The New Capital Adequacy Framework – Basel II

World Bank/IMF/Federal Reserve Seminar for Senior Bank Supervisors from Emerging Economies
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Elizabeth Roberts, Director
Financial Stability Institute
Agenda

- The Need for Capital
- Review of the Key Concepts of Basel I
- Basel II: the Treatment of Credit Risk
- Basel II: the Treatment of Operational Risk
- Basel II: Pillar 3
- Basel II: Implementation Considerations
Why Do Banks Need Capital?

- Source of funds (growth!)
- Buffer against future, unidentified losses
- Cushion that protects depositors and creditors
- Provides a level of confidence
What Factors Drive Capital Levels?

- Management strategy
  - the level which management deems appropriate based on internal assessments
- Market views
  - e.g. counterparties, rating agencies
- Shareholder expectations
  - Return on capital
- Regulatory capital requirements
  - Basel Accord
Why Was the First Basel Capital Accord Necessary?

Developments in the 70s and 80s

- Volatility (especially in exchange and interest rates)
- Deregulation
- Globalisation
- Innovation (especially the use of off-balance-sheet instruments)
- Latin American debt crisis

*Lead to the erosion of the capital base of most major banks worldwide*
Basel I

The 1988 Capital Accord

- Uniform definition of capital (Tier 1 and Tier 2)
- Risk-weights applied to categories of assets based on perceived risk (0, 20, 50 and 100%)
- Off-balance sheet exposures "converted" to an on-balance sheet amount with appropriate risk weight applied
- Minimum of 8 percent capital set for internationally-active banks in the G-10 countries (Capital/RWA $\geq 8\%$)
Definition of Capital (i.e. numerator)

- Tier 1: Core capital
  - Equity
  - Disclosed reserves
- Tier 2: Supplementary capital (limited to 100% Tier 1)
  - Undisclosed reserves
  - Revaluation reserves
  - General provisions/general loan loss reserves
  - Hybrid instruments
  - Subordinated debt (lower Tier 2)
- Tier 3: Short-term Subordinated Debt
Basel I

Work since 1988

- 1996: Amendment to the Accord to incorporate market risks (implementation: end-1997)
- Many additional clarifications and refinements
- 2001: A new Capital Adequacy Framework - revised draft
- Spring 2003: the third draft of the proposed changes
- June 2004: publication of the “final” document
Merits of the 1988 Accord

- Substantial increases in capital ratios of internationally active banks
- Relatively simple structure
- Worldwide adoption
- Increased competitive equality among international banks
- Greater discipline in managing capital
- A benchmark for assessment by market participants
Weaknesses of the 1988 Accord

- Does not assess capital adequacy in relation to a bank’s true risk profile
  - Limited differentiation of credit risk
  - No explicit recognition of operational and other risks
- Sovereign risk not appropriately addressed
- Does not provide proper incentives for credit risk mitigation techniques (hedging, etc)
- Enables regulatory arbitrage through securitisation, etc.
Objectives of the Proposed New Capital Adequacy Framework

- Continue to promote safety and soundness
- Better align regulatory capital to underlying risk
- Encourage banks to improve further their internal risk management systems
- Focus on internationally active banks but should be suitable for banks of varying levels of complexity and sophistication
Why Is Basel II So Complex?

- More risk sensitivity means more detail
- It is applicable to all banks, so in many cases there are more options
  - Banks in different jurisdictions
  - Banks of all sizes and levels of sophistication
- It is much more comprehensive: two new pillars plus operational risk
The Organization of the New Accord

Three Basic Pillars

- Minimum capital requirements
- Supervisory Review Process
- Market Discipline
Outline of the New Accord - Basic Structure

Three Basic Pillars

Minimum capital requirements
Supervisory review process
Market discipline

Risk weighted assets

Credit risk
- Standardised Approach
- Internal Ratings-based Approach
- Basic Indicator Approach
- Standardised Approach
- Advanced Measurement Approaches

Operational risk

Market risks
Core Capital
Supplementary Capital

Definition of capital

Core Capital
Supplementary Capital

Minimum capital requirements
Supervisory review process
Market discipline

Definition of capital
The Treatment of Credit Risk in Pillar 1
Recognition of Drivers of Credit Risk

Example: Loan to General Motors of € 500,000, of which € 300,000 is undrawn commitment, € 100,000 is collateralised by US Treasury Bonds, maturity 3 years

- **Type of risk**
  - Riskiness of borrower
  - Riskiness of transaction
  - Likely amount of exposure
  - Time dimension risk
  - Diversification/Concentration

- **Driver**
  - ?
  - ?
  - ?
  - ?
  - ?
Drivers of Credit Risk

<table>
<thead>
<tr>
<th>Type of risk</th>
<th>Driver</th>
</tr>
</thead>
<tbody>
<tr>
<td>Riskiness of borrower</td>
<td>Probability of default</td>
</tr>
<tr>
<td>Riskiness of transaction</td>
<td>Loss given default</td>
</tr>
<tr>
<td>Likely amount of exposure</td>
<td>Exposure at default</td>
</tr>
<tr>
<td>Time dimension risk</td>
<td>Maturity</td>
</tr>
<tr>
<td>Diversification/Concentration</td>
<td>Correlations</td>
</tr>
</tbody>
</table>
## Recognition of drivers of credit risk

<table>
<thead>
<tr>
<th></th>
<th>1988 Accord</th>
<th>Standardised approach</th>
<th>FIRB</th>
<th>AIRB</th>
</tr>
</thead>
<tbody>
<tr>
<td>Probability of default</td>
<td>Basel Committee</td>
<td>External Credit assessment Inst.</td>
<td>Banks' own assessments</td>
<td>Banks' own assessments</td>
</tr>
<tr>
<td>Loss given default</td>
<td>Few CRMs recognised</td>
<td>Expanded list of CRMs</td>
<td>Fixed LGDs</td>
<td>Banks' own assessments</td>
</tr>
<tr>
<td>Exposure at default</td>
<td>Credit conversion factors</td>
<td>Credit conversion factors</td>
<td>Credit conversion factors, fixed EADs</td>
<td>Banks' own assessments</td>
</tr>
<tr>
<td>Maturity</td>
<td>Hardly recognised</td>
<td>Hardly recognised</td>
<td>2.5 years or banks' own assessments</td>
<td>Banks' own assessments or 2.5 years</td>
</tr>
<tr>
<td>Correlations</td>
<td>Not explicitly recognised</td>
<td>Not explicitly recognised</td>
<td>Preset correlations</td>
<td>Preset correlations</td>
</tr>
</tbody>
</table>
Standardised Approach

- Objective is to align regulatory capital with economic capital and key elements of risk by introducing a wider differentiation of risk weights and credit risk mitigation techniques
- Balance between simplicity and accuracy
- Simplest of the three approaches to credit risk
- Will be used by most banks in the foreseeable future
The Standardised Approach

Main Features:
- Continue to slot exposures into risk-weighted buckets based on broad distinctions of risk determined by supervisors
- Risk-weights now more sensitive to inherent risks
  - based on external credit assessments
  - introduction of additional risk weight categories
  - more refined treatment of credit risk mitigation
Risk Weights - Standardized Approach

- Continue to be set by supervisors
- Risk weights determined by category of borrower:
  - sovereign
  - bank
  - corporate
- Risk weights dependent upon external credit assessments
Claims on Sovereigns

- Based upon ECAI’s long-term domestic rating for domestic and foreign currency obligations

<table>
<thead>
<tr>
<th>Credit Rating</th>
<th>AAA to AA-</th>
<th>A+ to A-</th>
<th>BBB+ to BBB-</th>
<th>BB+ to B-</th>
<th>Below B-</th>
<th>Unrated</th>
</tr>
</thead>
<tbody>
<tr>
<td>Risk Weights</td>
<td>0%</td>
<td>20%</td>
<td>50%</td>
<td>100%</td>
<td>150%</td>
<td>100%</td>
</tr>
</tbody>
</table>
Claims on Sovereigns

- At national discretion, supervisors may allow the use of ratings from Export Credit Agencies
- Available for a far greater number of sovereigns
- Assessments must be publicly available

<table>
<thead>
<tr>
<th>ECA Risk Score</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4 to 6</th>
<th>7</th>
</tr>
</thead>
<tbody>
<tr>
<td>Risk Weight</td>
<td>0%</td>
<td>20%</td>
<td>50%</td>
<td>100%</td>
<td>150%</td>
</tr>
</tbody>
</table>
National Discretion: Preferential treatment (e.g. 0% risk weight) can apply to exposures to a bank's own sovereign (and central bank)

- Preconditions for preferential treatment
  1. Exposure denominated in domestic currency
  2. Exposure funded in domestic currency
Preferential Treatment for Domestic Claims

- Other supervisors may also permit their banks to apply the same risk weighting (i.e. if South Africa applies 0%, Botswana can follow)
- This is provided that the claim on the sovereign is denominated and funded in the national currency of that sovereign (i.e., bank in Botswana has a claim on the government of South Africa denominated in SA Rand and funded in SA Rand)
Claims on Banks

- Two options:
  - based on assessment of sovereign
  - based on assessment of bank
- Supervisors must apply one option to all banks in their jurisdiction
- No unrated claim may receive a risk weight less than the sovereign of incorporation
Claims on Banks - Option 1

- Banks are assigned a RW one category less favorable than the country of incorporation.
- RW cap at 100% except in countries rated below B-, in which case the RW is 150%.

<table>
<thead>
<tr>
<th>Credit Assessment of Sovereign</th>
<th>AAA to AA-</th>
<th>A+ to A-</th>
<th>BBB+ to BBB-</th>
<th>BB+ to B-</th>
<th>Below B-</th>
<th>Unrated</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sovereign Risk Weight</td>
<td>0%</td>
<td>20%</td>
<td>50%</td>
<td>100%</td>
<td>150%</td>
<td>100%</td>
</tr>
<tr>
<td>Bank Risk Weight</td>
<td>20%</td>
<td>50%</td>
<td>100%</td>
<td>100%</td>
<td>150%</td>
<td>100%</td>
</tr>
</tbody>
</table>
Based upon the credit assessment of the bank itself

- At national discretion a preferential treatment exists for claims of 3 months or less (original maturity), subject to a floor of 20% (not available to banks rated below B-)

### Claims on Banks - Option 2

<table>
<thead>
<tr>
<th>Credit Assessment of Banks</th>
<th>AAA to AA-</th>
<th>A+ to A-</th>
<th>BBB+ to BBB-</th>
<th>BB+ to B-</th>
<th>Below B-</th>
<th>Unrated</th>
</tr>
</thead>
<tbody>
<tr>
<td>Risk Weight</td>
<td>20%</td>
<td>50%</td>
<td>50%</td>
<td>100%</td>
<td>150%</td>
<td>50%</td>
</tr>
<tr>
<td>Risk Weight for ST Claims</td>
<td>20%</td>
<td>20%</td>
<td>20%</td>
<td>50%</td>
<td>150%</td>
<td>20%</td>
</tr>
</tbody>
</table>
Claims on Multilateral Development Banks

- Risk weighted similar to banks under option 2
- 0% risk weight is possible (as determined by the Basel Committee) for MDBs that fulfill certain criteria:
  - majority of external assessments are AAA
  - shareholder structure is significantly comprised of sovereigns with long term issuer credit assessments of AA or better
  - strong shareholder support (i.e. amount of capital, amount of callable capital)
  - adequate level of capital and liquidity
Multilateral Development Banks Assigned to 0%

- World Bank Group
- Asian Development Bank
- African Development Bank
- European Bank for Reconstruction and Development
- Inter-American Development Bank
- European Investment Bank
- Nordic Investment Bank
- Caribbean Development Bank
- Council of Europe Development Bank
- Islamic Development Bank
Claims on Corporates

- Based upon comments received from the industry, a 50% RW was added and expansion of 150% RW
- Elimination of sovereign floor
- No unrated claim can receive a RW less than the sovereign RW

<table>
<thead>
<tr>
<th>Credit Assessment of Corporates</th>
<th>AAA to AA-</th>
<th>A+ to A-</th>
<th>BBB+ to BB-</th>
<th>Below BB-</th>
<th>Unrated</th>
</tr>
</thead>
<tbody>
<tr>
<td>Risk Weight</td>
<td>20%</td>
<td>50%</td>
<td>100%</td>
<td>150%</td>
<td>100%</td>
</tr>
</tbody>
</table>
Claims on Retail

- New lower risk weight for retail portfolio, e.g.
  - 35% for residential mortgages (currently 50%)
    - Past due mortgage loans are weighted at 100%
  - 75% for other retail (currently 100%)
    - The bank’s total exposure to the firm must be less than €1 million
    - Past due claims do not qualify for this preferential treatment
Other Risk Weighting Issues

- The unsecured portion of past due assets (90 days or more), net of specific provisions, will be risk weighted at 150%
- Other assets will continue at 100%
- Maturity is a factor relevant to the assessment of credit risk, but making the standardized approach more complex increases the cost
Standardised Approach – Risk Weights

<table>
<thead>
<tr>
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<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Sovereigns (Export credit agencies)</td>
<td>0%</td>
<td>20%</td>
<td>50%</td>
<td>100%</td>
<td>150%</td>
<td>100%</td>
</tr>
<tr>
<td>Banks</td>
<td>20%</td>
<td>50%</td>
<td>100%</td>
<td>100%</td>
<td>150%</td>
<td>100%</td>
</tr>
<tr>
<td>Option 1¹</td>
<td>20%</td>
<td>50%</td>
<td>100%</td>
<td>150%</td>
<td>100%</td>
<td></td>
</tr>
<tr>
<td>Option 2²</td>
<td>20% (20%)³</td>
<td>50% (20%)³</td>
<td>50% (20%)³</td>
<td>100% (50%)³</td>
<td>150% (150%)³</td>
<td>50% (20%)³</td>
</tr>
<tr>
<td>Corporates</td>
<td>20%</td>
<td>50%</td>
<td>100%</td>
<td>BB+ - BB-</td>
<td>Below BB-</td>
<td>100%</td>
</tr>
<tr>
<td>Mortgages</td>
<td></td>
<td></td>
<td></td>
<td>100%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other retail</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

¹ Risk weighting based on risk weights of sovereign in which the bank is incorporated, but one category less favourable.
² Risk weighting based on the assessment of the individual bank.
³ Claims on banks of an original maturity of less than three months generally receive a weighting that is one category more favourable than the usual risk weight on the bank’s claim.
External Credit Assessment Institutions (ECAI)

- Not a perfect solution but
  - Provides better differentiation of risks
  - Better than present OECD criterion
  - Most sovereigns are rated
  - No valid alternative proposed
Historical Default Rates

- Main reason for using ECAIs: increases the risk sensitivity
- High correlation between ratings and default rates

S & Ps PD over 5-year horizon

![Bar chart showing default rates for different credit ratings.](chart.png)
External Credit Assessment Institutions

- ECAIs must be recognized by the supervisor
- ECAIs may be recognized on a limited basis (i.e. type of claim or jurisdiction)
- Process for recognizing ECAIs must be disclosed
- Eligibility criteria
  - objectivity
  - international access (transparency)
  - resources
  - independence
  - disclosures
  - credibility
Internal Ratings-based Approach

The fundamental question
Who is the best judge of a bank’s exposure to credit risk?

- The supervisor?
- A rating agency?
- The bank itself?
Basic Elements of the IRB Approach

- Relies on a bank’s assessment of risk factors
- Based on three main elements
  - Risk components (probability of default, loss-given default, exposure at default, maturity)
  - Risk weight function
  - Minimum requirements
- Separate approaches for each portfolio of assets
- Subject to supervisory validation and approval
# IRB Approach – Risk Components

<table>
<thead>
<tr>
<th>Component</th>
<th>Recognition</th>
</tr>
</thead>
<tbody>
<tr>
<td>Probability of default</td>
<td>Bank</td>
</tr>
<tr>
<td>Loss-given-default (LGD)</td>
<td>Bank</td>
</tr>
<tr>
<td>Exposure-at-default (EAD)</td>
<td>100%</td>
</tr>
<tr>
<td>Maturity</td>
<td>Bank</td>
</tr>
<tr>
<td>Correlations</td>
<td>Built into risk weight function</td>
</tr>
<tr>
<td></td>
<td>(Fixed numbers)</td>
</tr>
</tbody>
</table>

- Built into risk weight function (Fixed numbers)
Risk Components (PD)

Assessment of Borrower Risk

- Quantitative information
  - e.g. balance sheet, income statement, cash flow
- Qualitative information
  - e.g. quality of management, ownership structure

Measures

*Probability of default (PD)*
Risk Components (LGD)

Assessment of Transaction Risk

- Factors: collateral, seniority, recovery time etc.
- Two-dimensional rating systems (matrix)
  - Borrower risk and transaction risk

Measures

Loss-given-default (LGD)
Risk Components (EAD)

Amount of Exposure at the Time of Default

- Nominal amount for simple structures
- For lines of credit:
  
  Amount outstanding + a portion of committed but undrawn lines

Measures

Exposure at default (EAD)
IRB - Categories of Exposures

- **Corporates**
  - Traditional (sovereigns and banks in principle subject to same risk weight curve)
  - SMEs
  - Specialised lending
  - High-volatility commercial real estate

- **Retail**
  - Residential mortgages
  - Qualifying revolving exposures
  - Other retail

- **Equities**
Risk Weight Function

"IRB" does not always mean lower capital requirements
Different kinds of assets rely on different risk weight functions (curves)
Concluding Thoughts on Credit Risk

- The New Accord’s main goal: more risk sensitivity
- The New Accord offers a range of options for the treatment of credit risk
- The Committee is moving away from a “one-size-fits-all” approach to capital regulation
- The IRB approach is primarily aimed at sophisticated banks, with well developed risk management systems in place
- The revised Standardised Approach is fully valid and beneficial for smaller and less complex banks
The Treatment of Operational Risk in Pillar 1
Outline of the New Accord - Basic Structure

Three Basic Pillars

- Minimum capital requirements
- Supervisory review process
- Market discipline

Risk weighted assets

- Credit risk
  - Standardised Approach
  - Internal Ratings-based Approach
  - Basic Indicator Approach

- Operational risk
  - Standardised Approach
  - Advanced Measurement Approaches

- Market risks
  - Standardised Approach
  - Models Approach

Definition of capital

Core Capital

Supplementary Capital
Definition of operational risk

- The risk of loss resulting from inadequate or failed
  - *internal processes*
  - *people*
  - *systems*
  or from *external events*
Operational risk event types

- Internal fraud
- External fraud
- Employment practice and workplace safety
- Clients, products and business practices
- Damage to physical assets
- Business disruptions and system failures
- Execution, delivery and process management
How big is operational risk?

- 2002 operational risk loss data collection exercise
  - 89 banks took part
  - 47 banks holding economic capital for operational risk
  - Ranges from 0% to 40% of current MRC
  - Mean 15%
Treatment of other risks

Pillar 1

Operational risks (including legal risk)

Interest rate risk in the banking book

Liquidity risk

Strategic, Reputational etc..

Other risks

Pillar 2 and Pillar 3
Continuum of approaches

- Basic Indicator Approach
- Standardised Approach
- Advanced Measurement Approaches

lower

sophistication

risk-sensitivity

higher
Continuum of approaches

Basic Indicator Approach ("BIA")
Basic Indicator Approach

- Capital charge is based on single indicator multiplied by fixed percentage (\(\alpha\))
- Proposed indicator: gross income

\[ \text{Capital charge} = \alpha \times \text{indicator} \]

- Calibrated to 12% of current MRC
- CP3: \(\alpha = 15\%\)
- Three year average
- No qualifying criteria – encouraged to comply with Sound Practices
- Generally not for internationally active banks
Continuum of approaches

Basic Indicator Approach ("BIA")

Standardised Approach ("TSA")
Standardised Approach

- Activities divided into 8 business lines
- Indicator: gross income
- Capital charge for each business line calculated by multiplying gross income by a factor (beta)
- Total capital charge simple sum of capital charges for each business line

\[
\text{Capital charge} = \sum (GI_{1-8} \times \beta_{1-8})
\]
## Standardised Approach

<table>
<thead>
<tr>
<th>Business Lines</th>
<th>Beta Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corporate Finance</td>
<td>18%</td>
</tr>
<tr>
<td>Trading &amp; Sales</td>
<td>18%</td>
</tr>
<tr>
<td>Retail Banking</td>
<td>12%</td>
</tr>
<tr>
<td>Commercial Banking</td>
<td>15%</td>
</tr>
<tr>
<td>Payment &amp; Settlement</td>
<td>18%</td>
</tr>
<tr>
<td>Agency Services</td>
<td>15%</td>
</tr>
<tr>
<td>Retail Brokerage</td>
<td>12%</td>
</tr>
<tr>
<td>Asset Management</td>
<td>12%</td>
</tr>
</tbody>
</table>
### Example - Standardised Approach

<table>
<thead>
<tr>
<th>Business line</th>
<th>Gross income</th>
<th>Beta</th>
<th>Result</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corporate finance</td>
<td>100</td>
<td>x 18%</td>
<td>= 18</td>
</tr>
<tr>
<td>Trading &amp; sales</td>
<td>100</td>
<td>x 18%</td>
<td>= 18</td>
</tr>
<tr>
<td>Retail banking</td>
<td>300</td>
<td>x 12%</td>
<td>= 36</td>
</tr>
<tr>
<td>Commercial banking</td>
<td>300</td>
<td>x 15%</td>
<td>= 45</td>
</tr>
<tr>
<td>Payment &amp; settlement</td>
<td>100</td>
<td>x 18%</td>
<td>= 18</td>
</tr>
<tr>
<td>Agency services</td>
<td>100</td>
<td>x 15%</td>
<td>= 15</td>
</tr>
<tr>
<td>Asset management</td>
<td>100</td>
<td>x 12%</td>
<td>= 12</td>
</tr>
<tr>
<td>Retail brokerage</td>
<td>100</td>
<td>x 12%</td>
<td>= 12</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>1,200</strong></td>
<td></td>
<td><strong>174</strong></td>
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</tbody>
</table>
Standardised Approach

Minimum standards for use

- Operational risk management function
- Track relevant operational risk data
- Regular reporting of operational risk exposures
- Documentation
- Internal and external review
Continuum of approaches

- Basic Indicator Approach (“BIA”)
- Standardised Approach (“TSA”)
- Advanced Measurement Approaches (“AMA”)
Advanced Measurement Approaches (AMA)

Key points

- Banks meeting rigorous supervisory standards can use their internal capital assessment techniques to calculate capital charges
- Range of measurement approaches emerging
- Committee setting general criteria - not going to specify approach banks have to use
AMA – Criteria

General and qualitative criteria:
- Independent risk management function
- Integration into day-to-day risk management processes
- ‘Use’ test
- Sufficient resources
- Reporting and compliance
- Internal and external validation
AMA – Quantitative Criteria

Balance between flexibility and consistency

- AMA soundness standard
  - AMA should be as robust as credit risk under IRB
  - But not specifying model parameters
  - Need to capture severe ‘tail events’
  - Review of industry progress by end-2006
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<tbody>
<tr>
<td>Corporate Finance</td>
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<tr>
<td>Trading and Sales</td>
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<td>Retail Banking</td>
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<td>Commercial Banking</td>
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<td>Payment &amp; Settlement</td>
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<tr>
<td>Agency Services</td>
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Risk Mitigation

- Overall calibration reflects traditional insurance products
- Further recognition of risk mitigation under AMA, but with qualifying criteria, including:
  - Minimum rating for insurer
  - Haircuts for declining residual maturity of policy
  - Minimum notice period for cancellation & non-renewal
  - Coverage mapped to operational risk loss experience
  - Insurance by a third party
  - Disclosure requirement
- 20% ceiling on total capital reduction from insurance
Pillar 3
The Organization of the New Accord

Three Basic Pillars

- Minimum capital requirements
- Supervisory Review Process
- Market Discipline
Pillar 3: Market Discipline

- The role of market discipline
  - A lever to strengthen the safety and soundness of the system
  - Reliable and timely information allowing well founded counterparty risk assessments
- Specific requirements for disclosure of certain information
  - composition of capital
  - risk exposures (credit, market, others)
  - capital adequacy
Industry Burden?

- The Committee does not expect that the incremental costs of making the proposed disclosures will be high.
- In many instances, banks already collect the required data.
Disclosure Methodology

- Accounting disclosures can be used to satisfy Pillar 3 requirements.
- If not disclosed under accounting rules, disclosures may be made via the internet or via the public portion of regulatory reports filed with the supervisor.
- Pillar 3 disclosures are not required to be audited by an auditor unless they are part of accounting disclosure requirements.
Materiality

- **Institution decides** which disclosures are relevant based on the materiality concept (consistent with IAS):
  - Information is material if its omission or misstatement could change or influence the assessment or decision of a user relying on that information
- Intended to convey that purpose of disclosure is to provide market participants with insight into organisation’s risk profile
Frequency

- Disclosures should be made on a semi-annual basis
  - but information on broader issues (e.g. a bank’s risk management function) could be provided annually
- Banks encouraged to disclose information that is subject to rapid change on a quarterly basis (i.e. tier 1 ratio, total capital ratio, and all capital components)
Disclosure Areas

- Scope of Application
- Capital
- Capital Adequacy
- Risk Management
Implementation of Basel II
Implementation of Basel II

- Focus has shifted from drafting the rules to implementation
- Implementation will be a major undertaking
- Several issues to deal with, e.g.
  - Implementing the rules
  - National discretion areas
  - Cross-border implementation
- Accord Implementation Group seeks to provide guidance
Based on a questionnaire sent to 115 jurisdictions

88 non-BCBS jurisdictions intend to adopt Basel II

Most plan to implement between 2007 and 2009 (but there may be delays)

One of the major drivers cited: implementation by foreign banks
What are Basel II’s main goals?

- **Adequately** capitalised banks
- **Improved risk management** in banks
  - Basel II is less a compliance exercise than an opportunity to upgrade risk management systems
- A sounder and safer banking (and financial) system as a precondition for a stable economy and economic growth
Implementation – the next critical step

• Implementation means transforming the framework into enforceable rules

• All three pillars need to be implemented

• Guidance provided:
  – Accord Implementation Group
  – July 2004 Paper on “practical considerations“
    • Intended as a „roadmap“ for implementation
    • Prepared by a drafting team of the Working Group on Capital of the Core Principles Liaison Group
What is the time schedule for implementation?

- **26 June 2004**
  - Release of Basel II Framework

- **2004 – 2006**
  - National processes
    - Impact studies (QIS 5 at end 2005)
    - Legislation and national rule making

- **End 2006**
  - Committee member implementation of simpler approaches

- **End 2007**
  - Committee member implementation of advanced approaches

- **2007 - ?**
  - Extended transition period for other countries
When should it be implemented?

- Only national authorities can answer this question
- Timing should be determined by a country’s own circumstances
- Basel II may be a lesser priority compared to other efforts
- Basel II Framework (June 2004)
  - “This document is being circulated to supervisory authorities worldwide with a view to encouraging them to consider adopting this revised Framework at such time as they believe is consistent with their broader supervisory priorities.” (Paragraph 3)
A first step: Assessing bank practices and readiness

- Understanding bank practices and implementation challenges is critical
- Prior to making a decision on which form of Basel II to apply, supervisors should
  - Take into account the current range of practice in risk management
  - Assess readiness of banks for Basel II and identify implementation challenges
- Engage in a dialogue with banks
Determining the scope of application

- Internationally-active banks/all banks

- Factors that may be considered when determining the population of banks to which Basel II would apply
  - Size of the bank
  - Nature and complexity of its operations
  - International presence
  - Interaction with international markets
  - Bank’s risk profile and risk management capabilities
Different Approaches

- EU versus US implementation as an example

- EU
  - Will apply to all banks (and securities firms)
  - In principle, all approaches will become available

- US
  - Implementation for small number of banks
  - Only advanced approaches
  - But those banks hold around 99% of foreign assets of US banks
Accord Implementation Group

- Established about three years ago
- Close contact with non-member countries mainly through regional sessions
- **Mandate:** to share information and thereby promote consistency in implementation of the new framework
- **Is:** forum for discussion; collector of information; sharing of learning; occasional creator of elaboration and guidance
- **Is not:** creator of vast amounts of new rules; central control; guarantor of uniformity in application of the new framework
Accord Implementation Group

- Will help to avoid performing redundant and uncoordinated approval and validation work in order to reduce the implementation burden on banks, and conserve supervisory resources.
- Will contribute to a more level playing field for internationally active banks
Cross-border implementation

- Cross-border implementation is a major issue
- Relationship between home and host supervisor
- Examples
  - Citigroup has offices in around 100 countries and jurisdictions
  - HSBC has offices in 76 countries and jurisdictions
  - Barclays has offices in over 60 countries
- Some countries are mainly hosts
Cross-border issues

Internationally active bank

Head office
London
FIRB

Branch
Country A
IRB not recognised

Subsidiary
Country B
Only AIRB recognised

Subsidiary
Country C
For few years still on Basel I

Consolidated reporting

Reporting to host regulator

Reporting to home regulator
Cross Border Implementation – Key challenges

- Initial and on-going validation of advanced Pillar 1 approaches
- Recognition of external ratings in different jurisdictions
- Supervisory review process under Pillar 2
- Banks to focus on managing their risks rather than managing the demands of different supervisors
- Need to develop enhanced cooperation agreements
Practical Implementation Problems

- But arrangements for cooperation have limits:
  - Supervision is a sovereign issue
  - Complex banking groups and business structures
  - “Distance risk”: difficult to measure and control activities outside the home environment
  - Cultural gaps
Cross Border Implementation - Guidance

- Committee has provided guidance
  - High-level principles for cross-border implementation (August 2003)
  - Principles for the home-host recognition of AMA operational risk capital (January 2004)
  - Enhanced cross-border cooperation (May 2004 press release)
Conclusion

- Publication of June 2004 Framework was only the beginning of a new phase: implementation
- Supervisors should have a strategy for implementing Basel II
  - It is their decision whether and how to implement Basel II
- Cross-border implementation requires a high degree of cooperation and coordination between home and host country supervisors
- Beyond principles and collaborative arrangements, at the end of the day what matters is having the right person at the other end of the line
Questions?

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