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Executive Committee

16th MEETING OF THE ASSOCIATES
- Bratislava, Slovakia, 13 June 2003 -

ITEM 6 OF THE AGENDA: LATEST DEVELOPMENTS IN BASEL II

Summary

The Basel Committee on Banking Supervision issued its third and final consultative paper (CP 3) on the New Basel Accord on 29 April. Comments are invited by 31 July. The goal of the Committee continues to be to complete the New Accord by the fourth quarter of 2003, with implementation to take effect in member countries by the end of 2006.

2. The Basel Committee released the global results of the third Quantitative Impact Study (QIS 3) on 5 May. The Committee concluded that the QIS 3 results confirmed that the framework as currently calibrated produces capital requirements broadly consistent with the Committee's objectives.

3. The European Commission has paralleled the Basel consultation process and aims to publish its third consultative paper on 20 June.

4. The European Parliament is producing an "own initiative" report on the New Basel Accord. The main areas of interest in the Parliament are the impact of the Accord on small banks and SMEs, and the United State's approach to implementation. The Parliament has also raised the issue of procyclicality.

5. In the United States, a Bill was introduced in the House of Representatives on 9 May which is intended to "establish a mechanism for developing uniform United States positions on issues before the Basel Committee". The Bill follows a Congressional Hearing on the Basel Accord on 27 February. The Bill is unlikely to be passed, but it puts further political pressure on the US regulators which could lead to further divergence from the New Accord.

Detail

Basel Capital Accord: CP 3

6. The Committee has introduced a number of changes to the New Accord in CP 3. Changes to *Pillar 1* (minimum capital requirements) include:

- The addition of a *simplified standardised approach*, which the Committee says is a collection in one place of “the simplest options for calculating risk weighted assets” rather than another approach.
- A reduction from 40% to 35% in the risk weight for lending that is fully secured by *mortgages on residential property* in the standardised approach. A transitional loss given default (LGD) floor of 10% has been introduced for retail exposures secured on residential property.
- Modification of the risk weight curve for *qualifying revolving retail exposures* (QRRE). The Committee acknowledges that the lower capital requirements for QRRE could encourage banks to switch from offering personal loans to credit cards and says that Member countries “will seek to ensure that banks do not reclassify lending facilities in a way designed solely to minimise capital requirements”.
- Changes to the treatment of *credit derivatives* in the credit risk mitigation framework following consultation with the industry.
- Changes to the *securitisation framework* concerning the treatment of liquidity facilities. Internal Ratings Based (IRB) banks may now calculate the capital charge at the level of the pool of exposures (the “top-down” approach), subject to supervisory approval.
- Permitting the partial use of the Advanced Measurement Approach (AMA) for operational risk to facilitate its adoption by large internationally active banks and banks with significant operational risk exposures.
- Allowing AMA banks to recognise insurance as an operational risk mitigant, limited to 20% of their total operational risk capital requirement.
- The introduction of an *Alternative Standardised Approach* for operational risk, which introduces a volumes based factor (loans and other banking book assets rather than gross income) for retail banking and commercial banking.

7. The Basel Committee has added a new section to *Pillar 2* of the Accord (Supervisory Review). It identifies specific issues that banks and supervisors should particularly focus on when carrying out the supervisory review process, including a number of key risks that are “not directly addressed under Pillar 1 and important assessments that supervisors should make to ensure that the proper functioning of certain aspects of Pillar 1”.

8. The specific risks identified by the Committee are:

- interest rate risk in the banking book;
- operational risk;
- credit risk stress tests under IRB;
- definition of default;
- residual risk;
- concentration risk;
- securitisation.

9. The Committee has “scaled back considerably” the disclosure requirements under *Pillar 3* (market discipline). Nevertheless, the proposals continue to include significant qualitative and quantitative elements.

QIS 3 results

10. The Basel Committee appears to view QIS 3 as the final calibration of the New Accord ahead of its implementation in 2006. The view emerging from FBE Members is that a further calibration exercise should ideally be carried out before implementation.

11. For the purposes of QIS 3, banks were split into two groups:

- Group 1 banks are large, diversified and internationally active with Tier 1 capital in excess of €3 billion;
- Group 2 banks are smaller and, in many cases, more specialised.

12. The overall QIS 3 results for EU banks are shown in the table below. The maximum and minimum figures relate to individual bank results. The European Commission plans to publish its own analysis of the QIS 3 results.

EU results: overall percentage change in capital requirements

	Standardised			IRB Foundation			IRB Advanced		
	Average	Max	Min	Average	Max	Min	Average	Max	Min
Group 1	6%	31%	-7%	-4%	55%	-32%	-6%	26%	-31%
Group 2	1%	81%	-67%	-20%	41%	-58%			

13. All EU banks on the Standardised approach show an increase in capital requirements. Group 2 banks show a fall on average under FIRB, largely reflecting the importance of retail exposures for these banks. Retail exposures carry high weights relative to risk under the current Accord. Some specialised banks see a significant increase in capital requirements because of the introduction of the operational risk charge.

Implementation

14. The Committee sees exchange of information between banks and supervisors and between supervisors in different jurisdictions as critical for the successful implementation of the New Accord. The Accord Implementation Group (AIG) will focus on these issues.

15. The Committee notes that the New Accord will require enhanced supervisory co-operation, particularly for the cross-border supervision of complex banking groups and encourages supervisors to “avoid performing redundant and uncoordinated approval and validation work”. The AIG is developing a set of principles to facilitate closer supervisory co-operation and information exchange, but nothing is currently included in the New Accord itself to provide a framework for the AIG’s work.

16. The Committee “broadly supports” the principle of mutual recognition for internationally active banks “as a key basis for international supervisory co-operation. Mrs Nouy, Secretary General of the Basel Committee, stressed this point when she met the G10 Banking Associations in March. She said, for example, that an EU bank on the standardised or foundation IRB approach which operates in the US should face no impediments arising from the US regulators’ proposal to apply only the advanced IRB approach to US banks subject to New Accord.

US approach to implementation

17. Senior representatives of the Federal Reserve Board, the Office of the Comptroller of Currency and the Federal Deposit Insurance Corporation told the US House of Representatives Committee on Financial Services on 27 February that:

- only the Advanced Internal Ratings Based Approach for credit risk and the Advanced Measurement Approach for operational risk will be applied to US banks;
- fewer than a dozen banks will be required to apply these approaches, although others can volunteer;
- other US banks will remain subject to the existing Basel Accord.

18. A Bill was introduced in the House of Representatives on 9 May to “establish a mechanism for developing uniform United States positions on issues before the Basel Committee”. It proposes establishing a Committee composed of the Secretary of the Treasury, Chairman of the Federal Reserve Board, Comptroller of the Currency and Chairman of the Federal Deposit Insurance Committee.

19. The Bill would require:

- a meeting of the Committee before any meeting of the Basel Committee;
- that all participants adhere to the consensus of the Committee in negotiations with the Basel Committee. Failure to reach consensus defaults to the position adopted by the Treasury Secretary;

- an annual report to Congress;
- reports to Congress before any agreement by a regulator with a Basel capital proposal. Reports must include an impact analysis, including an assessment of the costs.

20. The Bill is unlikely to be passed, but it puts further political pressure on the US regulators which could lead to further divergence from the New Accord.

Implementation in the European Union

21. The European Commission has paralleled the Basel consultation process and aims to publish its third consultative paper on 20 June. The consultation paper will include a draft of the proposed new Capital Adequacy Directive which the Commission hopes to formally adopt in February 2004.

22. The FBE's response to the Commission's November 2002 Working Document said that the EU legislative framework should set common minimum standards and must:

- apply to all credit institutions and investment firms;
- be based on the overarching principle that the same risks must be treated in the same way;
- be proportionate and practical in terms of application to the financial sector;
- avoid creating barriers to entry for small competitors and must *not* create competitive distortions;
- generate pressure to safeguard the Single Market by limiting the scope and reducing to a strict minimum the number of national discretions;
- ensure an international level playing field for European banks.

23. The FBE welcomed the Commission's confirmation that the three key objectives for the framework are flexibility, parallel implementation with the Basel Accord and supervisory consistency and convergence.

24. The European Parliament is producing an "own initiative" report on the New Basel Accord. The Economic and Monetary Affairs Committee held a discussion on 20 May on the basis of a second document produced by the rapporteur, Mr Alexander Radwan MEP. The main areas of interest in the Parliament are the impact of the Accord on small banks and SMEs, and the United State's approach to implementation. The Parliament has also raised the issue of procyclicality.

25. The European Parliament will not formally start its first reading of the proposal for a new Capital Adequacy Directive until after the Elections in 2004.

