Outline

Basel Committee on Banking Supervision

Basel II is here

Main elements of Basel II: the three pillars

- Minimum capital requirements
- Supervisory review process
- Market discipline

Implementation is underway

What is the Basel Committee?

- Established at the end of 1974 by Central Bank Governors of G10 to address cross-border banking issues
- Reports to G10 Governors/Heads of Supervision
- Members are senior bank supervisors from G10, Luxembourg and Spain
- Work undertaken through several working groups
- Chairman: Nout Wellink (Dutch Central Bank

Outreach to other countries

- Committee started as a “closed shop”
- Over time, has developed close ties with non-members
  - Committee tries to address issues relevant for all jurisdictions worldwide
  - Core Principles Liaison Group (includes 16 non-Committee jurisdictions, IMF, World Bank)
    - Working Group on Capital
  - Regional groups
  - International Conference of Banking Supervisors (ICBS)
  - Participation in work of the Secretariat
  - Training, speeches, consultation

The three C's

- **C**oncordat (and subsequent papers dealing with cross-border supervision)
- **C**ore Principles for Effective Banking Supervision
- **C**apital Adequacy Framework

- Many other topics: risk management, corporate governance, accounting, money laundering, etc, on the Committee's website (www.bis.org/bcbs)

Why do we need capital regulation?

- Financial instability is costly to the economy
  - Disruption in the distribution of funds
  - Preventing economic growth
  - Breakdown in the payment systems
  - Government (= taxpayers) may have to bail out weak banks
  - Possibility of international contagion
- Therefore, the need for capital standards
  - Capital regulation is a useful and crucial tool
  - Capital as the last line of resistance
  - But objective is not to assure that banks will never fail
- Competition among banks requires harmonised rules

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From 1988 Capital Accord to Basel II

- 1988 Capital Accord established minimum capital requirements for banks

➡ Minimum ratio: $\dfrac{\text{Capital}}{\text{Risk weighted assets}} \geq 8\ \%$

- In 1998, Committee started revising the 1988 Accord:
  - More risk sensitive
  - More consistent with current best practice in banks' risk management
  - Numerator (definition of capital) remains unchanged

Benefits of the 1988 Basel Accord…and some issues

- Created an internationally recognised standard
  - Adopted world-wide
- Contributed to financial stability
  - Reversed a downward trend in international banks' capital levels
  - Promoted level playing field among internationally-active banks
- Relatively simple

- Capital requirements less reflective of economic risk
- Does not address innovation in risk measurement and management practices
  - Arbitrage opportunities through e.g. securitisation
- Little recognition of credit risk mitigants
- "OECD Club Rule"

Basel II is now a reality

- Framework released in June 2004
- Some outstanding work finalised in 2005
  - "Consolidated" Basel II paper now on BIS website
- Focus has shifted from drafting the rules to implementation
- Reaching consensus was a huge challenge
  - Inside the Committee and beyond
- Basel II is meant to be a global framework
  - Intended for internationally active/systemic banks, but more widely applicable

Basel II – a global framework

- Committee involved non-member countries
- Extensive public consultation
- It is likely that, over time, Basel II will become the new yardstick for assessing banks' financial soundness
  - According to FSI survey, around 100 jurisdictions intend to implement Basel II
  - Timing of implementation will (and should) vary

FSI survey – September 2006

Table 2

Respondents intending to adopt Basel II

Regions	Number of respondents	Respondents intending to adopt Basel II
Africa	17	12
Asia[1]	16	16
Caribbean	7	4
Latin America	14	12
Middle East	8	8
Non-BCBS Europe	36	30
Total	98	82

[1] Excludes Japan since BCBS members were not asked to complete the Questionnaire.

What are the basic aims of Basel II?

- To deliver a ***prudent amount of capital*** in relation to risk
- To provide the right incentives for ***sound risk management***
- To maintain a reasonable ***level playing field***

  - Basel II is ***not*** intended to be neutral between different banks/different exposures
  - There is a desire not to change the ***overall*** amount of capital in the system

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Is this what Basel II is all about?

$$S[L] = \begin{cases} L & when\ L \le Kirb \\ Kirb + K[L] - K[Kirb] + (d \cdot Kirb / \omega)(1 - e^{\omega(Kirb - L)/Kirb}) & when\ Kirb < L \end{cases}$$

where

$$h = (1 - Kirb / LGD)^N$$

$$c = Kirb / (1 - h)$$

$$v = \frac{(LGD - Kirb)\, Kirb + 0.25\,(1 - LGD)\, Kirb}{N}$$

$$f = \left(\frac{v + Kirb^2}{1 - h} - c^2 \right) + \frac{(1 - Kirb) Kirb - v}{(1 - h)\, \tau}$$

$$g = \frac{(1 - c) c}{f} - 1$$

$$a = g \cdot c$$

$$b = g \cdot (1 - c)$$

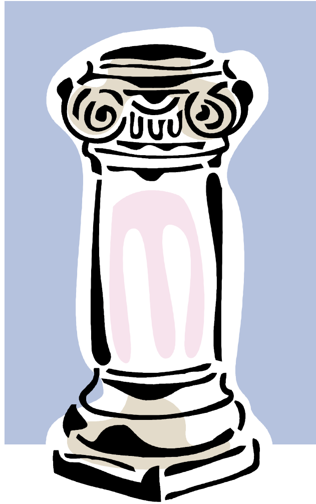
$$d = 1 - (1 - h) \cdot (1 - Beta[Kirb;\ a,\ b])$$

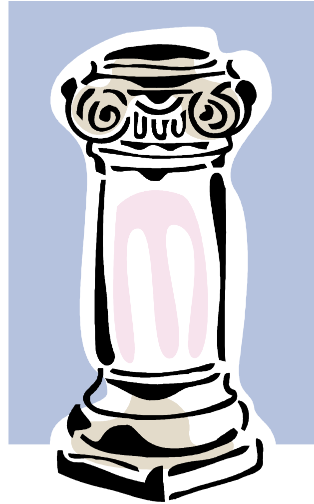
$$K[L] = (1 - h) \cdot ((1 - Beta[L;\ a, b])\, L + Beta[L; a + 1, b]\, c).$$

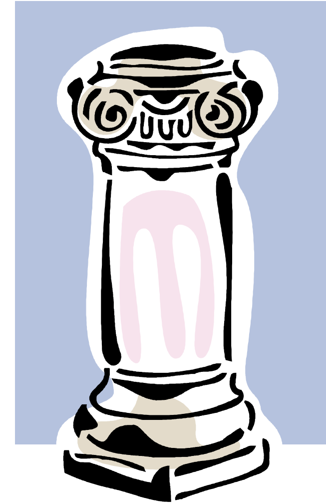
Main elements of Basel II

- Based on three pillars
- Capital requirements:
  - Credit risk: revised
  - Operational risk: new
  - Market risk: slightly changed
- Menu of approaches for the measurement of risks
- More recognition of drivers of credit risk

The three pillars







Minimum Capital Requirements	Supervisory Review Process	Market Discipline
– Credit risk	– Bank's own capital strategy	– Enhanced disclosure
– Operational risk	– Supervisor's review	
– Market risk		

The three pillars

All three pillars **together** are intended to achieve a level of capital commensurate with a bank’s overall risk profile

Pillar 1 – minimum capital requirements

Key changes:

- Wider spectrum of credit risk weights
- Greater recognition of collateral
- More refined treatment of securitisation
- Charge for operational risk introduced
- Some changes to trading book risks (agreed jointly with IOSCO) integrated into the new framework in November 2005 (eg credit counterparty risk, double default, unsettled trades)

Pillar 1: Capital requirements for credit risk

- Several approaches to choose from:
  - Standardised approach
    - Simplified standardised approach
  - Foundation internal ratings-based approach (FIRB)
  - Advanced internal ratings-based approach (AIRB)

Credit risk: Standardised approach

- Closest to 1988 Capital Accord
- OECD/non-OECD distinction for claims on sovereigns replaced
- Riskiness determined by external credit assessments
- Lower risk weights for claims on retail and residential mortgages
- Higher risk weights for higher-risk and past-due assets
- Significantly more recognition of credit risk mitigation techniques

Standardised approach – risk weights

Claim	Assessment						
		AAA - AA-	**A+ - A-**	**BBB+ - BBB-**	**BB+ - B-**	**Below B-**	**Unrated**
Sovereigns (Export credit agencies)		0% (0-1)	20% (2)	50% (3)	100% (4-6)	150% (7)	100%
Banks	**Option 1**[1]	20%	50%	100%	100%	150%	100%
	Option 2[2]	20% (20%)[3]	50% (20%)[3]	50% (20%)[3]	100% (50%)[3]	150% (150%)[3]	50% (20%)[3]
Corporates		20%	50%	100%	**BB+ - BB-** 100%	**Below BB-** 150%	100%
Retail	**Residential mortgages**						35%
	Other retail						75%

[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.

Standardised approach – external credit assessment institutions (ECAIs)

- Not a perfect solution, but :
  - Provides better differentiation of risks
  - Better than present OECD criterion for sovereigns
  - Six criteria to protect ECAI integrity (objectivity, disclosure, independence, access, resources and credibility)

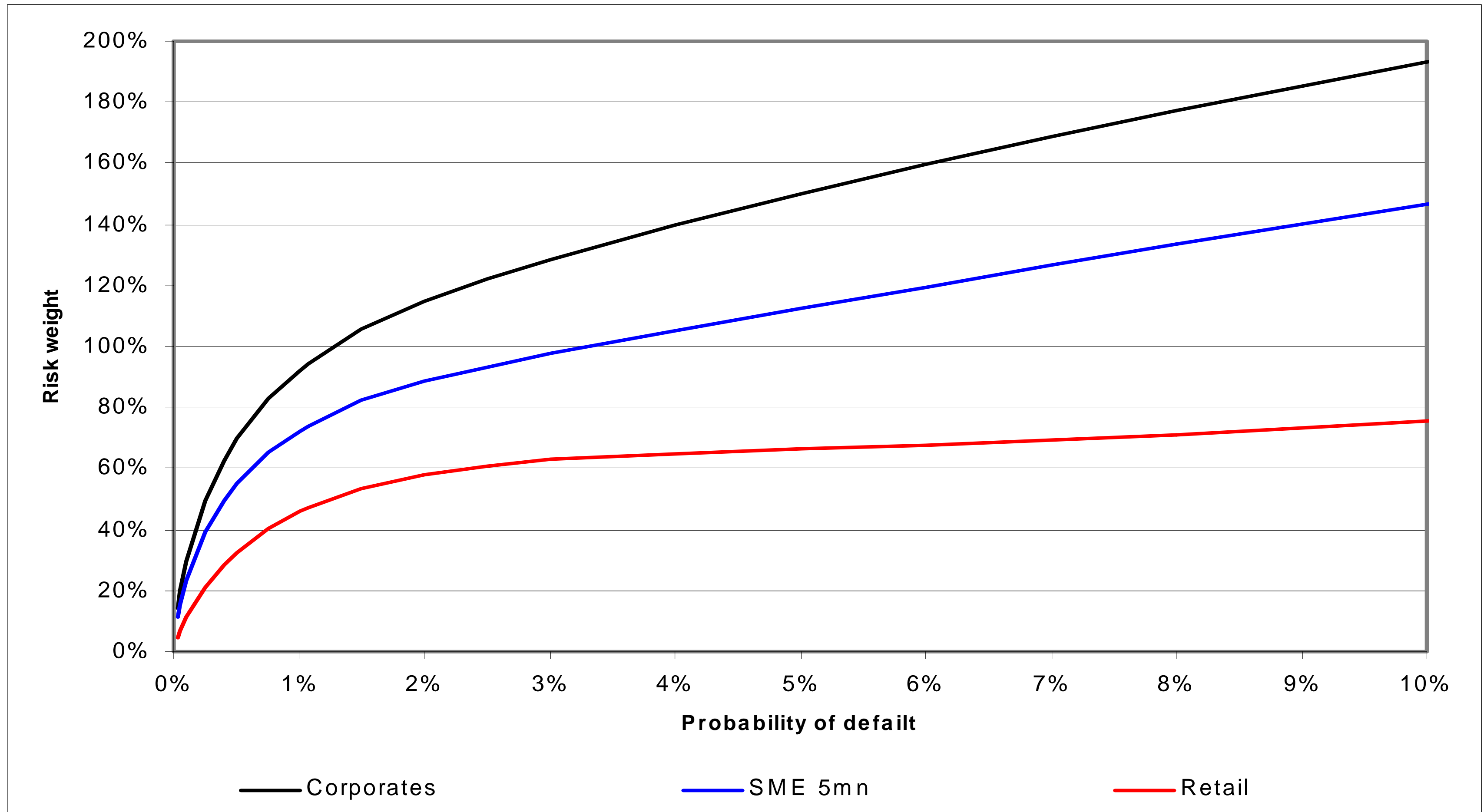
Simplified standardised approach (Annex 9)

- Establish sovereign risk weights - assuming no external ratings, export credit agency scores established by the OECD are a sound alternative
- Banks and regulated securities firms get one risk weight worse than the sovereign (i.e. 50% if sovereign is 20%)
- New risk buckets for mortgages (35%) and retail (75%)
- 150% weighting band for past due loans
- Conversion factor for undrawn commitments up to one year raised to 20% of principal (from zero)
- Operational risk charge (15% of gross income)

Credit risk: IRB approaches

- Relies on a bank’s internal ratings system
- Based on three main elements
  - Risk components (e.g. PD, LGD, EAD)
  - Risk weight functions
  - Minimum requirements
- Separate approaches for each portfolio of assets
- Subject to supervisory validation and approval

New risk weights under IRB



Recognition of drivers of credit risk

	1988 Accord	Standardised approach	FIRB	AIRB
Probability of default	Basel Committee	External credit assessment inst.	Banks‘ own assessments	Banks‘ own assessments
Loss given default	Few CRMs recognised	Expanded list of CRMs	Fixed LGDs	Banks‘ own assessments
Exposure at default	Credit conversion factors	Credit conversion factors	Credit conversion factors, fixed EADs	Banks‘ own assessments
Maturity	Hardly recognised	Hardly recognised	2.5 years or banks‘ own assessments	Banks‘ own assessments or 2.5 years
Correlations	Not explicitly recognised	Not explicitly recognised	Preset correlations	Preset correlations

Pillar 1: Operational risk

- Operational risk is growing, both from unexpected external events and internal problems
- Choice of three approaches:
  - ***Basic indicator approach*** (15% of average gross income over 3 years)
  - ***Standardised approach*** (based on separate scaling factors for gross income from defined business lines between 12% and 18% gross income)
  - ***Advanced measurement approaches*** (range of advanced methods based on loss experience, subject to additional risk control criteria)

Pillar 2: Supervisory review

- Pillar 2 is receiving more attention now
- Starting point and emphasis is bank’s internal capital adequacy assessment
- Pillar 2 can be implemented before Pillar 1

Pillar 2: Rationale

- Encourage banks to utilise better risk management techniques
- Encourage supervisors to enhance risk-based supervision
- Focus on internal, not regulatory, capital
- Ensure that banks have adequate capital to support ***all*** risks
- Accommodate differences between banks

Pillar 2: Key principles

Pillar 2 is based on four key principles:

1. Banks' own assessment of capital adequacy
2. Supervisory review process
3. Capital above regulatory minima
4. Supervisory intervention

Foundation = existing supervisory guidance, especially *Core Principles for Effective Banking Supervision*

Pillar 2: Capital add-ons?

- Pillar 2 is not intended to lead to formal, across-the-board capital add-ons
- Banks are expected to maintain capital above minimum
  - Competitive reasons (market demand, e.g. rating agencies)
  - Fluctuations in the capital ratio occurring in the normal course of business
  - May be costly to raise capital when market conditions are unfavourable

Pillar 2: Supervisory issues

- Resources (e.g. personnel, training) necessary for effective supervisory review
- Legal and regulatory impediments?
  - Ability to exercise supervisory judgement
  - Setting of higher than minimum capital requirements
- Transparency
- Home-host cooperation / level playing field
- Should be proportionate to the nature, scale and complexity of a bank's activities

Pillar 3: Market discipline

- Another lever to strengthen the safety and soundness of the system
  - Complements regulatory capital requirements and the supervisory review process
  - Reliable and timely information allowing well-founded counterparty risk assessments
  - Strong incentive for banks to conduct business in a safe, sound and efficient manner
- Pillar 3 can be implemented before Pillar 1
- Disclosure can be effective for all banks

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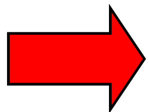
Time schedule for implementation

• 26 June 2004	• Release of Basel II Framework
• 2004 – 2006	• National processes – Impact studies – Legislation and national rule making
• 2007	• Committee member implementation of simpler approaches
• 2008	• Committee member implementation of advanced approaches (US: 2009)
• 2007 - ?	• Extended transition period for other countries

Implementation of Basel II

- Implementation will be a major undertaking
- Several issues to deal with, e.g.
  - Transforming the framework into enforceable rules
  - All three pillars need to be implemented
  - National discretion areas
  - Scope of application
  - Training
- Assistance provided for supervisors (e.g., FSI, AIG)



There is not one single way to implement Basel II

When should countries implement Basel II?

- 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 (e.g., *Core Principles for Effective Banking Supervision*, sound overall system of supervision, etc.)
- Basel II has significant benefits, but poses significant challenges as well
- Even Committee members have different schedules (e.g. EU/US)

Cross-border implementation

- Home-host issues are longstanding, but more prominent under Basel II
- Basel Committee‘s Accord Implementation Group (AIG) addressing home-host issues
- AIG is liaising extensively with other supervisors
- Supervisors engaging in bilateral and multilateral (supervisory college) meetings with supervisors and banks
- Can home and host supervisors have more mutual recognition?
- Challenge: to strike appropriate balance between legitimate home/host supervisory needs and goal of minimising burden on banks and supervisors

Questions or Comments