss data collection needs to be initiated as opposed to 'the bank must track'. In addition to this, it must be clarified whether the terms 'framework' and 'system' shall be used synonymously.

3. Ambitious measurement approaches (AMA) (paragraph 626)

(i) Qualitative requirements:

In terms of their content, we feel that the requirements in paragraph 626 are largely identical with the qualification criteria for the standardised approach (624). Yet, when compared to paragraph 624 we notice a slight change in the wording. If the wording was changed in order to reflect material differences, then clarification would be helpful. Otherwise we suggest including a cross-reference to paragraph 624 in paragraph 626 and to only postulate those AMA criteria that have to be met on top of the qualifying criteria for the standardised approach. Knowing that the opRisk management elements fixed for the standardised approach will also meet the supervisory requirements in the context of an AMA, would give the bank more certainty and allow them to plan ahead.

(ii) Quantitative requirements (paragraph 627-636)

a) AMA soundness standards (paragraphs 627-628)

It remains unclear, in which way banks should demonstrate that their approach is equivalent to a one year holding period and that it features a 99.9% confidence interval and also captures the 'tail' loss events. In order to receive a clearer picture of such implementation, we would appreciate examples.

(b) Detailed criteria

Paragraph 629 c) stipulates that the granularity of the risk measurement system must be safeguarded in order to take account of all influence parameters that are relevant for the shape of the 'tail' of the loss distribution. This requirement is unclear. We would appreciate an appropriate specification.

In paragraph 629 d) it is clarified that, for the purposes of calculating regulatory minimum capital, the risk measures of different operational risk estimates must be added. The use of different estimations for OpRisk primarily takes place in the context of a 'partial use' of supervisory approaches. Therefore, a clarification should be included in paragraph 629 d), line one, that '... the risk measures of different operational risk estimates' ... 'may' be added (e.g. within the framework of a partial use)'.

In determining operational risk, the use of correlations – provided that there is approval of the national supervisor – should be permissible. There need to be safeguards against an unequal treatment resulting from different degrees of rigour in the application of this provision at the national level within the various countries.

(c) Internal data

The mapping of the loss events (paragraph 633, first upstroke) to the Basel business lines and risk categories (binding on the basis of documented, objective criteria) shall exclusively serve the purposes of prudential supervision. Since this is not associated with any management benefit, an according mapping exercise should not be stipulated as a binding requirement.

The capturing of OpRisk induced loan losses remains a prerequisite for AMA recognition (paragraph 633, last upstroke).

From the point of view of business management and in line with the overall concept, it would make sense to aim for an analytical separation and for an event-based categorisation of loss from credit risk and operational risk. Yet, a consistent loss categorisation is far from being straightforward, particularly in those loss events that can be attributed to more than one risk factor.

Against this background, we request that the Basel Committee develops uniform methods and clear guidelines for the identification/categorisation of losses resulting from operational risk in the credit risk area. The banking industry would welcome the opportunity to cooperate in this undertaking.

Furthermore, there needs to be clarification that the bank may fix appropriate internal 'de minimis thresholds' below which credit losses do not have to be investigated with a view to the potential impact of operational risks.

Contrary to the 'Technical Guidance' (TG 613, last upstroke), paragraph 633 no longer contains any reference to trading area losses due to operational risks. The Basel Committee should clarify that OpRisk induced market risk losses shall also be subject to the capital requirement for operational risks (AMA calibration/AMA validation).

(iii) Risk mitigation (paragraphs 637-639)

Recognition of insurance coverage across all approaches is called for, in order to create efficient incentives for a reduction of operational risks. Whenever the efficiency of an insurance product has been demonstrated then there is no reason for exclusive recognition under the AMA. EU based Basel banks need comprehensive recognition of insurance policies also with a view to avoiding competitive disadvantages *vis-à-vis* EU banks that are not engaged in international transactions. In the course of the European implementation process of Basel II, the EU Commission plans to stipulate on a binding basis the recognition of insurance policies across all OpRisk measurement approaches.

The fact that consideration of insurance services should be limited to 20% is difficult to comprehend. In our view, a 20% haircut would be completely sufficient here, i.e. for the purposes of risk mitigation, insurance policies should be counted at 80%. Both, the high quality requirements with regard to eligible insurance coverage as well as the potentially applicable haircuts would warrant such an approach.

Amongst other prerequisites, one eligibility criterion for recognition of the risk mitigating impact of insurance policies' is that the insurance coverage must be explicitly mapped to actual operational risk loss exposure of the institution (opRisk loss exposure) (638, 5th upstroke).

This requirement is unclear. The provision, as we understand it, was based on the fact that insurance of certain assets (e.g. buildings) or of certain events may only be recognised for risk mitigating purposes up to the level of the actual operational risk which exists for this asset/event meaning that, in the case of over-insurance, the excess portion of the insurance cannot be counted towards other operational risks. It is recommended that the Basel Committee provides a clarification of this point.

Due to the ongoing evolution of capital market instruments, the Basel Committee should provide a derogation clause in order to allow flexibility with a view to the future recognition of other mitigation products.

D. Partial Use (paragraph 640 – 641)

One prerequisite for partial use of an AMA shall be, for instance, that at the point of the AMA's first-time application a material portion of a bank's operational risks is captured through the AMA (640, 3rd upstroke).

We recommend deleting this requirement. It is at odds with the Basel Committee's intention to allow banks to gradually grow into the complex supervisory procedures. If the other eligibility criteria for an AMA are met, then, in our view, partial use cannot be revoked again on the basis that this AMA cannot be applied throughout. A similar request is made with regard to the credit risk area.

International banking groups, in particular, meet a huge challenge when faced with the consolidated use of an AMA. A transitional partial use should therefore be possible for a

minimum 10-year period after Basel II comes into effect. A pragmatic approach with regard to the requested plan for the roll-out of the AMA to all legal units and business lines appears equally necessary. Changes to the organisational structure or to the business structure (e.g. by way of new acquisitions) need to be accommodated in a flexible manner and – whenever necessary – must even warrant abandonment or a change of plan.

Immaterial business lines and/or legal units of a banking group must be exempted from the AMA on a permanent basis (paragraph 640, 4th upstroke). For a group-wide application of an AMA, the fixing of an adequate materiality threshold is of pivotal importance. Whenever the aggregate volume of all of the bank/banking group's areas exempted from the application of the AMA approach - with a view to a forthcoming reference parameter that will still need to be defined in consultation with the supervisory authorities - regularly accounts for no more than 30% of the group's aggregate volume, a permanent partial use shall become an option for certain parts of a bank's operations/units which need to be appropriately and more closely defined in consultation with the supervisors. Potential cases where this level is exceeded would have to be assessed by the supervisor on a case-by-case basis.

Annexes 6 and 7

According to footnote 155, last section, the definition of gross income should not include operating expenses, i.e. these shall not be deducted in a calculation of the gross amount.

This requirement is unclear. We would appreciate a supplementary explanation of this matter¹⁰.

VI. Trading book issues

A. Definition of the trading book (paragraphs 642-647)

The terms 'trading book' and 'financial instruments' are defined in paragraph 642-647. In this context, it is our understanding that the tried and tested definition of the 1996 Basel market risk addendum/of the corresponding European standards will not be materially affected by this.

Provided that the Basel Committee sees a need for adjustment with regard to these issues, this will require an in-depth discussion not under the framework of Basel II, but within the framework of a separate initiative.

B. Treatment of counterparty credit risk in the trading book (paragraph 660-664)

Under the provisions contained in paragraph 660, the bank shall apply the respective procedure used in the banking book in order to establish capital requirements for counterparty risks from trading book transactions. In line with the regime stipulated in the current accord, this appears appropriate, on principle, because e.g. the time horizon for counterparty risks is not based on the assignment to different books, but on the actual maturity and particularly on the contractual provisions. However, at this point, we would

¹⁰ Comparable for instance to the definition of gross income in the survey on QIS- III, table 4.

like to once more reiterate our key requests for the treatment of derivative exposures, i.e. in particular:

- comprehensive and consistent presentation of the methods for deduction from capital under the standardised approach, foundation approach, IRB approach and advanced IRB approach,
- consistent treatment of derivative exposure and exposure from repo-/lending transactions (particularly concerning the VaR approach),
- specific admission of promising, sophisticated processes.

This issue is of key importance due to the QIS 3 findings, where capital market transactions have proven to be the third most important driver for an increase in capital requirements. In this context, we refer to our more detailed comments in earlier sections of this paper.

Part 3: The second Pillar – the supervisory review process

B. Four key principles of the supervisory review (paragraphs 683-718)

Principle 3 of the supervisory review process stipulates that supervisors shall be entitled to require banks to hold capital in excess of the minimum capital requirement. At this point we would like to point out once more that a bank's capital adequacy is generally safeguarded through the regulatory minimum capital requirement. This is particularly true given the further enhanced risk-sensitivity of the forthcoming provisions.

If the supervisory review process reveals that an institution's risk management is inadequate, then it would be sensible to directly address the identified root causes by means of supervisory measures. Therefore supervisors should primarily seek to address these shortcomings by way of qualitative provisions in a dialogue with the institution's management.

Contrary to this, increased capital adequacy requirements fail to directly address the identified root causes of the shortcomings and hence are not a constructive tool for remedial action. They also – at least in the short term – fail to address the institution's risk position. What is worse still: Particularly for an institution which finds itself in a precarious situation, any increase in equity capital requirements would add to its predicament since it may be forced to raise new capital at short notice. Therefore, additional capital adequacy requirements only present themselves as a means of last resort for sanctioning purposes which should only be adopted if, in the long run, the institution fails to remedy identified shortcomings in its risk management.

Along with the more fundamental problems which have been outlined earlier, bank-specific capital requirements would also be at odds with the objective of a level playing field because national supervisors are allowed national discretion in fixing capital additions.

The presentations in paragraph 692 only base credit risk monitoring on the bank's internal rating system. The possibility of a 'partial use' is completely ignored; this applies in particular with regard to the requirement that the rating system must provide detailed

observations across all exposures. In line with our earlier request (paragraph 225), the provisions contained in paragraph 692 should also be geared to a potential 'partial use'.

The wording contained in the first sentence of paragraph 693 is very broad. The credit risk analysis should adequately identify any weaknesses at the portfolio level, including any risk concentrations. Such wide-ranging wording would have as a consequence, that any bank would have to have a complex risk model, which – according to the Basel Committee – is currently not available and therefore cannot be recognised as an instrument for capital requirement purposes. Under the provisions of this paragraph, the credit risk analysis would also have to review whether each respective counterparty's banking supervisor complies with the 'Core Principles of Effective Banking Supervision'. In order to facilitate banks' compliance with this requirement, banking supervisors should publish an appropriate list.

C. Specific issues to be addressed under the supervisory review process (paragraph 719 – 755)

Paragraph 720, final sentence, still allows national supervisors to establish a mandatory minimum capital requirement where they consider that there is sufficient homogeneity within their banking populations regarding the internal methods for measuring risk. The final sentence of paragraph 630 should be deleted, as otherwise there is the danger of unequal treatment because of different prudential requirements in different countries. Above all, it is to be feared that, as a result, particularly more advanced markets and banks will be put at a disadvantage in that they will develop risk measurement methods which are basically similar in concept. The present-value methods in particular, by means of which the interest rate risk in the banking book is to be quantified and managed, are basically identical in concept. If banks have to fear that the enhancement of systems for management and supervision of interest rate risk in the banking book in the direction of homogeneous structures may lead to national banking supervisors then raising the capital requirements for this risk area, disincentives for system enhancement will ultimately be set.

The Basel Committee still sticks to its 'outlier approach' in connection with the treatment of interest rate risk in the banking book. The Committee intends to assume that an outlier exists where a parallel shift in the yield curve by 200 basis points would reduce liable capital by 20% or more. We should once more like to reiterate that the Basel Committee's proposal to base its decision on whether there is an outlier situation on the occurrence of a parallel shift in the yield curve by 200 basis points is excessively restrictive, especially given the fact that the Basel Committee plans to consider the parallel shift in the yield curve by 200 basis points into both directions thus expanding the scope on which its decision is based to 400 basis points. First sample surveys of banks have shown that if such a crash scenario were taken as a basis a not insignificant number of banks would have to be classified as outliers. This would mean that the basic approach of providing for capital requirements only for extreme losses would be reversed into its opposite. To avoid this consequence, the definition urgently needs correcting. In lieu of a parallel shift in the

yield curve by 200 basis points, we suggest focusing on a parallel shift in the yield curve by 100 basis points¹¹.

Credit risk

Stress tests under the IRB (paragraph 724)

As is widely known, under the First Pillar, banks should carry out credit risk stress tests as a minimum eligibility requirement for the use of internal rating approaches that are recognised by the supervisor. The objective should be to assess the impact of 'certain conditions' on capital requirements under the IRB. Under the Second Pillar, the Basel Committee additionally plans to stipulate that banks must have sufficient capital not only to meet the (additional) capital requirements under Pillar I but also those capital requirements resulting from the credit risk stress tests. We strongly reject this requirement.

Generally, in our view, regulatory minimum requirements give an adequate reflection of the bank's credit risks. Furthermore, regulatory capital requirements shall only apply to 'normal cases'. Collateralisation of the 'worst case' scenario would lead to a drastic overstatement of the institutions' true risks.

In addition to this, we would like to point out that, already under the First Pillar, potentially negative developments during the measurement of risk weights need to be taken into consideration. A borrower rating must represent the bank's assessment of the borrower's ability and willingness to contractually perform despite adverse economic conditions or the occurrence of unexpected events (paragraph 376). The backing of stress scenarios would thus lead to double counting.

Last but not least, a capital requirement that was not geared to the bank's real risk might engender mismanagement of risks.

Furthermore, due to bank's ample room for discretion with a view to the shape of stress tests but also due to the supervisor's scope for interpretation, the fixing of prudential capital requirements on the basis of internally performed stress tests incurs the danger of considerable competitive distortions.

Securitization

Significance of risk transference (paragraph 739 – 741)

As has already been pointed out in our comment letter concerning Pillar One (paragraph 516 (a) as well as 517 (d)), we object to the supervisory request according to which the securitizing bank needs to transfer a significant part of the credit risk concerning the securitized exposures to third parties. Through the minimum capital requirements for

¹¹ This would also be in line with the German Audit Report Regulations on imputable interest rate shocks.

retained securitization exposures, a sufficient degree of risk provision with regard to these items is safeguarded.

This applies in particular to the requirement set out in paragraph 740, under which also a significant portion of the notional value of the securitization portfolio needs to be transferred to third parties. We also reject the requirement according to which, for the sake of market cultivation, the repurchasing of entire tranches shall not be permissible. There are no obvious reasons why a partial return of a tranche should lead to a fundamentally different treatment of the entire transaction than would be the case in an event where the entire tranche was returned.

Paragraph 739 stipulates that supervisory authorities may regulate a higher capital requirement than that envisaged under Pillar 1. This provision is associated with a considerable scope for interpretation and thereby incurs potential for competitive distortions; in turn, this may lead to a further systemic increase of capital requirements.

Residual risk (paragraph 748)

With a view to the residual risk review mentioned under 748, the provision's scope of application is not sufficiently specified. We would therefore welcome a specification/supplementary explanation of its objective.

Call provisions (paragraph 749-753)

In paragraph 751, the term 'explicit incentive' should be specified, since an 'explicit incentive' shall only exist in those cases where, already at the point at which securitization takes place, reliable forecasts predict that a waiver to exercise the call will lead to considerable economic damage for the originator.

In paragraph 751, first indent, loss should be limited to 'material loss', because otherwise even minor sums would prevent the right to exercise the call, which would be at odds with the regulator's intention.

Under the provisions contained in paragraph 752, - depending on certain criteria - supervisors shall have the right to commit the bank (in an event where a time call is exercised) to a follow-up securitization. This is an objectionable interference with the bank's corporate policy, which ultimately should be regarded as highly doubtful also with regard to its feasibility on the capital market. We therefore request deleting paragraph 752.

In paragraph 753, there should be a supplement after the first sentence: The maturity for the underlying exposure will be identical with that period after which neither the lender nor the borrower may end the financing transaction without any compensation claims.

We also refer to our comments regarding paragraphs 518-520.

Part 4: The Third Pillar – Market discipline

A. General considerations (paragraph 757-768)

Pillar 3 of the present Consultation Paper in our view constitutes an important corollary tool for capital requirements and therefore for enhancing market discipline. After studying this paper, we noticed that individual provisions (e.g. with regard to credit risks under the IRB approach) are based to a lesser degree on case-based reasoning but moreover on abstract provisions meaning that, on the whole, the new provisions are more flexible than previous Pillar 3 papers. We welcome this shift, since this move takes account of the changing business environment and the heterogeneous structures of the individual credit institutions. A close analysis of the individual disclosure obligations has revealed, however, that a large part of the comments made in previous ZKA statements to the German supervisor and towards the Basel Committee have either not been reflected at all in the present Consultative Paper or are only reflected to an insufficient degree. At this juncture, we therefore see the need to reiterate once more arguments from earlier ZKA comment letters.

On principle, we note that the scope of the disclosure obligations continues to generate an information overkill for the target group; information is provided which is at odds with the principle of intelligibility and clarity. Ultimately this even becomes an obstacle with regard to transparency. It is therefore our firm conviction that a further reduction of the disclosure obligations in terms of content is absolutely vital.

Furthermore, the disclosure requirements continue to tie the use of lower risk weights/the use of collateral as well as certain national scope for discretion – e.g. under the internal ratings-based approach – to certain disclosure obligations (cf. paragraphs 757-761). There is no sound business case for any such correlation. Content regulation should precede any publication; yet, in this case, the cause-and-effect correlation is turned upside down. Hence we strongly oppose any such package-deal. The disclosure obligation stipulated in these provisions should instead be replaced by a reporting note explaining that the bank's approach/model has been reviewed by the supervisor with regard to conservatism and investor protection aspects and has been officially approved.

We explicitly welcome the stipulation of the principle of materiality. In our understanding, the institution considers and decides as duty bound which information needs to be disclosed in order to facilitate the investor's decision-making process. A similar kind of discretion would also be favourable concerning the extent to which sensitive and confidential information needs to be disclosed. This should be clarified by way of a respective wording ('a bank should decide...') in paragraph 768. We recommend including a clause which may be worded as a should provision (a bank should decide ...) under item 11. Under these circumstances, when discussing the degree of data aggregation for disclosure purposes for instance for smaller subportfolios, we recommend that particular attention be paid to the issue of breach of trust/i.e. the German term 'protection of confidence'. Under no circumstances should the envisaged new obligation to provide a

general description or explanation of the circumstances that lead to the non-publication of certain information impair the protection of confidence. In the event of low overall aggregation of individual information, such a kind of obligation might come at the cost of relinquishing the envisaged protection area for sensitive data. In order to avoid misunderstandings, we therefore recommend changing the wording to include a phrase clarifying that the mandatory justification for non-disclosure of certain data is subject to the principle of 'protection of confidence'.

We welcome the provisions contained in paragraph 769 and 764, which leave it to corporate discretion to decide on the most suitable publication medium with which to meet the disclosure obligations under Pillar 3. In order to prevent unnecessary duplication of work, it would be suitable to use the business report, respectively the prospectus for this purpose. The business report could thus include a condensed and comprehensible overall presentation of the corporate risk position which would simultaneously provide the mandatory information to be disclosed under the Third Pillar. Further and more in-depth information could remain the domain of special publications, e.g. prospectuses.

We welcome the fact that the consistency of the Pillar III disclosure obligations with international accounting standards has been explicitly enshrined as a principle. Here, we feel it is necessary that the disclosures will also be based on homogenous consolidation rules, measurement principles and nomenclature. The International Accounting Standards Board (IASB) together with the Financial Activities Advisory Committee (FAAC) is currently inter alia reviewing the disclosure obligations concerning risks associated with financial instruments. Against this backdrop, we feel it is necessary that the Basel Committee designs its disclosure provisions in a manner flexible enough to allow potential adjustments with regard to forthcoming IASB standards, i.e. of that board which provides the standard benchmarks in this field.

Already in their early stage, the disclosure obligations for the field of asset securitization feature the flexibility necessary to meet the constant changes and structural adjustments that are permanently going on in the field of asset-backed transactions. We welcome this fact. Yet, the Consultative Paper still contains an excessive amount of detailed regulations, such as, for instance, the requested break-down according to structure and type of securitized assets. We regard the latter as too comprehensive. In order to keep business reports as user-friendly as possible, the information on asset-backed transactions in business reports should be provided in an aggregated format (e.g. overall volume, retained tranches/volumes, type and number of transactions). Detailed information regarding individual transaction structures is generally contained in the 'Offering Circular' or 'Investor Report'. These documents are accessible to anyone or, moreover, can be requested by anyone. Particularly in the case of institutions with comprehensive asset-backed transactions, compiling the entire data of given transactions in the form of business reports would lead to extremely bloated and costly reporting.

Last but not least, in order to cater to the changing business environment and to new practical experience, we would like to suggest that the Basel Committee subject the Pillar 3 disclosure obligations to regular review.

B. Disclosure obligations

We would like to raise following points with regard to the qualitative and quantitative requirements concerning disclosure:

2. Scope of application

Table 1

Second qualitative requirement (b):

It remains unclear, whether the requested description should take place at the level of each mentioned sub-group or at the level of each individual, stand-alone bank. From our point of view, a short description at the level of each individual bank would become unmanageable. It may be possible to provide this data in the form of a list of equity investments.

Companies which are neither consolidated nor deducted from capital, play a secondary role from the point of view of risk weights. Therefore, we feel that the fifth sub-requirement (e) is dispensable and should be deleted.

Third qualitative requirement (c):

This requirement should be deleted, or should be clearly confined to material obstacles/material cases; it is recommended to add explanations thereto. Furthermore, in the event of a broad interpretation, the scope of business reports would become unmanageable. As far as capital is concerned, this requirement would not yield very meaningful information since – at the consolidated level - the subsidiary's separate components of equity provided by the parent company are not counted towards the capital item (i.e. at group level this will be neutral in terms of capital). From the point of view of liquidity, the funding decision needs to take into account existing constraints with regard to the transferability of financial assets.

Second quantitative requirement (e):

By definition, subsidiaries that are not consolidated under the provisions of the German banking supervision act do not carry out any banking transactions nor do they carry out any banking related business. Hence, in this case there should generally be no obligation for quantitative disclosures concerning capital adequacy. Furthermore, subsidiaries that are not consolidated shall not be subsumed under the financing sector; this circumstance gives rise to the question on which basis regulatory capital should be determined.

Third quantitative requirement (f):

Ultimately, for a comparison of the quantitative impact of different options (i.e. the difference between that method which is used and any other, potentially available methods), a parallel calculation of the various methods will become necessary. This appears too far-reaching.

3. Capital

Table 3

Fifth quantitative requirement (f), second upstroke: for significant bank subsidiaries:

For these institutions it should be sufficient to enter a note clarifying that they meet the national requirements in terms of capital adequacy. We do not deem it necessary to disclose quantitative information (e.g. ratios) and for certain group constellations (e.g. holding structures) we do not even regard such data as meaningful.

4. Risk exposure and assessment

Table 4

First quantitative requirement (b):

We think that the duplicate information of both, values at reporting date and mean values, is redundant because risk assessments will only be based on the values at reporting date and not on mean values. We therefore welcome the new footnote 119 according to which it may not be necessary to disclose the mean aggregate volume, if the period-end values are representative of the bank's risk exposures.

Note: Not even international institutions perform the daily averaging out on a consolidated basis mentioned in footnote 120, which is an exercise that would involve a considerable amount of extra resources.

Fifth and sixth quantitative requirement (f) and (g):

In the context of regions and industries or counterparties, we still view the disclosure obligation of the 'past due/impaired loans' with great concern, since customer identities might be derived under such an approach. If the capital market were to revise its expectations for a given industry due to reports of high value adjustments, then such a kind of disclosure might have a negative impact on the entire national economy.

On the other hand, we welcome the fact that the information on ‘days overdue’ is no longer a binding requirement but instead comes in the form of a recommendation (cf. also fn. 124).

Table 5

Qualitative requirements (a), third upstroke: a description of the process:

A description of the detailed transfer method of public issue ratings to banking book positions should not become subject to mandatory disclosure. A notice saying whether or not public issue ratings were used, should suffice.

Quantitative requirement (b), first and second upstroke:

We feel that giving information on each risk weight would be too detailed. Here, the creation of rating blocks, e.g. investment grade and non-investment grade, should be allowed.

Table 6

We would like to point out that the qualitative requirements in this section cover information that is potentially competition-sensitive. Therefore, we recommend to limit this requirement to the need to provide a general description of structures and processes. Each bank should have full freedom to disclose more detailed descriptions as such bank sees fit.

Third qualitative requirement (c):

We recommend confining the disclosure obligation at this juncture to a general description of the internal rating process. Plans to introduce an obligation for a detailed presentation of the valuation and validation approach behind PD, LGD and EAD should be abandoned. The methodological approach as well as the results from the validation of the entire internal rating system should be exempt from disclosure, too. This information is already collated in the context of the regulatory supervision process and is reviewed by the regulator for these purposes. The current policy is also sufficient as far as investor protection is concerned so that, at this point, a detailed disclosure obligation can be dispensed with. We should also like to point out that this information can be regarded as highly competitive (e.g. information on the method, validation/validation results). In addition to this, a break-down of the information into subportfolios would make for excessively convoluted reporting.

2nd quantitative requirement: risk assessment (e):

The mandatory information still features an excessive amount of detail and will not prove very intelligible for users of financial information who will find it hard to judge this information on an objective basis, so that the convoluted format might lead to mispremised interpretations. We continue to advocate for the disclosure of aggregate sums which we deem sufficient in this context. A more detailed list per PD class should remain exclusively reserved for the regulator under Pillar 2 regime.

Note: An external rating issued by an entity (e.g. Standard & Poors) should reflect a bank's risk exposure and its risk-carrying capacity in an objective manner and investors may widely draw upon such ratings as a decision making tool for investment decisions/the underlying credit assessments.

Third and fourth quantitative requirement: historical results (f) und (g):

We welcome the fact that, as opposed to previous publications, the disclosure obligation on verifications and backtesting in the present Consultative Document has been shaped in a more flexible manner and that less sums/ratios (e.g. EAD results per EAD band etc.) have to be disclosed. We also see it as a positive development that the disclosure of a comparison between PD estimates (resp. LGD and EAD estimates) and the actual rates of default shall be left to the banks' discretion ('where appropriate, banks should...'). Yet, we still regard the binding disclosure of quantitative information on 'historical results' within the framework of Pillar 3 as too far-reaching. The target group's prime source of information consists in the prudential supervision authority's seal of approval providing such users of financial information (in a meaningful manner) with data on the quality of the backtesting model. Furthermore, scientific preparation and penetration of the issue of backtesting within the framework of address risk measurement by way of internal models is only just in its fledgling stages. Therefore, for the foreseeable future, only qualitative data ought to be provided. We would also like to point out that any inconsistencies between the actual backtesting results and the forecasts are largely attributable to economic cycles.

Table 7

Qualitative requirement: (a) first upstroke: differentiation.

In practice, it will frequently not be possible to arrive at a clear-cut distinction between holdings where capital gains are expected and holdings which were established with a view to other objectives. Furthermore, this might constitute competitive information. This requirement should, therefore, be dropped.

Qualitative requirements (a), second upstroke: discussion of important...:

The national and international standard setters shall be responsible for the disclosure requirements mentioned hereunder.

First quantitative requirement (b):

In our mind this disclosure is dispensable.

Reason: Whenever there are public listings for shares then the fair market value – provided there are liquid markets – is reflected through these listings. Apart from this, there is no other scientifically sound and at the same time practicable model to establish the fair market values for illiquid positions.

In these cases, the disclosure becomes irrelevant given the major importance that attaches to lasting or long-term equity finance for small and medium sized companies through banks.

Third and fourth quantitative requirement (d) and (e):

Through the disclosure of the required information, banks with a less comprehensive equity finance volume could, unwittingly, allow inference with regard to individual transactions/customers. Therefore, each bank should have freedom to make a duty-bound decision on the degrees of disclosure as such bank sees fit.

Table 8

Footnote 142 should be dropped completely (cf. also our comments on paragraphs 757-761).

Qualitative requirement (a):

The requested qualitative provisions for credit risk mitigation contain information on strategies, approaches and degree of risk concentrations. This data is sensitive competition data and should not become subject to the disclosure obligation.

First and second quantitative requirement (b) and (c):

On competition grounds, the quantitative disclosure does not appear opportune and fails to deliver any additional insight or benefit. The reader of a balance sheet will not take an interest in whether compliance with the regulatory capital requirements is safeguarded

through the management of original exposures or through the use of collateral recognised by the supervisor. Readers will base their decision exclusively on the bank's net position.

Table 9

Generally, we would like to note that a breakdown based on type and structure of the securitized exposures appears too wide. In this context we refer to our earlier, general comments.

First qualitative requirement (a):

Disclosure of the scope of the investment should only be limited to a general description. More detailed information may contain competition-sensitive information and should be avoided.

First quantitative requirement (d):

The requirement contained in footnote 146 should be changed into 'that the bank shall not retain any material risks deriving from the securitization'. In practice, it may repeatedly be the case that for instance the seller will have to repurchase receivables because they fail to meet the eligibility criteria for the sold portfolio.

Fourth quantitative requirement (g):

A breakdown of the aggregate amount of the retained or purchased securitized receivables into a meaningful number of risk weight bands appears too far-reaching. A presentation in an aggregated format should suffice.

Sixth quantitative requirement (i):

Information on profit and loss amounts from securitizations should not become subject to disclosure. If the transaction was performed on strategical grounds, an apparent loss from a sale may be favourable for the bank as a whole. In such cases, disclosure may send the wrong signals.

Table 10

First quantitative requirement (b):

Whenever the envisaged quantitative disclosures of the capital requirements for interest risk, share risk, foreign currency risk and commodity risk shall be of secondary importance when compared to the overall ratio under principle I, we advocate for a waiver

of disclosing such information, since divulging such information does not provide the investor with any additional insight that will be relevant for the investment decision.

Table 11

First quantitative requirement: (d) second upstroke: The high, median and low VaR.:

We reject this requirement in its current form.

Reason: For the decision making process, only the deadline dates are relevant. Since they are being published every quarter, the target group already disposes of meaningful information.

Suggestion: A description of backtesting methods could be given under the qualitative disclosures.

First quantitative requirement (d), third upstroke: a comparison of VaR estimates.:

This requirement is dispensable, since historical deviations do not provide any insight with regard to the quality of the applied model. The only information that will be of interest for the target group is that the applied model has been reviewed and approved by the supervisor.

Table 13

The interest rate risk in the banking book is covered under Pillar 2. The requirements envisaged for Pillar 3 should be replaced through disclosure whether the bank, as an outlier, will be subject to special capital requirements.

ANNEX I

Third quantitative impact study on Basel II (QIS 3) Comments

On 5 May 2003, the Basel Committee on Banking Supervision published the final outcome of the Third Impact Study (QIS 3). The Committee's results suggest that the minimum capital requirements resulting under the new Basel Capital Accord are largely compatible with the Committee's objectives. We regard this conclusion as slightly premature due to the considerable variation across individual results and the partial absence of incentives for a transition to more advanced methods of measurement in individual segments as well as due to the qualitative shortcomings of the data material that was used. In the following paragraphs, we shall point out our concerns in greater detail.

One of the new Basel Capital Accord's key objectives is that the capital adequacy framework should enhance risk-sensitivity of regulatory capital requirements and should create incentives in order to implement and fine-tune an effective risk management regime. The QIS findings show, that in individual segments, these objectives cannot be achieved.

The minimum risk requirements which tend to be lower in the standardised approach when compared to more advanced methods of risk measurement, do not only fail to deliver incentives for the development of state-of-the-art risk management solutions, but instead also provide evidence that the respective parameter settings in the internal approaches have been fixed at a level that is too unfavourable. Both, the summary promulgated by the Deutsche Bundesbank of the QIS 3 findings¹² and also the official Basel report¹³, contain several examples for such disincentives. The following table will illustrate the outlined problems in the individual asset classes.

¹² Cf. Deutsche Bundesbank: Ergebnisse der dritten Auswirkungsstudie zu Basel II – Länderbericht Deutschland, 2nd June 2003.

¹³ Cf. Basel Committee on Banking Supervision: Quantitative Impact Study 3 – Overview of Global Results, 5th May 2003; Basel Committee on Banking Supervision: Supplementary Information on QIS 3, 27 May 2003.

Average percentage change of the minimum capital requirements in comparison to the present Accord:

QIS 3 based findings for G10 Group 1 – Banks¹⁴

	Standardised Approach	Foundation IRB Approach	Advanced IRB Approach
Claims on sovereigns	19%	47%	28%
Claims on banks ¹⁵	43%	45%	16%
Qualifying revolving retail exposures	- 14%	- 3%	14%
Equity exposures	6%	115%	114%
Securitization transactions	86%	103%	129%

Furthermore, the Basel Committee for Banking Supervision’s positive assessment of the QIS 3 findings is merely based on average values. In our view, such average values do not sufficiently back the statements that have been made with regard to the quality of the new capital requirements. In our view, the observed immense variation of results – particularly but not limited to the IRB foundation approach – cannot merely explained by differences in the risk portfolios held by individual banks. A differentiated analysis of the variation of the results in the various asset classes demonstrates that those areas in which no material difference is to be expected between individual banks (e.g. the class of mortgage claims¹⁶ still feature considerable variation. In our view, the high degree of variation across the findings highlights problems of a more fundamental nature in the data collation.

Despite banks’ best intentions, the insufficient quality of the used data constitutes one major concern with regard to the reliability of the findings. This is not only due to a lack of available data but also due to a number of working assumptions that need to be made by the bank itself in those cases where there is no clear brief – e.g. with regard to determining the point at which an event of default occurred under the internal ratings-based approach or with regard to the counting of credit risk mitigation methods. Furthermore, lack of transparency in the implementation of the impact study would similarly be open to criticism from regulating banks.

¹⁴ Cf. Basel Committee on Banking Supervision: Quantitative Impact Study 3 – Overview of Global Results, 5 May 2003, pp. 17, 23, 29.

¹⁵ In this asset class, certain discrepancies between the standard and the IRB foundation approach are more pronounced at a national level. For German Group 1 banks, there will be capital increase of 22.6% under the standardised approach and of 68.6% under the IRB foundation approach. Cf. Deutsche Bundesbank: Ergebnisse der dritten Auswirkungsstudie zu Basel II – Länderbericht Deutschland, 2nd June 2003, pp. 20.

¹⁶ In an analysis of the result variations at a national level, the influence parameters created through different national approaches are left unconsidered. For a closer debate of the result variation across German banks cf. Deutsche Bundesbank Ergebnisse der dritten Auswirkungsstudie zu Basel II – Länderbericht Deutschland, 2nd June 2003.

On the whole, a critical analysis comes to the conclusion that the Third Impact Study does not yet provide a sufficient basis for a meaningful assessment of the new Basel Capital Accord. The implementation of further impact studies and a close analysis of the reasons for the huge variation across results are therefore necessary. Key decisions for the processing of the data material that will be fundamental for the quality of forthcoming studies will have to be discussed with the supervisors as soon as possible. Therefore, finalisation of the calibration process – particularly given the incentive problems mentioned earlier – should be kept open.

ANNEX II

**Glossary
of
Operational Risk Terms**

Introduction

A meaningful discussion on the future prudential treatment of operational risk (OR) is only possible on the basis of a common understanding of the terms involved. Both supervisors and the industry are currently trying to establish a uniform operational risk terminology. To support these efforts, the Zentraler Kreditausschuss has compiled the following list of OR-related terms. The terms are grouped in line with the definitions proposed by the Forum for European Discussions on Operational Risk (FEDOR) in December 2001. Our definitions reflect the current status of the discussion. Given the ongoing developments in the area of operational risk management, amendments or additions may therefore be necessary.

Category	Term	Definition
Risk definition	Event type	Standardised loss category treated as one group depending on specific similarities.
	Exposure	The amount at risk faced by the financial bank/business unit.
Risk categories	Business risk	Business risk is the risk of reduced revenues due to an unexpected decline in income from ordinary business operations (most likely from a decline in business volumes caused by business cycles, price pressure or competition).
	Legal risk	The risk stemming from non-compliance with the legal and/or judicial framework due to ignorance, negligent interpretation or handling and/or late adoption. It is a subset of OR. The risk of a changing legal environment or case law does not constitute an OR but a → business risk.
	Reputational Risk	The risk of potential damage to a firm due to deterioration of reputation. This damage results from missed future opportunity, → foregone (future) revenues and customers. Reputational Risk is a secondary risk, which is not a part of Basel II.
	Strategic risk	The risk of → losses or negative impact on a firm's earnings caused by faulty, unprepared or simply misjudged strategic decisions.

Category	Term	Definition
OR features	Cause	The underlying reason(s) giving rise to an OR event.
	Effect (= Impact)	The financial or non-financial result of an OR event.
	Foregone (future) revenue (= Opportunity Costs)	Income that would have been earned in the absence of an OR event.
	Impact	See → Effect
	Loss (= LGE)	The negative → effect on the Bank's physical, financial or immaterial assets by an OR event or a series of OR events. This does not include → foregone (future) revenues nor any investments for preventive action, quality improvement, automation.
	– Direct loss	A → loss which is directly visible and attributable in P&L accounts.
	– Indirect loss	→ Opportunity costs caused by an OR event and → losses which are secondary to → direct losses. .
	– Gross loss	The →loss irrespective of any recoveries (e.g. insurance, cost sharing agreement).
	– Net loss	The → loss after taking into account recoveries/reimbursements etc.
	Loss given event (LGE)	See → loss.
	Near miss	An OR event that potentially could but actually did not result in a → loss.
	Opportunity Costs	See → Foregone (future) revenue
	Residual Risk	The remaining OR that a firm cannot further reduce through (qualitative and quantitative) OR management activities without dropping business activities.

Category	Term	Definition
	Risk profile	The level of OR across a firm's → business line and/or risk categories.
	Risk tolerance	A firm's prioritisation of OR management activities.
Organisation	Business continuity management	A management discipline aimed at ensuring the continuous operation of a firm's essential business and support functions.
	Business line	A combination of similar business activities within a firm.
	– Standard business line	A combination of business activities within a firm defined by the regulators.
	Business line mapping	Mapping of business activities to → Standard business lines.
	Controls (including internal controls)	A measure that reduces the probability and/or the severity of an OR event. This measure can be expressed in policies, standards and procedures.
	OR Committee	A group of OR responsible managers in a firm, that discusses the operational risk issues on a inter-business level and monitors the progress of the implementation of an OR framework and advises or decides on activities to be performed.
	OR Control	An → oversight function and activity to evaluate the level of operational risk in a firm.
	OR Control Culture	Clear lines of responsibility and segregation of duties

Category	Term	Definition
	OR Control Environment	The overall attitude, awareness and actions of directors and management regarding internal controls and their importance in the entity (encompassing the management style, and corporate culture and values shared by all employees), which provides the background against which the various other controls are operated. The control environment can often be referred to also as the Control Culture.
	OR Controlling	See → Oversight function.
	OR Culture	The set of combined influence of individual and group values, attitudes, competencies and patterns of behaviour (e.g. awareness and knowledge through education and training) that determine a firm's commitment to and style of OR management. It influences a firm's operational risk management priorities and decision-making process.
	OR Environment	Term not used in the banking industry. A definition of this term is not necessary in our opinion. A firm's OR Environment is determined by its → OR Culture and its → OR Control Environment.
	OR Guidelines	See → OR Policy.
	OR Management	The sets of activities to reduce, transfer, transform avoid and accept OR, to which a unit/the financial bank is exposed (part of → OR Management Process).
	OR Management Framework	The set of prerequisites that help to introduce an → OR Management Process. The framework consists of organisational standards, management tools, methodologies, systems etc.
	OR Management Process	Consists of: → identification, → assessment, reporting, → management and → monitoring of OR.
	OR Oversight Function	Term not used in the banking industry (see → Oversight function).

Category	Term	Definition
	OR Policy (=OR Guidelines)	An internal document reflecting the internal and regulatory requirements for the implementation of an → OR Management Framework within a firm.
	Oversight Function	The set of activities, which makes OR transparent to allow (senior) management to take decisions and the independent monitoring of the adequacy and the completion of the consequent actions. In addition the Oversight Function is responsible for ensuring consistency of methodologies, policies, systems and procedures. In some firms this set of activities is performed by OR controlling or OR management functions.
Instrument s	Benchmark	A value which is used to compare the situation in the own organisation with the situation in other organisations (external benchmarking) or between organisational units within one organisation (internal benchmarking).
	Best practice	The best known standard for activities in the industry or cross industry wide. Best practice is normally used as a norm in the benchmarking analysis.
	Business Continuity Plan	A plan of action to be followed when an OR event occurs that threatens to disrupt or destroy the continuity of normal business activities and which seeks to restore operational capabilities.
	Disaster Recovery	A plan of action to recover from an unlikely event of a severe business disruption
	Exposure indicator	A measure reflecting the → exposure of the individual firm/business line (used for scaling or relevance adjustments).
	Model	A simplified representation of reality for theoretical and practical analysis.

Category	Term	Definition
	OR Assessment	An assessment of the level of OR to which (a part of) a firm is exposed to (part of → OR Management Process). This assessment can be performed by external or internal experts.
	–Self assessment	An → OR assessment conducted by the responsible staff in the assessed (part/unit of a) firm.
	OR Categorisation	Process to assign OR events to different categories, e.g. <ul style="list-style-type: none"> – → event types (what happened?), – causation categories (why did it happen?), – effect types (where in the bank’s books is it reflected?), – risk types.
	OR Evaluation (=OR Measurement)	Quantification of the → exposure by using an appropriate → model.
	OR Financing	The set of capital market products that help to pay for → losses.
	OR Identification	The process by which a firm discovers what can happen and how it can happen (part of → OR Management Process).
	OR Measurement	See → OR Evaluation
	OR Mitigation	The set of activities which aim for a reduction of OR.
	OR Monitoring	The independent observation of the OR management activities through the → Oversight Function. The OR Monitoring responsibility is part of the → OR management process and should be documented as part of the → OR Policy.

Category	Term	Definition
	OR Strategy	The OR-related part of a firm's strategy in order to achieve the firm's objectives. Components include the → OR Management Framework, roles and responsibilities of the OR management structure, standard policies and methodologies, tools and techniques and information flows to be complied within the firm.
	OR Transfer	The set of insurance products that help to pay for → losses.
	(Key) Performance indicator	A hard fact measured on a regular basis, which indicates the performance of a process or a function. Performance indicators may allow for a trend analysis over time and may trigger escalation procedures.
	(Key) Risk indicator	A hard fact measured on a regular basis, which indicates the operational risk profile of the financial bank. Risk indicators may allow for a trend analysis over time and may trigger escalation procedures.
	Risk Map	A structured overview of the main components of a firm, which will be used as a basis to analyse risks, → losses and problems.
	Size indicator	A measure reflecting the size of the individual firm/business line (used for scaling or relevance adjustments).
Capital	Allocated capital	The capital a firm has allocated to a business unit according to some risk measure and/or other considerations of management.
	Economic capital	The capital which is set aside to cover the risks to which the firm or part of it confidently believes it is exposed.
	Regulatory capital	The capital charge, which is based on the requirements of the supervisors to cover risks.