



Opinion

UEPC

European Commission Documents on the
3rd Consultation Paper of the Basle Committee
on Banking Regulations and Supervisory Practices
(Status 1 July 2003), submitted by the Directorate-General for Internal Market

UNION EUROPEENNE DES PROMOTEURS-CONSTRUCTEURS
EUROPEAN UNION OF DEVELOPERS AND HOUSE BUILDERS
EUROPÄISCHE UNION DER FREIEN WOHNUNGSUNTERNEHMEN

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I. Introduction

The European Commission on 1 July 2003 submitted three documents on the 3rd Consultation paper of the Basle Committee for Banking Supervision of April 2003: a discussion paper that sets out the arrangements under the 3rd Consultation paper and the changes to the 2nd Consultation paper of January 2001 in great detail and, where applicable, albeit not entirely – deals with the changes that the Commission considers necessary when implementing a European law for all credit institutions and securities firms. Linked to this is a working document containing draft amendments to existing European directives in line with the Basle proposals as drafted for the 3rd Consultation paper. Finally, as the most extensive paper, there is a multiplicity of annexes in which the particular problems of the supervisory authorities and the banks are discussed in detail, in the light of the new Basle Rules.

With its documentation, the European Commission treads a converse path to the Basle Committee, as is evident from the trend set in progressing from the 2nd to the 3rd Consultation paper. Consequent to the improvements in the first draft of 1998, the 2nd Consultation paper contained a selected list of safeguards for reducing credit risks and the broad lines of risk assessments for credit portfolios as based on internal banking statistics. This threw up numerous queries that inevitably led to a plethora of technically aligned banking working papers. On the other hand, the 3rd Consultation paper is far more orthodox, streamlining the technical discussion on the banks and in some cases realigning them. The paper deals with the 2nd Consultation paper, starting with technical details of financial innovation to secure banks' risk assets, especially unconditional futures contracts such as swaps and options. The alignment of the Basle Rules is here aimed at large internationally active banks.

This is a path that the European Commission's documentation cannot follow, simply because its desire is to prescribe the Basle Rules as binding for all credit institutions and, a few exceptions regarding business activities apart, for all investment firms. This also explains the profuse technical detail in the annexes, since smaller credit institutions are far more reliant on supervisory strictures than the larger institutions in keeping to the anticipated net worth guidelines. By breaking it down into a basic discussion document, proposals to update the Directives, and technical annexes, the European Commission feels it has confined to the annexes subject-matter that according to its experience with the new net worth guidelines will already soon be subject to numerous amendments, while the "philosophy" and the European Directives will hardly need amending. However, this at the expense of much duplication in the technical rules for banks, a degree of opacity, which will no doubt compel repeated editorial improvements in due course, and innumerable stipulations which will lead to different decisions by the supervisory authorities in the European economic area.

This Opinion concerns itself almost exclusively with the problems that, according to the European Commission's existing documentation, will emerge when transforming the Basle Rules into European law. The problems regarding real estate which still remain in the 3rd Consultation paper or have even newly appeared, have already been raised in the UEPC European Association's Opinion. The Opinion on the European documentation is therefore a supplement, that does not revert to the criticism already mentioned of the Basle decisions, in which the European Commission can participate only without the benefit of a vote.

II. The European Commission's discussion paper

Even this document falls far short of the systematic clarity of the 3rd Basle Consultation paper. Consequently, preference is given for criticism purposes to dealing with the collection of problem areas section by section.

Sections 64F and 85F

The difficulties in implementing the Basle Rules into European law having regard to the different structure of the credit industry in the States of the European Union

The Commission takes the view that the Basle Rules will contribute towards transparency in the European financial market. However, this is hardly consistent with the fact – as the Euro-

Section 225 **Allowing for back-to-back guarantees from State bodies and institutions only for reducing credit risks**

The 3rd Consultation paper (sections 60 et seq.) deals extensively with the economic and legal properties of guarantees that can be recognised for reducing credit risks both in the standard procedure and under the IRB approach. A limitation on back-to-back guarantees is not contemplated. It is not therefore clear why the European Commission permits this for State bodies and institutions as sureties under Section 224 of the discussion paper but not for undertakings in section 225.

Section 226 **Pledging to reduce credit risks**

The 3rd Consultation paper leaves plenty of space for other legal formulations in the sections on reducing credit risks by “guarantees”. Whether the reduction of credit risks can also be achieved by pledging as security, the European Commission regards as a matter for discussion. In view of the fact that pledges play an important role as “guarantees” in business life, especially when loans are granted, there should be no doubt that they are recognised by the supervisory bodies for reducing credit risks.

Section 227 **Unconditional guarantees as regulatory net worth**

The European Commission does not wish to include unconditional guarantees amongst the securities that reduce credit risks but classifies them as regulatory net worth. It is therefore very doubtful whether unconditional guarantees for financing instruments from banks or investment firms should be restricted in this way. Guarantees whereby credit risks are reduced also in fact exist between the customer of a credit institution and his trading partners. In property business, in particular, until the construction contracts are signed, project costs are secured by bid bonds, which really act as a contract penalty.

Sections 233-4 **Fictitious dissolution of reserves through stress tests with major loans**

The European Commission has paved the way for a substantial relaxation for major loans insofar as risk premiums for margins can be allocated to regulatory net worth not only through transfers to a revenue reserve within the framework of the “solvency regime” but also through stress tests by means of revaluations. However, the rules for this purpose must still be created under commercial law.

Sections 248-251 **Risk weighting for industrial premises in efficiently functioning markets**

With the LGDs for loans fully secured by industrial property in effectively functioning markets, the European Commission is proceeding on the basis of an LGD of still only 35% above the 3rd Consultation paper (section 47, associated Note 21), which still provides for only 50%. The basis for this is the loan-to-value procedure (as enshrined in the Table in Section 274 of the 3rd Consultation paper). However, there is no reason for converting the process for valuing credit risks fixed by the Basle Committee in such a way that the parallel nature of valuations is abandoned, on account of the “philosophy” that security by means of real estate under the standard procedure is always provided by assets while under the IRB basic approach a reduction is made for the risk-laden part of the loan. The 35% risk weighting for loan-to-value is included in Annex E-3 1.4.2 only because the 140% produces an “over securing” (over-collateralisation) in relation to the value of the security and credit volume. It is not therefore clear why the Commission wishes in Section 251 of the discussion paper to restrict the 35% risk weighting to the IRB basic approach and does not extend it to the standard procedure as well.

Sections 253-4 National differences with the LGDs for security through property

The assessment of the European property market as effectively functioning is supported by a study by the European Central Bank, at least for the housing markets¹. The 35% risk weighting for fully secured loans for residential and industrial property should therefore be dealt with uniformly in European law. Consequently, the purely “technical divide” between the standard procedure and the IRB basic approach is therefore finally eliminated (see Section 255). One would otherwise be faced with the difficulty that uniform credit portfolios or asset classes for lending on property in the European economic area could not be included under risk management under “Basle II” because ongoing corrections by the individual national supervisory authorities are inevitable.

Section 285 Reductions in the implicit maturities of loans the collateral assets for which are intended to be sold

The European Commission’s decision rightly stated that an implicit approach to the residual periods of loans of 2.5 years under the IRB basic approach may conflict with the provisions of the Commercial Code. This applies especially in cases where loans are taken up in order to purchase businesses that are to be resold. A further application still to be taken into account by the European Commission would be revolving credit business by building developers where following the sale of a piece of land the mortgage loan is transferred to other land prepared for building in the meantime.

Section 286 Valuation reserve as equivalent to provisions

The problem has already risen in connection with the stress test for major loans. However, it must also be applied to a margin substitute comprising interest and charges for mortgage loans where these form part of refinancing. It is consequently not clear why no potential flattening of the risk weighting curve is to be permitted in the retail area for property loans when allocating earnings.

Section 299 Valuation of collective fund assets by market values

The European Commission in a number of places objects to capital formation by revaluations instead of allocations to revenues. This on the one hand concerns transparency of valuation but, on the other, also securing the liquidity of “collective funds”. In fact, the supervisory problem is that market risks must still be measured as well as credit risks, that may correlate positively with credit risks.

The question to be answered here is whether it is meaningful under European law to transfer the valuation procedure and even risk weighting from banks’ risk-laden assets in respect of their credit business and equity participations to investment firms.

Section 340 Valuation of investment firms’ operating risks

The same doubts arise where the process for measuring operational risks for banks is applied to investment firms. The operational risks for investment firms arise directly from “performance”. Insofar as their market influences are to be insulated away, as the 3rd Consultation paper seeks to do, operating risks must first be identified as legal risks, system risks or organisational risks. This immense requirement, which is not even backed up by precise statistical results, appears both exaggerated and even misplaced in view of the circumstances of investment firms that specialises in equity participations.

¹ European Central Bank. Structural factors in the European housing markets.

III. Selected real estate questions on the draft Directive “Review of Capital requirements for banks and investment funds” (status 1 July 2003)

The draft Directive supplements and partly replaces the existing European Directives 2000/12/EEC on the assumption and exercise of the activity of credit institutions, 93/6/EEC on appropriate equity capitalisation for securities firms and credit institutions, and 92/121/EEC for monitoring and controlling major loans by credit institutions.

Art. 1 Section 26A Mortgage-protected “Covered bonds”

When securing long term loans by first-rank secured mortgage collateral on residential property, the restriction to “market value” should be abandoned. There is no reason for treating residential property differently from commercial property, where, quite rightly, recourse can be made to “fair value” insofar as “market value” cannot be ascertained. An addition to this effect to the 3rd lemma of section 26A therefore appears indispensable, also in view of the applicability of IAS 40².

Under the 4th sub-paragraph regarding long term loans secured on commercial property, the rule appears too complex. Firstly, as already advocated above for security based on residential property, first-charge collateral should be based not only on “market value” but insofar as this cannot be ascertained, also on “fair value”. This applies all the more so, when, with regard also to the security threshold for commercial property in the long-term loan portfolio, reference must necessarily be made to the “fair value”. So that this proportional threshold can be fixed at 8% in relation to the total volume of the long term loans issued, a provision should be made for a transitional period of 4 years for new investment firms and for the new weighting, that can be monitored by the supervisory authorities, for collateral for long term loans in the trading policy of a credit institution or investment undertaking.

Art. 3 Supervisory risk categories to ascertain minimum net worth

The provision as at present worded, since the intention is to add together various risk categories, would further tighten up the quantitative provision for financial service providers regarding the risks to be taken into account with capital backing, without the banking supervisory authorities laying down calculation methods for the standard procedure based on external ratings or for the simple IRB approach. Column 1 of the Basle Rules particularly highlights the failure risks for loans and, in conjunction, makes a largely undifferentiated attempt to take operational risks into account as well. Whether further risks require additional capital backing under art. 3 (1) b–d of the Basle Rules must be investigated by the banking supervisory authorities under the 3rd Consultation paper as soon as there is a reason for doing so. However, these are problems of intervention by the banking supervisory authorities, that must be qualitatively decided for column 2. Only the requirement of quantification under art. 3 (1) b. for major loans is linked to a corresponding quantifying arrangement in the 3rd Consultation paper, since here – at last uniformly, as under the Basle Committee’s 3rd Consultation paper – granularity risks are determined. Consequently, the delimitations under the major loans Directive are an exception.

If art. 3 (1) c-e were to be kept in its present form, implementation of both the standard procedure and the simple IRB approach would be complicated. The second sentence of art. 3 (1), according to which the existing capital requirements for investment companies were hitherto assessed under Annex IV of the European Directive 93/6/EEC at one quarter of the fixed overheads of the previous year, already points to this. Not only must the market risk be isolated in accordance with art. 102 from the placement and counter party risks under art. 3 (1) c., but so must the credit risk under art. 3 (1)a. This would methodically make such high demands of investment firms under the standard procedure, and even more so under the ordinary IRB approach, that it would take years, to say the least, before these could be mastered.

² Cf. IAS 40, Investment Property (January 2001) nos. 31 et seq.

A distinction must therefore be made under the basic breakdown of the Basle Rules, between Column 1 and Column 2 when establishing capital backing.

Art. 18 **Establishing capital backing on a non-consolidated basis**

According to art. 18 (1) the net worth requirement for groups and holding companies would have to be made on an unconsolidated basis as soon as its delimitation was subject to a foreign supervisory authority. The possibility of such delimitation remaining beyond supervisory control is not dealt with at all. This shows that in order to establish capital backing, reference must be made back to the consolidation level, but subject to the provision of financial linkage, as also provided in the Basle Rules.

With an update of this kind, the provisions other than those of arts. 18, 19 and 20 would be limited to supervisory action in accordance with Column 2 of the Basle Rules and an unnecessary complication of quantitative risk assessment governed by supervisory law would be avoided beyond the third consultation paper. This simplification would be more than evident if Rule no. 1 could be deleted from art. 20, since the permissibility of capital backing on a consolidated basis under Rule 2 would suffice.

Art. 27 (2) **Scope of risk-carrying regulatory retail portfolios**

The positions to be taken into account under art. 27 (1) for the scope of risk-carrying assets, also include (under XIII) positions to be secured which amongst other things cover all kinds of derivatives, but also credit insurances. Section 81 amongst the definitions under art. 1 expressly mentions this securing of payment flows or payment claims also for classifications secured in the pool. It is not therefore acceptable for the scope of the regulatory retail portfolio to be established without allowing for such security.

The restriction under art. 27 (2) 2. should therefore be deleted.

Art. 47 (6) **Return of investment for equity participations**

The first sub-paragraph presupposes that the "return of investment funds" is to be expected solely from the sale of the participation or the sale of the rights therein or liquidation of the long term investment concerned. However, this is hardly compatible with the legal structure that emerges from Annex D-1 (10). Rather, the participation risk must similarly be applied to the use of return on investment (ROI) as a characteristic of earnings, so that a payment flow of this kind will round off the new capital characteristics of the investment.

Any such clarification appears especially necessary because it affects not only the investments of the institution itself, which are subject to the Basle Rules and corresponding European directives, but just as much the credit financing of such investments by third parties.

Art. 47 (8) **Highly volatile investments in commercial property as a sub-classification of Special Lending**

The Basle Rules have since the 3rd Consultation paper certainly included the additional classification for highly volatile investments in commercial properties under Special Lending. However, introducing this category of risk is expressly left to the national supervisory authorities. Although the draft Directive naturally contains a multiplicity of opening clauses for national special rules, the full number of the five sub-classifications of Special Lending under art. 47 (8) 1. appears mandatory or at least unrestricted.

Since the new sub-classification complicates the basic nesting of Special Lending, on which banks' statistics depend, in corporate financing, art. 47 (8) should provide for corresponding national special rules. In addition, however, there is a need for a regulatory approach, especially for the European economic area, because the national supervisory authorities would be permitted to decide for "their" property markets whether this risk classification of the highly

volatile investments in commercial properties would apply. The UEPC therefore proposes that this sub-category of Special Lending be deleted.

The second lemma of the second sentence of art. 47 (8) contains an additional provision regarding Special Lending, whereby the “borrowing entity” need demonstrate neither other material assets nor other activities beyond the assets with which the Special Lending requirements are to be satisfied. However, this already appears an inappropriate restriction when these assets are included amongst the operating capital of a project company. This applies all the more so where project finance is taken up for particular activities of an undertaking that are limited in terms of accounting and personnel deployed. Moreover, such an organisational delimitation replaces the breakdown under company law, especially for investments in the property industry, where a denominations system is out of the question.

Art. 49 (2) Application of qualitative criteria for project financing and assessment of credit risks from projects other than corporate financing in the IRB approach

Since the banking supervisory authorities have laid down established qualitative criteria (“slotting”) for Special Lending sub-classification (see Annex D-7), that the relevant decision on risk weighting should be incorporated on art. 49 (2), in addition to both the quantitative determination under the IRB basic approach and also the banks’ statistical procedure under the advanced IRB approach (AMAs in the terminology of the 3rd Consultation paper), seems to be the right outcome.

However, it must be made clear that this methodical coexistence – unlike the other provisions for roll-out under the IRB approach – applies without restriction in time.

Art. 49 (3) Banking statistical procedure for equity participations

Art. 53 of the draft Directive provides a specific procedure for risk weighting for equity participations since banking statistics are virtually non-existent in this area. Art. 49 (3) should therefore also establish that here – other than with the typical “roll-out” cases for the IRB approach, which are especially concerned with mergers of financial service providers – a methodical coexistence unlimited in time must be assumed here.

Art. 51 (1), 3. and 5. Simplified assessment of PDs, ELs and LGDs for corporate financing

The provisions in question are sensible because in European law the new provisions for capital backing of risk-carrying assets of credit institutions and securities undertakings also become applicable in supervisory law to small providers.

The assessment of PDs for all loans in one debtor rating class with the aid of long-term averages for one-year observation periods appears sensible, but must still be declared “robust”. Firstly, on account of the refinancing provisions in art. 34 (1), it must remain clear that no risk mark-up is necessary for mismatches. Secondly, since express reference is made to Annex D-5 (5), it is necessary that the requirements made there for a “normal” credit structure (distressed restructuring) (Annex D-5 (43)) and the possibility of using external data (ibid. no. 44) should similarly not result in corrections to the risk weighting.

Under the advanced IRB approach, art. 51 (5) permits an assessment of LGDs as percentage proportions of the corresponding EADs. As the advanced IRB approach offers substantial reductions in capital backing as against the simple IRB approach, one wonders, however, whether the methodical relaxation in question is acceptable. The Basle Committee’s third consultation period presupposes stochastic procedures clearly secured by financial market statistics for advance risk measurement models (AMAs), which does not fit well with art. 51 (5). This applies all the more so, since annex D (5) 5. 61 regards LGD assessment as economic (“average economic loss”) and not as regulatory.

Art. 51 (5) may in no event require questionable relaxation to be permitted for the advanced IRB approach, while – as a counter-measure, as it were – the banking supervisory provisions are tightened for the simple IRB approach.

Art. 52 (3) “Hybrid” credit pools in the retail area

In order to use the special risk-reducing structure of retail portfolios, an advanced IRB approach is required. Determinants such as an EAD or LGD should according to art. 52 (3) be individually determined for each sub-classification in the retail area. With the shifting of credit risks through the sale of entitlements thereto (“purchased retail exposures”), tranching is frequently undertaken without allowing for this supervisory risk classification, so that under art. 52 (3) “hybrid” pools of credit risks are created amongst purchasers. However, to conclude from this that the highest risk weighting function must then be selected, appears misguided, on the technical consideration that – unlike under the otherwise advanced IRB approach – risk weighting curves are set up for sub-classifications in the retail area. Sub-classifications in the retail area always presuppose a heterogeneity in security recognised by the supervisory authorities, which is especially noticeable in residential financing.

The problem arising from art. 52 (3) is that a specific risk weighting must really be found for the sale of retail portfolios that would have to be reflected in various conversion factors.

Art. 53 (6) Risk weighting with equity participations

The three processes mentioned for risk weighting for equity participations should be appropriate to the “individual” circumstances of the institution taking these risks. However, art. 53 (6) 3. should make it clear that the supervisory authorities cannot require a company’s own statistical material to be made available for all three processes. For the consistency of risk estimation, it must be sufficient for a procedure once approved to be continued without the provider being at liberty to change to another procedure. In any event, this always means heavy expense for operational conversion. The reasons for the choice of procedures adopted can be changed vis-à-vis the supervisory authorities only if an institution has obtained approval for two or all three methods being applied.

Art. 110 Allowing for insurances against operational risks

It is right to permit insurances against operational risks to be taken into account when weighting the risks concerned. However, it appears incomprehensible that this concession should be limited to use of the advanced IRB approach. Both under the standard procedure and under the ordinary IRB approach, the net worth that must be set aside to cover operational risks is derived from calculations made by the supervisory authorities that will regularly result in higher operational risks than when applying the bank’s sophisticated, internal estimations of such risks. It must therefore be all the more possible to enforce the established claims under insurances against operational risks.

The problems play an increasing role for the risks under borrowed capital financing of property investments, when such financing takes place in conjunction with associated contracts and viable capital market property products.

Art. 111 Combination of various approaches for credit risk assessment in conjunction with the advanced IRB approach

A comparable problem was already discussed in the criticism of art. 49 (2) and (3) under the IRB basic approach. The sole enduring provision appears in art. 50 of the IRB basic approach for the risk assessment of loans to states and institutions that are similarly governed by the Directive for supervisory purposes. The combination of the advanced IRB approach with other procedures for assessing credit risks is limited in art. 111 by a reference to H-5 to “roll-out” cases when implementing the advanced IRB approach.

Art. 146 (3) 10% LGD floor by 31 December 2009

The advanced IRB approach will be the most readily adopted for LGD measurement of mortgage loans in the retail area, at least in the European property markets. Firstly, because homes for occupation by single families predominate, these credit portfolios are comparatively unheterogeneous. Secondly, because of the preponderance of owner occupiers, the proportion of borrowed financing by banks is comparatively stable. The 10% floor precaution is taken solely because housing finance attracts a comparatively high share of total bank loans in the European Union's economic area.

The UEPC therefore advocates a lowering of the LGD minimum value, namely from 10% by the end of 2007 to 9% by the end of 2008, and to a transitional rate of 8% by the end of 2009, which – at least for the German situation – can also be established empirically as an estimate.

Consideration may be given to whether the 10% LGD floor might not be waived not only in the case of State guarantees but also of guarantees by backers with very good ratings.

Art. 156 (5) Specific valuation approach for equity investments by the end of 2016

So far, there are virtually no capital market statistics available for equity participation financing. It is therefore right, as in Annex D-5, to adopt specific valuation processes, until the prerequisites for an ordinary IRB approach exist. However, a transitional solution is acceptable up to the end of 2016 only if it is made clear that in accord with the supervisory requirements – the providers of equity participations have voting rights in the risk assessment procedure as approved by the supervisory authorities. A decision on valuation procedure cannot be left to the supervisory authorities alone.

It seems very much a problem that investment undertakings can benefit from the exclusion of the IRB approach provided they do not have a voting or capital majority in their participative interests. The problem already arises with the fact that under investment law, majority participation is prescribed by the supervisory authorities for certain forms of investment, and especially for investments in property companies. The relaxation provisions under art. 146 (5) then conflict with the statutory requirement to take up equity participations that can be valued only by a procedure which has not been tried or even permitted by the supervisory authorities.

The claw-back under art. 146 (5) 2. for participations in holding companies must therefore be eliminated.

IV. Draft changes to the Directive concerning the monitoring and control of major loans (92/121/EEC)

Art. 49 (7) p. Privileging of mortgages for commercial properties

The fact that under art. 49 (7) p. the changes to the Major Directive on Mortgage Loans on commercial properties may be deducted from the credit volume at up to 50% of the "value" of such properties must be welcomed. However, there is a problem insofar as this "value" can be ascertained only by a procedure laid down by law, other government regulations or administrative provisions. This is apparently intended to achieve special objectivity for the valuation procedure, because comparability is considered particularly important for the protection of credit institutions against the agglomeration of credit risks. However, this methodical clarity falls victim both to association with the lending value and also to the economic value of residential properties.

It appears incomprehensible that the aim should be only a privileging of major loans for residential property. This conflicts with the Basle Committee's approach, whereby virtually all commercial properties in established markets also justify privilege conditions for granting credit.

The fact that the aims of supervisory provision in the solvency scheme are different from those for risk weighting for major credits, does not exclude the linkage of privileging of commercial property as a means of reducing credit risks on their treatment in conjunction with major loans. Under the supervisory provisions of the Basle Committee, risk diversification is calculated on a straight line basis, so that it corresponds to the risk reduction aimed at under the Major Loans Directive.

The UEPC therefore advocates a provision of similar content for commercial buildings under art. 49 (7), in parallel with the reduction in the risk-carrying proportions of large loans for dwellings, so that at least 40% can be deducted.

V. Selected queries concerning property in the Annexes

C-9.1.3 Shares in mortgage loans fully secured by residential property

The conditions that must exist under the supervisory authority measures to justify a 35% risk weighting also include that debt servicing should not be paid essentially by contracts for a dwelling secured by a mortgage loan (“underlined property or project”). Instead, the payment potential of a debtor from “other sources” should predominate. The European Commission permits national supervisory authorities to waive this condition.

The condition should be abandoned altogether if – as is correctly done in the technical banking section of the European documents – housing finance in the retail area is dealt with in the Basle drafts by corporate finance and project finance. Here, too, the aim has always been to constitute project finance separately, while the allocation of housing finance to the corporate area or to the retail area was left open.

9 C-1 9.2.4 Parallel conditions for mortgage loans secured by commercial property in functioning markets

Here, too, the same condition, again subject to waiver by the national supervisory authorities, is made that debt servicing may not depend on a commercial property. This condition, too, should be deleted because in the case of investment in commercial properties in particular, their earning capacity is in any event more important than their material value, while with residential property the divergence of these two yardsticks is generally less.

In addition, risk weighting should be reduced to 35%, as for residential property.

C-1.9.2.3 Uniformity of risk weighting for proportions of mortgage loans previously secured by property extended to leasing (property leasing)

As with commercial premises, the risk weighting for the proportion of mortgage loans fully secured by the property value is reduced to only 50%, instead of 35 as for other financing. However, leasing, in particular, is based on contractual arrangements that secure the payment flow over a longer period than is usually the case with residential and non-residential lettings. In particular, a fixed lower level of this kind would no longer be plausible if – as is frequently the case with models of public private partnership – leases are concluded with local authorities.

C-1.11 Private equity as regulatory high risk credit classification

Here, the other method of calculation under the 3rd Basle Consultation paper for equity participation financing comes to bear, according to which the risk weighting would lie at 1.5 times the corresponding credits for corporate financing. However, since with corporate financing – depending on its creditworthiness – a great many lower values can be achieved from the risk weighting than 100% and the risk-carrying proportions of a loan can nonetheless be reduced

However, this decision of the European Commission makes sense only if equity participation financing can also be returned to the measurement of credit risks for corporate finance. Both restrictions are very important to future borrowed financing for major property projects.

D-2 1.1 (2) and (3) Introduction of tabulated period mark-ups on risk assessment of corporate finance and project finance

The European Commission is faced with the challenge of the Basle Rules or their implementation into European Directives being made legally binding within the area of the European Union, and not for small credit institutions alone. The risk weighting formulas are therefore reduced to simple tables outside the Basle approach, because smaller credit institutions could not otherwise benefit from the IRB basic approach. However, it appears highly questionable for risk components to be indirectly again introduced that depend on the residual period of the loans. The Basle Committee has solved the problem largely by presupposing a general residual period of 2.5 years under the IRB basic approach. The European Commission now, however, wishes to impose a differentiation of loans with a residual period of up to 2.5 years and of more than 2.5 years for corporate finance, doing so with sensitive intervals in risk weighting. This also affects project financing insofar as it can be assigned to the corporate area. The same distribution may also be found applied to external financing of highly volatile commercial properties, with correspondingly tighter additions to the Table in the 3rd Consultation paper (see section 249 in the latter).

These changes have been plucked from the air, i.e. without any background in banking statistics. However, they increase the risks of long term financing, especially of major property projects. These additions should therefore be deleted from the Basle Rules.

D-4 15 “Fair Value” valuations for equity participation financing

Equity participation financing by banks should for supervisory purposes be allocated – independently of accountancy questions – directly to the regulatory capital or net worth formation through revenues. It is therefore significant that the European Commission has decided to prescribe a commercial “Fair Value” assessment. This has been implemented in Germany outside the Commercial Code, which in view of its economic defects regarding valuation principles can only be welcomed. However, it is not clear why the “Fair Value” approach should be applied tax-adjusted when a demand is made at the same time for the same figures also to be used for accounts presentation. In particular, major property projects generally require short-term or long-term financing for participations up to completion, with “off-balance-sheet items” where a value is allocated only for regulatory net worth purposes.

The problem with the provisions of D-4 15 is that the net worth component is directly compared with the risk-carrying assets. This does not, however, allow for taxes.

D-5 14 Use of external valuations in internal bank rating

This Rule is particularly important if a bank has opted for the IRB basic approach but the bank’s internal statistics appear inadequate for risk weighting of the credit to be granted. The borrower is in this case in a position to obtain an external rating which is then included in the bank’s internal rating.

However, what is missing from D-5 15 are comments on the permissibility of such a procedure under banking supervision law.

D-5 23 Linking of quality criteria for project finance with internal banking statistics

The permissibility of linking the so-called “slotting approach” for quality risk categorisation of project finance with internal banking statistics, which for the most part originate in corporate financing, is of particular value, especially for major property projects.

What must still be clarified in this important decision of the European Commission is that where fixed valuations by the banking supervisory authorities compete, the banks' internal assessments have precedence over the latter.

D-5 43 Measurement of loss on debt default

The further opinion on D-5 deals with procedures that the European Committee wishes to recognise in order to establish the determinants of risk weighting. It will become evident that operating and statistical procedures are so heterogeneous that the valuation can be used only with the greatest caution as to its accuracy. However, these methodical weaknesses are virtually unavoidable if credit institutions of every size are to be included in the supervisory obligations under the Basle Rules and their implementation into the Directives of the European Commission.

D-5 43 calculates the credit default in such a way that previously incurred interest and charges are not allocated to net worth, that previously undertaken credit depreciation from actual risk management is taken into account and that the "economic" value of the loss, i.e. at least a valuation by the market value procedure, is applied without having to allow for possible discounts for a deterioration in creditworthiness.

In actual fact, apart from depreciation previously undertaken, this procedure produces a value which does not reflect the actual calculation for risk management. The result, making a virtue of a statistical necessity, is a complex system of ratios that can no longer be incorporated into the Basle Rules.

D-5 54 et seq. Permissible sources for assessment

These sections contain the estimates of default probabilities from very diverse sources but individually regulated for the risk asset classes for corporate financing, from bank-to-bank lending and loans to governments on the one hand to the retail area on the other. Expansion of staff concerned with operational business, external data from possibly pooled credit ratings and more demanding internal banking statistical models can be used as statistical "sources".

According to D-5 55 and 59, it is possible, quite correctly, for the procedures to be combined in each case so that it can be assumed that the IRB basic approach will permit segmentation based on nominal average values.

D-5 61 et seq. Requirements of the bank's own LGD assessments

It is quite clear that the European Commission wishes to regulate one of the determinants under the advanced IRB approach here – in addition to the EADs. The requirements of an LGD assessment include above all the relationship of the debtor risk and reduction of risk-carrying aspects of the loan to be covered by security and a sufficiently "conservative" margin. In the retail area, actual nominal losses may even be related to potential defaults and an LGS assessment obtained in this way.

Obviously, the European Commission is proceeding between an advanced IRB approach and the stricter requirements of the Basle Committee for AMAs (Advance Measurement Approaches) operating with complex stochastic procedures. At the same time, it is clear that the simplified procedure leads to an increased application of risk buffers through interest and charges.

D-5 70 et seq. Requirements of the bank's own EAD assessments

In view of the relaxation for LGD assessments, as applied through D-50 61 et seq. it is surprising that the substantially easier assessment of EADs for banking statistical purposes should be overwhelmed by the prerequisites, so that both for long-term time series and also for the economic cycles a volatility must specifically be ascertained for the credit portfolio regarding the status of the downward trend, and that the higher value of the EAD assessment must be used as a basis overall.

On the one hand, this would mean that the typical or atypical sub-partnerships of banks in real estate project financing would have to be reassessed quarterly although the investor and the bank are agreed – possibly after many years of business partnership – that conversion to credit financing should follow only on the bank's participation being replaced by other participating interests.

A highly critical factor is that with the exaggerated requirement for two EAD estimates, the procedure intended to simplify matters for smaller credit institutions, that an LGD also as a percentage of the EADs under the various portfolios in fact means doubling the risk buffer for risk-carrying assets, could still be applied only with difficulty. Apart from a possibly higher assessment of the volatility in the economic cycle, a mark-up must also still be made following resort to a simplified procedure for LGD assessment based on EADs (D-5 70-71).

D-5 101 Risk weighting for residual values on articles leased

Within the advanced IRB approach, the parameters for leasing appear too restrictive and especially not to conform to the customary economic costings for leasing purposes. Contractual security regarding the acceptance of the leased article by the lessee is – outside of an option – already not normally possible for tax reasons, since economically a sale transaction would otherwise arise. However, isolation of the residual value as provided in D-5 101 would apply in specific cases, instead of a corresponding portfolio, the risks of which – despite a leasing agreement potentially extending over several decades – must be controllable in banking statistical terms. For the start-up phase of establishing the new Rules, resort must consequently be made to plausible costings for leasing.

In no way can the long term agreements required for many leasing transactions trigger the reservation that the agreed payments flow may be capitalised but a 100% risk weighting would be required for the residual value – as with a non-rated business transaction or asset.

D-5 104 Risk management for equity participations

This section, too, is concerned with a banking supervision arrangement for capital banking for risk-carrying assets. No statistics for risk valuation of course exist as yet for an equity participation, as a new classification of risk assets, for either banks or investment firms. Nonetheless, to demand the complete integration of the internal risk models, as under D-5 104 (a) is going too far, since the risk assessment for the operational business would thereby be adopted for ascertaining capital backing. The precautionary measures for operational business would thereby once again prove detrimental to capital backing.

Legally, the problem will arise that as is similarly clear from D-5 104 (a) and 9b), the regulatory capital will have to correspond to the economic capital. However, this would further to the above result in balance sheet reporting matters becoming banking supervisory matters at the same time. However, this encroachment on operational business should not be possible as a result of the extended powers of the supervisory authorities when implementing the Basle Rules. On the one hand, the economic net worth can be derived from the lower reported net worth by adding the net asset value of hidden reserves through participating interests, property securing contingent loan losses and pension provisions to the book value of net worth (subscribed capital, capital reserve, revenue reserve and net profit).

The level of the so-called regulatory net worth therefore lies between the reported net worth and the economic net worth, consequently however also above the economic net worth. With regularly net worth, the borrowed capital must be taken into account as additional capital in classes I and II, together with the residual capital and the net profit. In addition, however, contrary to the position regarding economic net worth, account is thereby taken of both the capital in the general bank risks fund under banking supervisory law and also third-charge liabilities under net profit on balancing up all Commercial Code items and short term secondary liabilities with a normal original currency of more than two years.

G-1 1.1.3.4**Valuation of property on a reduction in credit risks by criteria of both subjective and objective financing theory**

This section is still tainted with the defects of the first consultation paper of 1998, in which material security not traded in a regulated market was left out of account. According to the technique for reducing credit risks by security, with the status of the discussions to date by the Basle Banking Supervision Committee, it no longer seems reasonable to describe loan security as “additional”. The fact that independently of the credit classification – especially in the retail area and with borrowed financing of small and medium-sized undertakings – the reduction in credit risks through property is regulated generally for leased dwellings and leased commercial property, i.e. yield-producing real estate, is welcome. This does not of course rule out special arrangements for the ratio of owner-occupied to leased living space in the retail area or for small or medium sized companies.

However, it is highly problematical for the security function of real estate in the IRB basic approach to be broken down in E-1 1.1.3.4 II into two principles belonging to conflicting financing theories: the “objective” that prevails in Europe, aligned on the value content of the property, and the “subjective” prevailing in the USA and the United Kingdom, which is oriented on debtor creditworthiness. This seems to indicate that member states of the European Union evidently assess the cluster risks of real estate yields for their property markets differently. A partial solution is being sought in the objective function of real security fully replacing the subjective in the technical reduction of credit risks, in line with the current position in the Basle consultations, provided the supervisory authorities of a member state waive the second condition of risk measurement for their national territory, whereby the debtor risk should not be based on the “performance” of the property securing a loan. This condition is in any event likely to undermine the financing of real estate projects to the furthest degree. In any event, it is quite incompatible with the sub-classifications of Special Lending.

In addition, however, where a supervisory authority suspends the second condition, the situation arises that all that is achieved is an assessment of the domestic property markets as well developed and long established with binding effect on domestic credit granting. This produces an asymmetrical situation: the waiver of the debtor risk approach of yield-bearing property is, on the one hand, not a general rule for the credit risk portfolios concerned of domestic financing institutions, since nothing is said of foreign property markets, even within the economic area of the European Union. If, however, a member state wishes to take account of cluster risks generally, this includes not only an assessment of specific property markets but a spill over effect is achieved on credit financing in the foreign property markets.

The result is a confusing overlap of supervisory regulations. There is the target provision for the national supervisory authorities, that an assessment of the foreign property markets by the local supervisory authorities is taken into account when credits are granted by a lender in the home country subject to supervisory law. It is consequently left to the national supervisory authorities not to place the institutions answerable to them in a poorer position with their foreign commitments than domestic competitors on the other market. Conversely, however, there is no provision requiring the supervisory authorities to allow for the fact when assessing risk assets under foreign business with property credits that the local supervisory authorities have failed to relieve the institutions answerable to them from the condition of debtor creditworthiness when assessing security based on property.

This unsatisfactory situation is due firstly to the powers of national supervisory authorities. Secondly, it follows from the legal principle of avoiding discrimination against foreigners. Nonetheless, this heterogeneity of supervisory regulations concerning the value of properties used for security is affected by a subjective financing theory that is incompatible with freedom on the European capital markets, since the national supervisory authorities may in effect discriminate systematically against local residents. Whether the national supervisory authorities must take account of a favourable assessment by the local supervisory authorities of the foreign property markets in the case of foreign commitments of institutions answerable to them also remains unanswered.

The duty to report a waiver of the condition of debtor creditworthiness to the European Commission burdens the Commission with coordination tasks when taking account of favourable assessments of domestic property markets by the foreign supervisory authorities for the granting in the home country of property loans. Nonetheless, a further unregulated area of domestic discrimination remains in the specific, non-positively assessed property markets and their discrimination against domestic lenders that are answerable to the supervisory authorities for their foreign commitments. The Basle negotiations to date do not ensure that such regulations will be introduced. This is a European "addition", which should again be removed.

Insofar as a national supervisory authority sees reason for countering cluster risks, this can be avoided only by means of quantitative or qualitative prerequisites regarding the use of value-at-risk models under the IRB basic approach, provided capital market freedom in the European economic area is not to remain incomplete within the important sector of property credits. A great many different credit classifications, from the retail area, through corporate financing to Special Lending would be affected.

E-2 2.1.5.2 "Margins" when purchasing receivables

Credit arbitrage, already described under item 2 of this section and the valuation of which has been dealt with, is itself as a "margin" the result of market activities and – unlike premiums, where a risk buffer must be formed – cannot therefore be left out of a capital approach relevant to risk assessment. The rules are sensible. However, they also indicate that simple money market transactions are sufficient to cover the unsystematic character of the handling of risk premiums under the Basle Rules and acceptance of the latter in the draft Directives submitted, together with the technical annexes.

An appreciable imbalance exists especially where the Basle Committee has allowed the risk buffer of charges and interest to flow directly into net worth in the retail area in order to avoid risk and disallows this only in the case of mortgage loans. This would result indirectly in non-meaningful period mark-ups in the retail area on account of the high diversification of credit transactions within it.

In actual fact, the overall treatment of "conservative margins" must be fully revised as a risk buffer in the Basle Rules.

Annex F-5 Allowing for original periods of loans with credit risks valued by the standard procedure for risks under credit insurances

Neither the Basle Rules nor the draft Directive submitted require credit periods to be taken into account in the standard procedure based on external ratings of both the debtor and of credits. This applies both to the original period and to the residual period of loans. It is all the more irritating that the original period under credit insurances, as governed under Annex F-5, is stated. However, in this case only admissibility criteria are defined as to which long term and current receivables may be taken into account at all for reducing the risk by a credit insurance. However, the risk weighting for permissible credit insurance is also laid down quantitatively at the same time.

The effect of credit insurances is dealt with in Annex F-5, which according to the definition in Art. 1 (81) of the Draft Directive must be valued in a pool, is based only on an exhaustion effect and not on repeated risk diversification. The "look-through" process described in Annex F-5b would otherwise not also be applicable.

Since the pools are customarily very stable for credit insurances, there is no reason for cutting out higher risks under the poorer rating steps for long-term receivables already at point 4 and for short-term receivables at as low as point 3. Short-term interim financing is technically transferred to long-term end-financing in the property business especially. Heterogeneous treatment for credit insurances according to a plan laid down under banking supervision law – i.e. without empirical backing – would therefore complicate credit insurance for projects in

which even short-term financing must be replaced by long-term financing with the same borrower, or even render it impossible

Annex H-2 **Basic indicator for operational risks**

Assessing the operational risk inclusively at 15% for favourable revenues while zero percent would suffice for the operational risks for negative revenues seems a meaningless relocating imposed on the supervisory authorities of operational risks with a capital rating for risk-carrying assets.

There is no reason why revenues should not already be defined for a discounted assessment of operational risks as part of the basic approach – corresponding to an overall view of costs. This would also ensure that they need not of course – but can – increase on negative revenues.

Annex H-3 **Separate accounting of anticipated and unanticipated losses in an assessment of operational risks**

A very tight confidence interval of 99.9% is laid down in Annex H-3 1.2.1 for the assessment of operational risks. However, it is not clear why a possible separation of anticipated losses, with an indication that these are covered by premiums, should be left only to the advanced IRB approach. With the latter, too, resort must be made to a very simple statistical valuation procedure that has sufficed for the measurement of risk buffers in charges and interest rates to cover anticipated risks.

Annex H-5 **Combination of the risk assessment procedures under AMAs**

The third sub-paragraph of Annex H-5 provides for a scheduled approach to be agreed with the supervisory authorities when measuring operational risks.

This problem would be avoided if – in accordance with the above proposal regarding Annex H-2 – the basic approach using the revenue indicator were changed to intervals in risk weighting or in income.