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Finalising Basel II

BEST IMAGE AVAILABLE

1. Introduction

There can be no doubt of the commitment shown by US regulators to solicit extensive and open dialogue with trade associations, academics and banks with the aim of promoting the integrity of the Accord and ensuring optimal implementation in the US. CSFB is honoured to be able to present our views as part of this process.

Recent developments, particularly the Announcement of the Basel Committee after its Madrid meeting, have restored substantial momentum to the finalisation of the Accord. Focus has shifted to national implementation issues and to meeting the tight timetable which the Committee set for itself in Madrid. At the same time, the Committee demonstrated its willingness to listen to industry comment and, in particular, to agree to revisit certain areas of the Accord which have received heavy criticism.

At this late stage in the process, we believe it is imperative that industry comment such as ours be carefully delineated and constructive. Accordingly, we have focussed on just three key areas where we feel that real improvements can be achieved:

- Asset securitization;
- Relations between home and host supervisors (Home host,, issues);
- Operational risk.

We highlight these issues (as we did in our ANPR comments), not because these areas require a particularly radical re-write but because we believe these areas are both important and amenable to improvement in the short time remaining. In the case of Asset Securitization, we believe that the Basel Committee may be overreacting to industry comment and is now at risk of unnecessarily damaging a valuable element of its own framework. We present an alternative scheme for simplification of the Asset Securitization rules below. In many ways our proposal is less radical than what the Committee has recently proposed, but we feel it could achieve sufficient, practical simplification while still retaining the useful advances embedded in the SFA.

In the case of home host rules, we accept that little definite (e.g. legal) change can be achieved in the timeframe remaining to completion of the Accord. However, we wish to underline once again the absolutely critical place these relations will play when the rules come into force and encourage the Accord Implementation Group to give the banking community as much certainty on the likely outcome of these issues in practice.

Our concerns regarding Operational Risk stem as much industry beliefs as from regulatory views. To a much greater extent than credit and market risks, operational risk is still in the process of being developed into a stable set of concepts that can be used reliably in a consistent capital framework. We remain concerned about several aspects of this development.

- We worry about the risk that we may be forced into adopting settled,, truths,, about operational risk - many carried over from market and credit risk - before they have been well established in a different arena. This may retard the further development of the subject as banks react to the need to implement an acceptable calculation in a short timeframe and defend their assumptions, many of which have large intrinsic uncertainty, against potential regulatory criticism.
- We are further concerned about the current language that requires alignment of capital quantification with daily operational risk management. This raises the risk that bank's control efforts may be diverted, in part, from managing the risk to,, managing the model,,.

2. Asset Securitization

Submitted by legal division

2.1. Introduction

The Basel II proposals for asset securitization have been the focus of substantial criticism from the industry. The Basel Committee announced in their Madrid press release in October 2003 that the rules would be re-examined with a view to simplification, and in particular that the supervisory formula approach (SFA) would be eliminated.

We have joined in industry criticism of the original rules, focussing on the complexity, prescriptive tone and difficulty of implementing the current proposals. However, there is also much excellent work embedded in these rules, which could be lost if the SFA was simply eliminated. We believe there is a more dexterous solution to this issue, one that addresses the substance of the concerns raised by industry while also retaining the advantages of the current proposal.

We believe it would be a mistake, and a misunderstanding of industry criticism, if the supervisory formula were simply jettisoned. It is not the mathematical complexity of the supervisory formula *per* that has created the controversy in this area (though we believe it can, and should be simplified somewhat). On the contrary the basic formula has been widely admired by practitioners and there has been, to our knowledge, no significant industry comment asking for elimination.

The brunt of the legitimate criticism centers on the difficulty of the procedures that govern the use of the SFA. For example, there is a regulatory override to deduct an equity tranche from capital when the formula already provides a very high (but not quite 100%) capital charge. It would be easy to remove this override, giving a simpler approach with essentially the same risk characteristics and with little impact on overall capital. We believe that this example illustrates the right way forward to creating a workable and practical set of rules for asset securitization.

The building blocks of the proposals (supervisory formula and RBA approaches based on ratings) should be modified in some areas, but they are generally robust and well-founded. The key changes needed are mostly in the framework that describes how the components of these rules fit together. If the,, flow chart, aspects of the rules could be simplified and clarified, we think these rules could become much more workable and effective. The result would be a set of rules that retained the,, best practice,, advances embedded in the current document, but structured to be more practical given the realities of bank infrastructure and process. It would provide risk sensitive capital, correct incentivisation and arbitrage deterrents, but would be more adaptive to future changes in the marketplace. We believe it could be accomplished with relatively modest changes to the current wording of the proposals.

2.2. Finalising the asset securitization rules

Before submitting our specific modification proposals, we would like to review the requirements that should be satisfied by a good solution for asset securitization.

First, we believe the Basel II rules for asset securitization must be practical, recognising today's market practices and the typical data possessed by parties to a securitization. Banks should be able to perform their capital calculations without onerous systems or data requirements. As a concession to practicality, therefore we believe that banks should have a free choice as to the approach they take under the rules, either the SFA or ratings-based. We believe experience with the rules so far (e.g. QIS3) and industry comment indicates that this is a necessary step to create workable rules.

On the other hand, the rules must provide a capital treatment that gives good risk management incentives, and is proportionate to the underlying risks. We believe that both the RBA and SFA approaches are directionally correct, embed good incentives to risk management and deter arbitrage. Between the two, we believe the SFA is the approach most likely to give capital which is calibrated most accurately (neither too high nor too low) for the underlying risks in specific portfolios.

Therefore, for banks with relatively modest securitization operations, we would argue that the RBA approaches are adequate, because they are reasonable and incentives good risk management. Although the allocated capital is not as well calibrated to the underlying risk as the SFA calculation, the overall improvement in comfort that would result from required use of the SFA will not typically justify the potential extra difficulty in employing this approach.

However, we believe the SFA should be the preferred approach for large, sophisticated institutions where securitization activities are sufficiently material that the capital allocated to securitization is significant to overall good capitalisation[1]. We believe that these banks should be encouraged to use the SFA approach where possible. Alternatively, an internal modelling approach based on the principles underlying the SFA and addressing the risks capitalised by the SFA may be a suitable alternative for these institutions. Encouragement to use the SFA or an equivalent should be part of a bank's dialogue with its supervisor under Pillar II.

In summary, each of the current elements of the approach (SFA, RBA) should remain in place, but we should allow more freedom in the rules surrounding their use. Banks should be able to choose, on reasonable grounds, the approach most suitable for them, subject to supervisory review. The SFA approach should be recognised as more appropriate for large banks with material securitization activities, on account of its superior risk sensitivity. These banks should aim towards using the SFA or equivalent generally, in an evolutionary approach. These proposals are set out in more detail below.

2.3. Our proposals

Modified Supervisory Formula Approach ("SFA")

- The supervisory formula approach (SFA) offers an important and valuable approach based on sound principles.
- The SFA should be retained, with some simplifications specified below. Banks should be encouraged to use the modified SFA where possible, by a more pragmatic approach to validation of KIRB calculations detailed below.
- The following simplifications should be made to the SFA (in order of importance):
  - o Remove the deduction override below kirb.
  - o Remove co (technically, set co = °°; co is no longer needed if tranches below Kirb are not deducted).
  - o Remove x (technically, set x = °°).

Calculations of Kirb

- The main difficulty of using the SFA for banks is calculating K_{IRB}, and in particular obtaining sufficient certainty that their calculation of Kirb will be satisfactory to supervisors. CP3 paragraph 575 states that positions must be deducted where Kirb cannot be calculated,,, but this is substantially a matter of supervisory judgement and does not offer any indication to banks of their likelihood of having their calculations accepted.
- Therefore, although Kirb calculations should naturally be validated by supervisors, it should be clarified that this will be on reasonable principles and on a business-wide basis, not on an asset by asset, basis. This kind of process would be more analogous to IRB verification.
- To encourage evolution toward better securitization risk management and widespread use of the modified SFA, supervisors should accept a lower overall standard for SFA calculations than for IRB calculations, provided calculations are done to the best of ability within reason.

[1] In terms of a quantitative guide to materiality, bearing in mind the impact of error or uncertainty in capital calculations for a given business area on overall capital, we would tend to regard an area contributing more than 10% to total capital as material and a focus area for validation and use of best techniques.

Simplification of the framework

- The distinct rules for originators and investors and the consequent need to distinguish these types of participant are a major cause of the unnecessary complexity of the current rules. Regulatory distinctions between originator and investor should be eliminated. All the approaches (SFA, use of ratings) should be available to all parties in principle, subject to supervisory review.
- In addition, internal ratings should be allowed for securitization tranches, subject to supervisory approval. Approved rating systems would likely be based on rating agency models and should, where possible, be compared with the results of the SFA as a validation.
- However, it should be recognised that while all the approaches offer good risk management incentives and deter arbitrage, the modified SFA offers the most comfort in terms of risk accuracy. Therefore, banks with securitization activities that are material to their total capitalization should be encouraged to adopt the modified SFA or an equivalent internal approach wherever possible, analogously to adoption of an advanced IRB approach. Adoption of SFA approaches or an equivalent approach should be encouraged and managed under Pillar II of the Accord.

Liquidity facilities

- Liquidity facilities pose particular difficulties. Current market practice, while incorporating reasonable risk management diligence, does not always result in banks collecting the information required to perform the capital calculations proposed under the draft Accord.
- However, banks do typically assign ratings to liquidity facilities, either via an external rating or an internal one derived under rating agency principles. Allowing a ratings based approach for liquidity facilities would eliminate the current practical difficulties in this area, and would also remove the need for a separate regulatory definition of liquidity facilities.
- However, we believe that for liquidity facilities as for other securitization assets, the SFA or equivalent is the better approach where the accuracy of the result is material to overall soundness. In such cases banks should be encouraged under Pillar II to aim towards use of a modified SFA, recognising that substantial investment and time may be needed to achieve this.

3. Home host issues

A workable home - host structure is critical for the internationally active banks at which the IRB approach is aimed. National supervisors must establish uniform standards that apply to all of such banks' operations, wherever these may be located, and that they accept responsibility for synchronising their approaches into a consistent cooperative framework. On the other hand, if supervisors neglect the issue, then the cost of failure will fall on the banking system and their customers.

An effective international framework for operating the IRB approaches without wasteful duplication of effort, conflict and uncertainty should satisfy the following elements:

- National implementations are as uniform as possible, with minimum divergence in either capital requirements or qualification standards for the various approaches.
- Regulators in the host supervisor position for foreign subsidiaries defer in situations where the home regulator has granted IRB/AMA approval for the parent-banking group using consolidated data.
- Where deferral is not possible, regulators meet to iron out their differences in a committee, so that a common application can be achieved (see detailed proposals on this matter below).
- Where an irreconcilable difference exists, host supervisors aim to avoid requiring a different system or different judgements, but instead reflect any such concerns by applying a prudential multiplier.

The IRB approaches require complex validation and ongoing supervision covering many parameters and processes. If an international banking group would have to operate different IRB and/or AMA approaches or use different data for such approaches for each individual jurisdiction in which it operates, serious problems will arise. This would result in the development, testing, implementation and maintenance of parallel systems and processes - a potentially huge misuse and diversion of risk resources away from the improved management that Basel aims at. Indeed, the complexity and confusion created by such multiple systems could itself lead to an increase in risk.

We would have preferred to see a greater commitment on the part of the Basel Committee to providing a meaningful solution to the home - host issue. The only guidance issued by the Basel Committee to date on the issue of home - host relations is,, High level principles for the cross - border implementation of the New Accord,,, released August 2003. This document attempts to establish a framework setting out six,, principles,, governing home - host supervisor relations. We believe this document should have gone further towards providing concrete solutions to the problem. The six principles are merely statements of current fact and evidence of good intentions, but they offer no solution to what is an inherently difficult global situation.

Specifically, the principles governing individual legal responsibilities conflict with those suggesting enhanced cooperation and oversight by the home regulator . It must be recognised that where there is a conflict, legal obligations will necessarily win out over generally good intentions to cooperate and the result will be that the Committee's principles will be effectively voided.

We believe two important issues lie at the heart of the home - host problem:

- Supervisors' existing legal obligations are often inherently irreconcilable with material reliance on and cooperation with other supervisors.
- No effective mechanism exists to promote and coordinate cooperation even where the legal framework permits it.

The legal issue can only be resolved if leading supervisors commit to a review of their own legal obligations, and propose to their respective legislatures changes to the laws applicable to them in their own jurisdictions, to allow them to meaningfully cooperate with each other. We recognize that this is a long-term suggestion and will require significant commitment and time, but we cannot see any other effective approach.

The practical issue also demands a more creative approach. We commented on this in reply to CP3 (CSG CP3 Comments, 9) and there suggested a solution based on the formation of a_a committee of supervisors,,, constituted of the,, main,, supervisors of an internationally active bank, for example those supervisors responsible for 10% or more of the bank's capital requirements. The committee of supervisors would mediate the various home-host relationships relevant to the bank. When requested by the bank, they would commit to reconcile the requirements of different supervisors into a single approach that satisfied both the home supervisor and the relevant host supervisor.

An additional home host issue specific to Operational Risk is that of the determination of legal entity level AMA capital calculations. There are a number of issues preventing a meaningful calculation of AMA capital for subsidiary legal entities including the lack of loss data, and the lack of alignment of the business unit structure used for managing a business and the legal entity structure of a firm. Therefore an apportionment mechanism to determine legal entity capital from the group derived AMA charge, embedded with in the Basel Accord, is essential for AMA to operate in a meaningful manner.

In large banking groups, capital is utilised and transferred intra-group where required. Accordingly, any requirement that the sum of the legal entity capital is greater than the Group level capital is adding extra conservatism at each legal entity. In order to prevent this, and to ensure that the total level of capital required is not a function of the legal entity structure of the firm, the sum of the subsidiary-level AMA capital charges should be equal to the Group derived AMA charge as the word apportionment literally suggests. The Basel Accord has been calibrated at Group level only, so if the sum of the subsidiaries exceeds the Group level requirement, then the total Group capital requirement will be greater than the desired benchmark, and will be another source of over-conservatism being built into the New Accord. This is a critical implementation issue for multinational banks and to date little comfort has been received from the Committee. We urge U.S. regulators to specifically address this problem both within the U.S. regulatory framework and with the Committee.

4. Operational Risk

4.1. Introduction

We found when we studied the ANPR document that US regulators thinking on operational risk was in many respects significantly clearer and more conceptually sound than the equivalent views expressed in Basel documents and other national implementations. In fact, this mirrored the situation for credit risk and, in our opinion, reflects both the excellent resources available to US regulators, as well as the conceptual freedom available in the US as a result of the bifurcated implementation there, which allows expressions of capital requirements to be aimed directly at the large, sophisticated banks for which the Accord was intended.

Given the inevitability of a Pillar I charge for Operational Risk it is in our interest to ensure that the methods of calculation and conceptual framework allowed, are such as to enable us to reconcile in the best way our external capital requirements and internal capital calculations and business information needs in a sound conceptual framework. With operational risk in particular we are concerned that many current ideas prevalent both in the industry and the regulatory community are a threat to the possibility of true progress towards conceptually correct framework for operational risk modelling. The key areas where we have concerns are set out below:

4.2. Correlation in Operational Risk

The US stance has already recognised implicitly that operational risk is a fundamentally different problem from market and credit risk and cannot be legislated for by a simple carry over of existing rules and concepts.

An example of inappropriate carry over from credit risk is the sense from many regulatory authorities that explicit assumptions regarding dependence are required for operational risk. This presumption is present, for example, in CP3.

There will never be enough data to estimate empirically levels of correlation dependence between risks, but more importantly, there is simply no conceptual reason why the imposition of positive (or negative) correlations should be regarded as a natural part of the modelling process for operational risk. The role played by correlation (or systematic risk) in credit risk has no natural counterpart in operational risk. We believe that this may be a vestige of a credit risk concept that has been mistakenly carried over to an area where it has no natural application.

Therefore, in the absence of substantial data to the contrary, there should not be a presumption that risks are adversely correlated. A qualitative approach to the estimation and recognition of correlations must be allowed within the AMA to allow the natural diversification of operational risks to be recognized, and should be reflected in the rules.

4.3. Loss collation thresholds

We welcomed the recognition in the ANPR that loss data thresholds may be tailored to the risk profile of different business units. We were also pleased that the ANPR did not quote exemplary loss thresholds, unlike in CP3, because we are very concerned at the power of orthodoxy to develop an unsubstantiated practice of collating insignificant loss data at considerable cost and to the detriment of real risk mitigation in operational risk.

We strongly believe that only large losses are relevant to the determination of capital for operational risk and would expect the loss thresholds used to reflect this. In our ANPR response, for example, we suggested a loss data collation threshold of $500k for investment banking, or 0.01 % of our capital base in that area. A loss collation threshold set at 0.01 % of our capital would be more reasonable for the purpose of capital estimation (although some might argue that that is still too low, and might focuses excessive attention on small, fairly common events rather than the rarer but more meaningful ones). Such a threshold would capture a significant portion of the overall total of operational risk loss at most institutions and be a practical way to incorporate the loss events relevant for a capital discussion.

It can be demonstrated mathematically that the required capital to cover losses under a certain threshold is equal to the average annual aggregate value of these losses (i.e., the expected amount of these losses). This result can be used to estimate the capital effect of any losses not captured as part of any loss distribution and further reinforces the argument that small losses are irrelevant to the determination of operational risk capital.

4.4. Soundness standards in Operational Risk

The ANPR refers in a number of places to a soundness standard for operational risk of a one-year holding period and 99.9% confidence interval. While that statement is appropriate as a qualitative guideline, it should not be seen as statistical standard. As mentioned above, there is not enough relevant data to allow a bank to demonstrate the,, 1 in a 1000 year,, soundness standard (which is implicit in the 99.9% confidence interval), and therefore it will not be possible to determine whether this standard has been met. We believe that a statement recognizing that this soundness standard is inherently qualitative, and does not require an implied statistical validation.

The ANPR also indicated that, due to the uncertainty and potential error implicit in the evolving nature of operational risk measurement, a degree of conservatism will need to be built into the framework. The requirement to use conservative assumptions and to build in degrees of conservatism,, will increase the confidence standard to beyond the 99.9% confidence level and will further erode the capital incentive of the AMA compared to the Basic Indicator approach. Thus we believe that the requirement to build in conservative assumptions in many places within the operational risk measurement framework should be removed.

4.5. Incentivisation of management

We believe that it is not possible for any AMA model to closely replicate the size and distribution of the actual operational risks in a bank on a daily basis. It is thus difficult for the potential management incentives provided by an AMA model may not actually reduce a bank's true operational risk. Indeed, creating a pressure for, efficient capital management,, will naturally divert at least some resources from managing the real issue to managing the number instead. This is the risk of false reliance,, on the model, a risk that is particularly relevant in operational risk given the current state of modelling.

We believe that the requirement that any AMA provide incentives to improve management behaviour may actually detract from established and effective (qualitative) risk management practices, and that such a requirement should be removed. Incentives for better operational risk management are best derived from the management framework, not the measurement framework.

4.6. Reporting requirements

The current proposals require AMA institutions to report on at least a quarterly basis the results from the measurement system, and that the reports should summarise a prescribed list of information.

While the production of reports for management purposes (e.g., Key Risk Indicator reporting) is relevant on a quarterly basis, operational risk (unlike market and credit risk) capital levels do not vary significantly over short periods of time. Therefore, we do not believe that operational risk needs to be calculated as frequently as quarterly, particularly for business lines such as investment banking. We would suggest that the requirement to calculate the operational risk capital measure be on at least an annual basis.

The prescription of the content of the operational risk reports may divert senior firm- and business-unit management's attention from the tools and techniques that it believes are most appropriate for the management of operational risk within each institution. The potential result is that this prescription may hinder rather than assist in the effective management of operational risk.