KPMG

BaselBriefing

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Editorial

Welcome to the fourth edition of *BaselBriefing*. We are now in the middle of the QIS3 process. Many firms are participating in what is seen as the last real chance to influence the calibration of Pillar 1 before the final draft is issued next Spring. Although the technical guidance to QIS3, strictly speaking, relates only to the QIS process, it gives a good indication as to where the Committee and national supervisors have moved in the "fine tuning". The new categories for SME lending, qualifying revolving exposures within retail, and highly volatile commercial real estate within specialized lending, are all further evidence that the Committee has taken steps towards dealing with the apparent inequities contained within the original proposals. We summarize the key changes to the Pillar 1 requirements contained within the QIS3 technical guidance.

In this edition of *BaselBriefing* we are delighted to have obtained the input of Peter Williams. Peter is the Deputy Director General of the Council of Mortgage Lenders in the UK, and he sets out his views on how different countries are facing the challenges of the SME markets.

In this edition, we consider the challenges of implementation in the United States, which does not have the benefit of a single legislative authority driving the process. Our summary of the regulatory structure in the US may be illuminating to many, but the "wait and see" message is probably less of a surprise, at this stage.

As the operational risk proposals are bedded down, we continue our focus on the Advanced Measurement Approaches, looking at some of the issues surrounding scorecards, and the challenges of collating loss data.

The results of the 2nd edition of the KPMG International Basel Survey are now collated and analyzed, and a summary is included in this edition. Not surprisingly, more respondents this year said that they have started their Basel projects than did so last year, and there is more certainty over which approaches they are likely to adopt. However, firms still cite data collection as their key concern for implementation, and the Committee's announcement in July that a year's parallel running will be required for IRB approaches gives added incentive to firms to keep moving forward on their data projects.

Jörg Hashagen
Head of KPMG's Basel initiative

Contents

Implementation of Basel in the US

Much of the commentary and criticism of the new Basel proposals has come from Europe; however, in spite of the stated scope of the Accord being restricted to 'internationally active' banks, the whole banking industry in the US will eventually be affected. We take a look at the response of the US banking community, including the regulators, to the Basel proposals.

An overview of US banking regulation

The presence of both federal and state bank regulators has brought almost all banks under the regulatory authority of more than one agency. All banks fall under the supervision and regulation of their chartering authority, at either the state or federal level. If deposit insurance is obtained – as it virtually always is – a bank is subject to certain statutes of the Federal Deposit Insurance Act, and in the case of non-Fed member banks, to direct FDIC supervision. If a bank becomes a member of the Federal Reserve System, the Fed is its primary regulator. The Fed is also the primary federal regulator of foreign branches and agencies. Formation of a bank holding company or financial holding company subjects banks and banking organizations to an additional layer of regulation and supervision at the parent company level. The Fed is the primary regulator of all Bank Holding companies, and the umbrella regulatory of all financial holding companies.

The three primary Federal agencies that will be responsible for overseeing commercial banks affected by Basel, are (for the number of banks and deposits under their control, please see the table):

1 *Office of the Comptroller of the Currency (OCC)*. The OCC is responsible for chartering national banks and their supervision and examination. The Comptroller of the Currency sits on the board of the FDIC.

2 *The Board of Governors of the Federal Reserve System (the Fed)*. The Fed, established in 1913, directly supervises and examines state-chartered banks that choose to become members. As a result of supervising holding companies, the Fed gains an insight into the operations of many banks not directly under its supervision. The Fed is also responsible for monetary policy and setting the benchmark level of interest rates for the US economy.

3 *The Federal Deposit Insurance Deposit (FDIC).* Established by the Banking Act of 1933. It directly supervises and examines insured state-chartered banks that are not members of the Federal Reserve System. Although the FDIC insures a large number of banks, its main function is to insure deposits at commercial banks and thrift institutions. Before a bank can obtain deposit insurance, it must apply to the FDIC and receive approval. FDIC responsibilities also extend to protecting insured persons, acting as a receiver for failed banks, and administering the deposit insurance funds, which is financed by assessments on insured banks.

As of 31/12/99:	Total deposits $USD bn (percents of nationwide held deposits)	Number of banks (percents of total commercial banks)
OCC	1,776 (56%)	2,368 (27%)
Fed in its role as supervisor of state chartered banks	634 (20%)	1,010 (12%)
Fed in its role as supervisor of bank holding companies	3,045 (96%)	5,116 (58%)
FDIC	761 (24%)	5,262 (60%)
State chartered banks	1,395 (44%)	6,209 (71%)

Source: Banking Regulation: Its purpose, implementation and effects, 5th edition; by Kenneth Spong, Division of Supervision and Risk Management, Federal Reserve Bank of Kansas City, 2000.

The linking of regulation to capital and the introduction of the Basel 1988 Accord

The Federal Deposit Insurance Corporation Improvement Act of 1991 created a supervisory framework linking enforcement actions to the level of regulatory capital held by a bank. This system of supervision, commonly known as prompt corrective action, represents an attempt to provide a timely and non-discretionary triggering mechanism for supervisory action. A key objective is to resolve banking problems at an early stage and at the least possible cost to the bank insurance fund.

Under this legislation, the federal banking agencies must assign each bank to one of the five capitalization categories:

Capital categories	Total risk-based capital ratio	Tier 1 risk-based capital ratio	Leverage ratio
Well capitalized	10% or greater AND	6% or greater AND	5% or greater
Adequately capitalized	8% or greater AND	4% or greater AND	4% or greater
Undercapitalized	Less than 8% OR	Less than 4% OR	Less than 4%
Significantly Undercapitalized	Less than 6% OR	Less than 3% OR	Less than 3%
Critically Undercapitalized	-	-	-

Where: Total risk-based capital ratio = total capital to risk weighted assets, i.e. Tier 1 + Tier 2 capital to risk weighted assets; and Tier 1 capital represents the most permanent form of capital and the highest quality of capital that is available e.g. Common stockholders' equity; and Tier 2 capital, while still providing protection against losses, may be of limited life and carry an interest obligation or other characteristics of debt instruments e.g. subordinated debt. Tier 1 risk-based capital ratio = tier 1 capital to risk weighted assets. Leverage ratio = Tier 1 capital to total average assets

Banks in the top two capital categories are not subject to any prompt corrective action enforcement steps. However, banks which fall below these categories will face a set of mandatory enforcement actions that may also be supplemented by other actions at the supervisor's discretion. In 1996, the regulators issued a joint rule which included the requirement that banks having significant trading activities measure capital for market risk.

The position of the US bank regulators in relation to Basel

All of the banking regulators in the US have been supportive of the new capital proposals. Bill McDonough, president of the Federal Reserve Bank of New York is the chair of the Basel Committee on Banking Supervision. Publicly, the Fed has muted any criticism. However, the OCC representatives have been more vocal in their criticism, particularly in the measurement of Operational Risk. While the regulators share some of the banking market's concerns about whether it can be implemented globally under the Basel umbrella, representatives from these regulators have stated that they will encourage banks to adopt most of the Basel proposals as they represent best practise. There is, however, concern among regulators and banks that the proposals will not be applied consistently around the globe.

Unlike the EU, the US regulators have not provided their collective view, and we may have to wait until the Basel Committee finalizes the Accord before the US regulators issue their own proposals for adoption.

Which banks will be affected?

In the US, this is the un-answered question. Unlike the EU, where every bank plus other savings institutions must conform with the Basel proposals, it is unclear in the US where the demarcation line lies.

The latest official view on coverage was provided by a Fed Vice Chairman, Roger W Ferguson Jr, speaking at a community banking conference in May this year, who said that "…for most banks in this country, they (the new rules) will have virtually no effect". However, one of the representatives from the bank trade associations said: "Eventually the requirements of a new Basel Accord will become the de facto best practises of the industry, and small banks that don't measure up could find themselves at a competitive disadvantage – both in terms of their cost of capital and in the public perception of their risk."

Watch this space for further developments.

Major concerns US banks have about the Basel Proposals

Due to the particular regulatory regime and some particular bank practises, US banks have raised the following concerns:

Independence of rating review

The Basel committee is currently requiring 100 percent verification by an independent loan review. In most practising loan review, a sampling level of say 60-70 percent of the portfolio would normally be sufficient, so the 100 percent requirement should be reviewed in light of this requirement.

Consistent risk rating guidelines

Consistent risk rating guidelines between the US supervisory authorities and what Basel requires for qualification for the advanced approaches. For example, the OCC's revised risk rating guidelines released in April 2001, mention the Basel reform process, but they do not provide risk-rating guidelines that are consistent with what Basel requires.

For OCC regulated banks it may be difficult to comply with both OCC and Basel requirements. For example, the OCC guidelines still require a single expected loss rating. Basel, on the other hand, very clearly stipulates that banks must have risk ratings that distinguish clearly between Probability of Default and Expected Loss. There must be more coordination between the Basel Committee, the Fed, and the OCC so that banks' requirements are consistent across all regulatory agencies.

Consistency

The Accord potentially could require banks to hold regulatory capital against activities for which they already directly hold capital. The result may be that these activities would be performed primarily by non-regulated entities.

Disclosures

Are the disclosures under Pillar 3 to be determined as part of the Basel Accord or as part of subsequent US rulemaking?

Securitizations

- Under the Standardized Approach, there are certain inconsistencies between risk weightings for corporate and securitization exposures – e.g. a BB rated corporate requires a 100 percent risk weighting while a BB rated asset backed security requires a 150 percent risk weighting. Why are these equally rated assets weighted differently?
- Retail loans (not secured by residential property) under the standardized approach appear to be covered by the other Assets category and risk weighted 100 percent. If a rating agency was able to provide a rating on a portfolio of retail loans, could that portfolio qualify for a lower risk weighing?
- The clean break requirement for asset securitization appears to be similar to the requirements specified in FAS 140. Is the intent to conform to FAS 140? Are there any additional requirements being contemplated, since the Consultative Paper indicates that these are minimum requirements?
- Could the regulators provide specific examples showing the effect on capital requirements of securitizations with varying levels of retained interest and different ratings by external credit assessment agencies?

Conclusion

There are still many questions unanswered for US banks, in particular, which ones will be affected by Basel. The complex regulatory structure also means that, so far, there have not been issued any collective views on how Basel will be implemented. Therefore the wait must continue for US banks.

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One size fits all?

One of the most difficult aspects of any international agreement is to accommodate differing cultures, varying structural models, and the complexities of public policy. The proposed new Basel Accord has attempted to create a menu of approaches that can be adopted given differing institutional sophistication, however, the reality is that strategic drivers are pushing relatively modest sized institutions down the advanced path. The structure of the Accord, with its emphasis on statistically valid data sets, does tend to favor the larger institutions which have larger customer bases, more resources, and can benefit from the economies of scale in technology. This does raise the important issue of the fate of smaller lenders.

Structural and political issues

Smaller, regional lenders tend to be a feature of the larger economies, such as the US, Japan, Germany, UK and France, with many smaller countries having a limited number of larger indigenous lenders. The Basel round tables hosted by the European Mortgage Federation would suggest that each country has a very different approach to Basel, based on its own particular circumstance.

In Germany, public policy has been prominent in lobbying on behalf of SMEs with resultant concessions. The political structure in Germany means that the regions have considerable powers, and there have already been data pooling initiatives amongst smaller regional mortgage banks with the strong support of the regulator. This close regulatory relationship supporting Basel is also common in the smaller countries such as Eire and in Scandinavia, where the limited number of larger banks enjoy a supportive relationship. In France the government is active in the sector through its direct and indirect equity holdings.

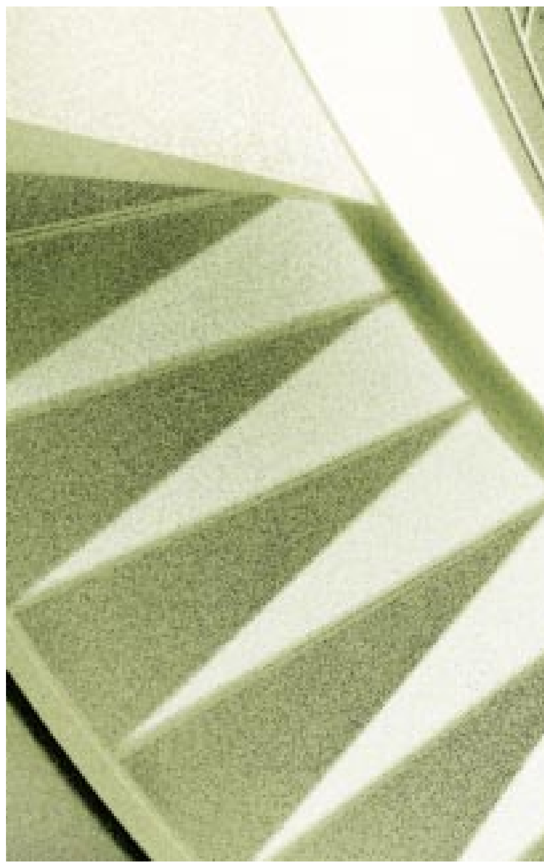
It would appear that, in most countries, the public policy agenda is somehow intrinsically linked to the implementation of Basel. The obvious anomaly is the UK, where regulatory independence from the government has meant that there are few voices on behalf of the industry. The UK government appears to have ignored the potential effect of Basel on competition and smaller lenders, despite financial services competition being high on the political agenda.

David and Goliath?

The European Union agenda to make Financial Services the first truly European single market, has competitive implications for smaller and larger institutions alike. Competition is already fierce in most markets, and the signs are that this will intensify. Alongside Basel, there are other pressures coming to bear on the smaller lender, such as the costs of technology, the increasing costs of regulation, and competition. However, we lose such lenders at our peril. They provide competition, diversity, innovation, and support regional economies and financial sectors outside the big financial centers. Their contribution to local economies should not be underestimated.

David's sling

The fate of the smaller lenders is dependent on how they respond to the undoubted pressure, and how much recognition is given to them through the public policy agenda. In many cases



changing the business model will be necessary. The potential pressures also create opportunity. Leaving aside the pressures to merge, there are initiatives that can be taken in order to remain competitive. In order to compete with the economies of scale enjoyed by larger institutions, smaller lenders have the potential to share IT platforms, share data, share back office functions, or outsource certain functions. As many people have discovered, internet distribution has allowed lenders to compete on equal terms, not reliant on the traditional accessibility of a branch network.

Conclusion

It is important that all governments examine the implications of the Accord in respect of competition, its effect on certain customer groups, and certain sectors of the industry. Whether the agenda is addressed through regulators, central banks, or ministries will differ in different countries, however, what is important is that it is indeed addressed. Basel should not be designed and implemented in a regulatory vacuum.

It is worth reminding ourselves of two of the key objectives of the Basel Committee, being that the new Accord was to focus on internationally active banks, and to enhance competitive equality. It is highly debatable whether either of those objectives will be met, in whole or in part.

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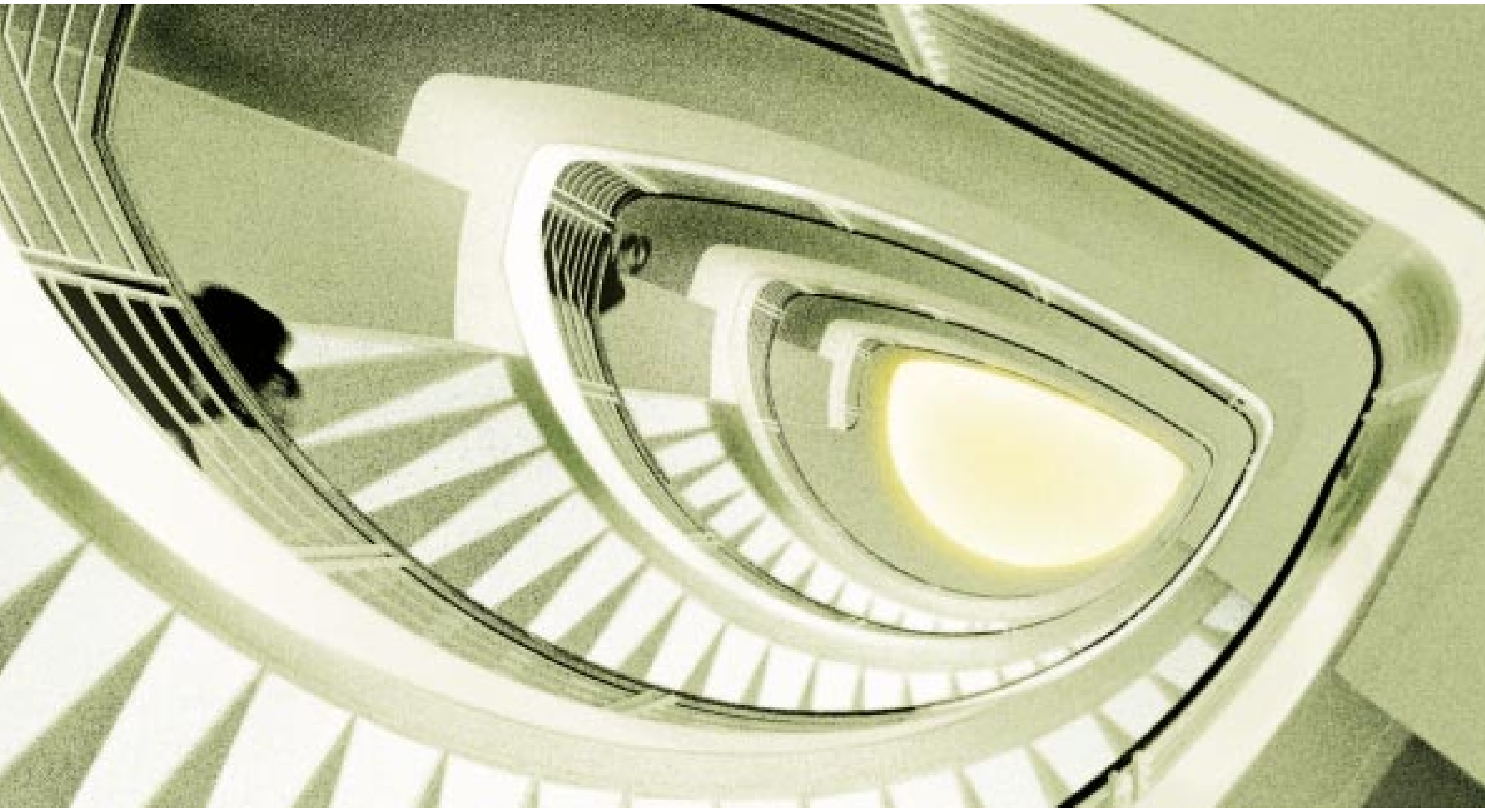

2-1 to the Scorecards!

Overview

Operational risk is very different in nature to market and credit risks; a large proportion of operational risks are qualitative and judgmental, making modeling very complex and difficult and often not clearly discernible from market and credit risks.

The objective of any operational risk measurement process is to obtain information and analyze data so that uncertainty is turned into quantifiable risk. It is only with quantifiable risk that appropriate management action can be taken; however, quantitative risk measurement/management systems should be used with extreme care as they can create new risks:

"one of those is the risk of trying to measure what cannot be measured, and falling into the trap of thinking that what is not measured does not exist"

Quotes from 'Beyond value at risk' - Kevin Dowd

Most measurement approaches have some advantages, but suffer from important drawbacks such as the low data quality and the extensive time required to produce a complete model. While there is still no industry measurement standard, some of the most interesting and promising attempts to quantify operational risk so far have been made in the area of operational risk scorecards.

Many in the industry believe that, in the future, hybrid approaches including scorecards could offer the most appropriate way forward to measure operational risk, and so, on a relative basis, it would appear to be 2 – 1 to the scorecards!

What is a scorecard?

As part of the AMA (Advanced Measurement Approach), the Basel Committee has proposed that financial institutions may use scorecards as a means to adjust qualitatively operational risk capital initially determined on a quantitative basis, for instance, using the Loss Distribution Approach (LDA).

The aim and the design of a scorecard is to reflect the underlying operational risk profile and risk control environment. Scorecards combine both qualitative and quantitative measures to enable more robust forecasting, capital calculation and effective management of operational risk.

The main building blocks of scorecards components typically include some or all of the following areas:

- Business complexity;
- Risk and control self assessment;
- Performance measures; and
- Losses.

These building blocks are assessed through qualitative assessments (e.g. control assessments/questionnaires) and quantitative metrics (e.g. key risk indicators), which are combined to provide a relative ranking of the different types of operational risks. Scorecards can be enhanced by using statistical techniques, such as Fuzzy Logic and Bayesian Belief Networks that will assist the identification of the key drivers behind operational risk exposures. If properly designed, scorecards reflect changes in operational risk exposures and the organization's unique control environment.

What are the benefits?

Scorecards can

- provide valuable information in relation to an organization's unique control environment and operational risk exposures;
- introduce forward looking elements which will enable management predict future operational risk losses;
- provide incentives for risk management within the business to improve controls and therefore reduce losses and enhance performance;
- enhance a risk sensitive operational measurement and capital allocation methodology;
- use common practices such as self assessment which are understood and adopted by business management; and
- increase awareness of operational risk issues and identify the causes of operational losses and incidents.

What are the implications?

Identification of forward looking indicators

- For certain loss event types, such as fraud, the identification of a single forward looking indicator to predict fraud is difficult. A combination of indicators, control assessments and questionnaires can facilitate the identification of the predictive element of operational losses.

Aggregation

- The aggregation of operational risk information/data (including loss distributions) and combinations with other advanced measurement approaches can be problematic. The usage of advanced statistical methods including Bayesian Belief Networks and copulas may overcome a number of the aggregation issues.

Scorecard design

- A thorough and labor intensive causal analysis behind the key drivers of operational risk events is required in order for scorecards realistically to reflect a financial institution's risk exposure. Bayesian Belief Networks enable the usage of qualitative/ subjective risk information in the measurement approach.

Validation

- A key component to the implementation and robustness of the scorecard approach is the correlation between qualitative and quantitative assessments and actual operational loss experience. Regression analysis and sufficient amounts of historic information can assist with the back testing and validation of the relationships between forward looking scorecard components and historical losses.

Why scorecards?

Scorecards can overcome the problems of other advanced approaches, including:

- Many years' loss history doesn't necessarily reflect the future.
- Recognition of improvements in the management and control environment following a major operational loss event.
- Organizations change too rapidly for loss data models to provide the entire solution.

There are issues which still need to be addressed but adopting a scorecard approach provides many benefits and useful learning points for many organizations in terms of improving operational risk management, measurement and capital allocation practices.

Don't score an own goal by ignoring the benefits!

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The emerging role of operational risk loss data collation

Loss data collation activity

The latest operational risk data collection exercise prompted banks and other financial institutions once again to submit operational risk data, this time for financial year 2001. The Basel Committee has stated that the results of this exercise will contribute towards refining the calibration of the Basic Indicator and Standardized Approaches, and assist in deriving the qualifying criteria for the Advanced Measurement Approaches (AMA).

After the poor quality of information and data received from the Quantitative Impact Study last year, the Basel Committee has provided some additional direction on its expectations regarding loss data collation. In its 'Working Paper on the Regulatory Treatment of Operational Risk', of September 2001, the Committee highlighted loss data collection and analysis as a key issue in operational risk management, encouraging organizations to track operational risk losses to contribute towards formulating an accurate risk profile.

Additionally, the Basel Committee has expressed as one of the qualifying criteria for the use of the Standardized Approach, the need for systematic tracking of relevant operational risk data, including internal loss data, by business line. The Committee has not defined the precise nature of operational risk data, other than loss data. However, in the current data collection exercise, six exposure indicators were identified and data requested, with the intention to identify any correlations between these indicators and the loss data. Regardless of the current exercise, further direction and guidance will be required from the Committee to ensure that all firms are capturing appropriate and consistent operational risk data (e.g. key risk and exposure indicators) so that industry comparisons and further analysis can be made.

For many firms, much of the time dedicated to completing the operational risk data submission was focused around the collation of loss data. This, in turn, has given organizations an opportunity to take stock of how they define an operational loss event, their current processes for capturing loss data, and to raise more questions around how they should organize and categorize this information in the future.

With the recent completion deadline, there has been little opportunity for firms to analyze and report on the captured operational risk information. Once the Basel Committee publishes the official industry response, additional detailed analysis can also then take place by individual organizations to draw salient and meaningful benchmarking information on the organization's operational loss profile and possible management practises. This management information may include:

- benchmarking internal operational loss event types and exposure indicator responses compared with the industry respondents;
- the review of each of the distribution profiles of the operational loss event types and exposure indicators for comparisons, differences and calibration purposes;
- the emergence of any loss trends with previous responses;
- the ability to determine the key operational loss event types and initiate causal analysis;
- the identification of meaningful exposure indicators; and
- the ability to correlate loss information with key risk and exposure indicators.

Establishing the information to be captured

The prerequisites for loss data in this year's exercise were direct losses "costing" firms in excess of €10,000. Whilst this was the prescribed threshold for the exercise, an organization's own internal loss reporting monetary limit will be determined through consideration of several factors. These may include some of the following:

- Risk appetite – The minimum reporting limit should be set to take account of the firm's overall risk appetite or tolerance for operational risk. Additionally, a firm may wish to set threshold levels for particular types of operational risk based on its risk appetite or tolerance for risk. Tolerance for risk may also be articulated with reference to risk or exposure indicators.
- Materiality of information – Budgetary and write-off arrangements within firms will determine the level at which material information is captured within an organization.

- Volume of loss events experienced – Where the volume of loss events is high, careful consideration should be made of the volume of losses captured, the ability to capture and store the information/data and the reporting time cycle. Collecting information for low value and high frequency losses may result in a disproportionate amount of time being spent in gathering the information, compared with the benefit of analyzing the information.
- External databases – Internal loss data may be supplemented with information obtained from external databases. Where this is pursued, the firm will need to take into careful consideration the data, the source, the comparability, the threshold limit used and the likely need to scale the information.

Having access to comprehensive loss data will contribute towards enhanced operational risk management information. Analysis can be performed on this data to reveal trends and areas of concern for the firm as a whole or on an individual business line basis.

Practicalities of loss data collation

In most cases, the practicalities of completing the data collection exercises are not always straightforward. Examples of some of the common issues are:

- A mis-match may arise between the firm's business activities to the Basel Committee's predefined lines of business.
- Losses may fall into a number of the Basel Committee's event type categories, with management having differing opinions on the proximate cause of similar events.
- Insufficient information captured by source systems may cloud the distinction between losses from operational risk and other risk types such as processing errors in credit ratings.
- A lack of understanding and awareness amongst those responsible for capturing loss data as to what constitutes an operational risk loss event.
- Duplications or omissions arising from confusion over where responsibility lies for the collation of operational loss events.
- Lack of clarity and definition of expected and unexpected losses.

Future loss collation activity

The Committee envisages that these exercises may form part of the on-going program of data collection over the next few years to further refine the calibration of the operational risk charge. Whilst adding to the accuracy of the calibration of the capital charges, individual firms taking part in such exercises will reap the benefits of enhancing their operational risk management framework and controls, as a result of having a more informed view of their operational risk profile, the types of losses experienced and valuable causal information to mitigate operational loss events.

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SMEs – The long and winding road

On the road to Basel the effect of the proposals on banks' customers appears to have been largely forgotten as regulators gather with the sole aim of ensuring capital adequacy. The approach came to an abrupt halt over the issue of SMEs, as public policy rather than regulatory objectives took center stage. It was not surprising that the sector moved into the spotlight, as it remains at the core of most countries' economies, and therefore its well-being is central to many governments' policies. From hereon in, public policy will become an increasing aspect of the Committee's work, as the compromises necessary to broker an international agreement find their way into the final accord.

Politics and policy

The concessions made for the SME market are evidenced in the technical guidance paper issued to help with the completion of the QIS3 exercise. The SME sector has been split between the Retail and Corporate categories based on turnover and exposure. For those that would be classified as Retail, this gives the sector the benefit of a more favorable risk curve than would otherwise have applied. This improvement is further enhanced by the removal of the maturity adjustment that would have been added for a Corporate classification. For those SMEs that remain under the Corporate risk weights, a specific SME adjustment is proposed that would reduce the level of applicable capital.

From a purist risk point of view, compromises such as those outlined above, may seem flawed. There is little logic in an SME entity that has a similar rating to a large corporate having a lower capital charge. This would appear to be sector subsidization, that is more appropriately undertaken by government than via a prudential regulatory framework.

Implementation disparity

It is the case in many countries that such lending has high volatility in both default and loss rates. This is unsurprising, as in an economic downturn the sector has less resilience and limited access to capital markets. It would therefore seem inappropriate to reduce risk weights to levels that in some countries may not be sufficient to cover unexpected loss. However, regulators could and will add additional capital during the Pillar II process to account for such anomalies, that may negate the Pillar I concessions negotiated in the Basel Committee. However, the reality is that Pillar II is the area where national interest may prevail, with some regulators exercising over-prudence and others bowing to governmental pressure. Such disparity would further devalue the level playing field objective of the Accord.

Conclusion – more politics to come

The road to Basel has been long and arduous, but represents only part of the story. The legal implementation of the Accord through the legislative processes of G10 and the EU has the potential to be protracted as politicians start to examine in detail the effects on other customer groups in their individual countries. The EU has issued a public tender for a study of the potential effects of Basel within the EU, and in common with other legislators will want to deliberate and consider before giving the accord legal status. It is likely that there will be more issues, more lobbying, and more compromise.

The more anomalies that such compromises create, the more opportunity for regulatory arbitrage and a disparate implementation. The concern is that the objective of a level playing field is becoming an increasingly distant goal.

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KPMG's 2nd survey on Basel readiness: results

Following the success of its 2001 Basel survey, in Autumn 2002 KPMG conducted a further international survey to assess the readiness of the industry for the new Basel Accord. 190 institutions participated, representing 19 countries.

The results have been analyzed by country and segment. We found that, overall, financial institutions have now begun to work in earnest in preparing for Basel and that, compared with 2001:

- more firms are now intending to adopt the more advanced approaches;
- 89 percent of respondents have started work on Basel compared with 75 percent of respondents a year ago; and
- 34 percent now intend to adopt the most advanced approach to credit risk (compared with 25 percent last year).

Some institutions could be in for an unpleasant surprise, particularly if they adopt more basic approaches to calculating risk. Respondents were consistent across sectors and countries in identifying a reduction in capital requirements as the main potential benefit of implementing the Accord. However, this reveals a possible misconception in some sectors, as not everyone can expect to gain through the Basel Accord. While capital requirements for some are likely to fall - particularly in the retail banking sector - for others they could rise. Institutions operating in riskier markets, or with more complex products, could see their total capital requirements increased. The results of the current Quantitative Impact Study may bring the message home to some institutions.

Not surprisingly, given the long data runs required, and the current timetable, data collection was widely viewed as the main obstacle to implementation of the Accord, with resourcing issues and cost also causing concern.

The number of respondents globally that are undecided as to which approach for credit risk they will adopt has fallen significantly, from 24 percent to 8 percent, reflecting the general progress that institutions have made with their projects. Germany is instrumental in this, where the percentage of undecided institutions has fallen from 38 percent to 14 percent. The same is valid for operational risk, where institutions undecided as to which approach to adopt decreased from 34 percent in 2001 to 18 percent in 2002.

Banking Regulation in Accession Countries

Budapest

26-27 February 2003

As the EU accession date draws closer and we move towards 2005, the goal of a single market in financial services, the banking industry and the regulators are gearing up to meet regulatory requirements and compliance standards. There is still a massive amount to be done for the banking industry to meet regulatory requirements but compliance is fast becoming the integral part of an organisations risk management framework.

KPMG will be speaking at the two-day conference on Banking Regulation, on the subject of implementing and presenting an internal risk appraisal system to comply with Basel II. Delegates will gain clarity on what needs to be done, when and how. In addition, speakers will outline the approaches for calculating capital requirements and assess the costs associated with enhancing systems and processes. Other topics covered at the conference include anti-money laundering laws, cross border securities trading and CESR recommendations relating to the investor protection regime.

You can register for the conference via KPMG, which entitles you to a 15 percent discount.

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QIS 3 – Is this an indication of the way ahead?

Basel's latest Quantitative Impact Study (QIS 3) was officially launched on 1 October 2002 with the following aims:

- to calibrate the new risk weight calculations; and
- to act as a further consultation exercise prior to the release of CP3 in 2003.

The recently released documents contain detailed instructions on how to complete the QIS, together with a list of National Discretion items and QIS 3 Technical Guidance, which gives the latest working of how the Pillar 1 proposals will look.

Although the regulators' National Discretion items are strictly only for the purposes of the QIS 3, they provide a strong hint as the direction of the regulators' thinking as they work out how to implement the new Basel proposals in their home country.

The reporting spreadsheet must at first have appeared a little daunting to participants, with some 26 worksheets and over 100 pages when printed, but the Committee has done its best to minimize the amount of data input required.

Process and data

The main requirement of the QIS is to provide an analysis of one's portfolio across:

- Basel exposure category types;
- PD (probability of default), LGD (Loss Given Default), EAD (Exposure At Default) and maturity bands;

together with an analysis of capital, operational risk income figures and exposures included or excluded.
The process for information capture gives firms an indication of the availability of data throughout business units and how their models and systems can cope with the extraction process.

Key messages and issues

The instructions for the QIS 3 have indicated the following key areas where preliminary agreement appears to have been reached:

- SME – initially just for the QIS 3, a new category of SME has been introduced which will result in reduced risk weights for exposures to corporate counter-parties whose turnover is less than €50m, requiring the capture of an additional data field. This can be seen as a necessary compromise to achieve a complex international agreement. While helping to avoid negative impact of the Accord in some countries in others this may lead to problematic effects, as the turnover cut-off is quite low relative to lending levels, and is for example likely to encompass a substantial amount of Investment Property lending.
- Specialized Lending – a new category of specialized lending, Highly Volatile Commercial Real Estate, has been introduced. However, some regulators are not yet able to detail fully what types of property this should include (other than speculative development finance), the expectation is that most firms will not be categorizing any such exposures for the purposes of the QIS. Also, it is the Committee's view that where firms are able to determine PD, LGD and EAD for specialized lending-type exposures with sufficient rigor to satisfy the IRB standards, they are prepared to allow firms to use the standard corporate calculations instead. However, in the area of investment property lending, for instance, where there is strong evidence that PD and LGD are highly correlated, it is not clear that firms' current rating models would meet the requirements for accurate separate risk characteristics.
- Qualifying Revolving Exposures – the development of a third retail risk weight curve for exposures with a stable, predictable level of expected loss, covered by Future Margin Income (FMI) shows how the Committee have listened to the concerns of the industry and are actively rethinking the calibration of the Accord. The requirement on FMI is a sensible one, and one that relevant institutions should be able to demonstrate.
- Physical collateral in Foundation IRB approach – combined with the pre-announced reduction in LGD to 45 percent, the recognition of further physical collateral items at Foundation stage is part of an overall effort to get the capital incentives across the three Credit Risk approaches correct. However at this stage, actual physical property such as Commercial and Residential Real Estate, which is the sole source of the income for loan repayment (such as the majority of investment property lending), still does not provide any benefit to firms' LGD values until the Advanced approach, unless firms can demonstrate that there is minimal correlation between counterparty default rate and value of the collateral.

- Maturity adjustment – the Committee has introduced an exemption to the use of an explicit maturity adjustment in the Advanced IRB approach. This relates directly to some countries concerns over the financial health of their SME sectors. The effects of the revised maturity adjustment calculation based on a 'mark to market' methodology are significant for low PD, long maturity loans, with a possible 3-fold spread of risk weights between the shortest and longest maturity loans.
- Securitization – the Committee has published revised securitization proposals as part of the official launch on the 1 October, which were absent in the July package. This has been followed by a working paper which deals further with the rationale behind the latest changes and the Pillar 2 aspects. The only key change for banks investing in securitization tranches is a requirement to divide up senior tranches (AAA to A) into three bands depending on their granularity (measured by effective number of exposures and seniority), which should not present significant problems for those banks concerned. For originating banks, there has been considerable change in the following areas:
  - The definitions of traditional and synthetic securitization have been modified slightly and structures with a single exposure are now captured under the securitization definition;
  - Introduction of credit conversion factors (CCF) and EAD for liquidity facilities and other off-balance sheet exposures. This has been developed further for structures with early amortization features and the UK has succeeded in getting a favorable CCF structure for the UK-style "Controlled Amortizations";
  - Revision to the supervisory formula approach (SFA) for calculating risk weightings where there is no external or inferred rating for the tranche to make it more risk sensitive. The formula now depends on the following factors: risk of the pool, LGD of the pool, effective number of exposures and other supervisory parameters, rather than being based on an arbitrary percentage of the reference IRB capital level;
  - Introduction of a cap on the capital requirement for originators that use the SFA so that the capital requirement for a securitization transaction cannot exceed the reference capital level.
- The delay in providing information on the latest approach to Securitization exposures speaks volumes about the problems that the Committee has had in reaching a workable solution for both the Standardized and IRB approaches. The Committee is keen to receive feedback and comments on any matters in the working paper throughout the next couple of months in advance of the formal CP3 release.
- We are pleased to see that the 'Minimum Operational Requirements' section has been comprehensively restructured so that it is now clear which requirements relate to each counter-party type and risk characteristic and with much reduced overlap and repetition.

Opportunities

While the QIS 3 exercise requires significant effort to provide realistic and worthwhile data distributions, particularly considering the changes made to the proposals over recent months, firms should consider it as an excellent opportunity to test the initial progress made on their Basel projects and rating systems.

The risk weight formulae and spreadsheet models, issued on 1 October, should allow firms to use the QIS 3 exercise as a further impact analysis and ongoing working capital assessment tool for the short term.

In addition, where regulators have initiated regular update meetings with firms, these have provided a good forum for discussion, consultation and revision of proposals. Firms should seize this last real opportunity to influence the form of the Accord as no major changes are likely to be sanctioned following the release of CP3.

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Topics to be covered in the next edition include:

- Results of the KPMG Programme Management survey
- More on securitizations
- The role of internal audit

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KPMG has an international network of regulatory, risk management and data management professionals in over 60 countries. To discuss any of the matters raised in this issue, or any other regulatory, risk management and data management matters on which we may be able to help you, please contact:

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