

The Basel Capital Accord

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Outline

- A: Overview of the Capital Accord**
- B: Pillar 1: Minimum Capital Requirements (focus on credit risk)**
- C: Specific Issues Related to Project Finance and Credit Risk Mitigation**
- D: Specific issues related to Preferred Creditor Status of Multilaterals**

A: Overview of the New Basel Capital Accord

What does the Committee want to achieve with the revision?

- Enhance the risk sensitivity of capital requirements
 - Accord 1988: Four broad risk weighting categories
- Comprehensive coverage of risks
 - Accord 1988: Credit risk plus (since 1996) market risks
- Present a menu of options to choose from
 - Accord 1988: Simple ratio, but one that is based on a one-size-fits-all approach

A: Overview of the New Basel Accord

What does the Committee want to achieve with the revision (continued)?

- Application to banks world-wide
 - Accord 1988: Internationally active banks
- More power to supervisors and the market
 - Accord 1988: only minimum capital requirements

New Accord to Achieve Objectives via the Three Pillar Approach

A: Overview of the New Accord

Pillar 1: Minimum Capital Requirements

Concept unchanged: Capital/Risk Weighted Assets

But: Comprehensive, evolutionary approach to risk management

- Credit Risk: Standardised and Internal Ratings-Based Approaches
- Operational Risk: Basic Indicator, Standardised, and AMA
- Market Risk: Rules unchanged

A: Overview of the New Basel Accord

Pillar 2: Supervisory Review Process

- **Based on four key principles:**
 - Banks' own assessment of capital adequacy,
 - Supervisory review process,
 - Capital above regulatory minima,
 - Supervisory intervention.
- **The main challenges are:**
 - Adequate human resources,
 - Consistency in the implementation process.

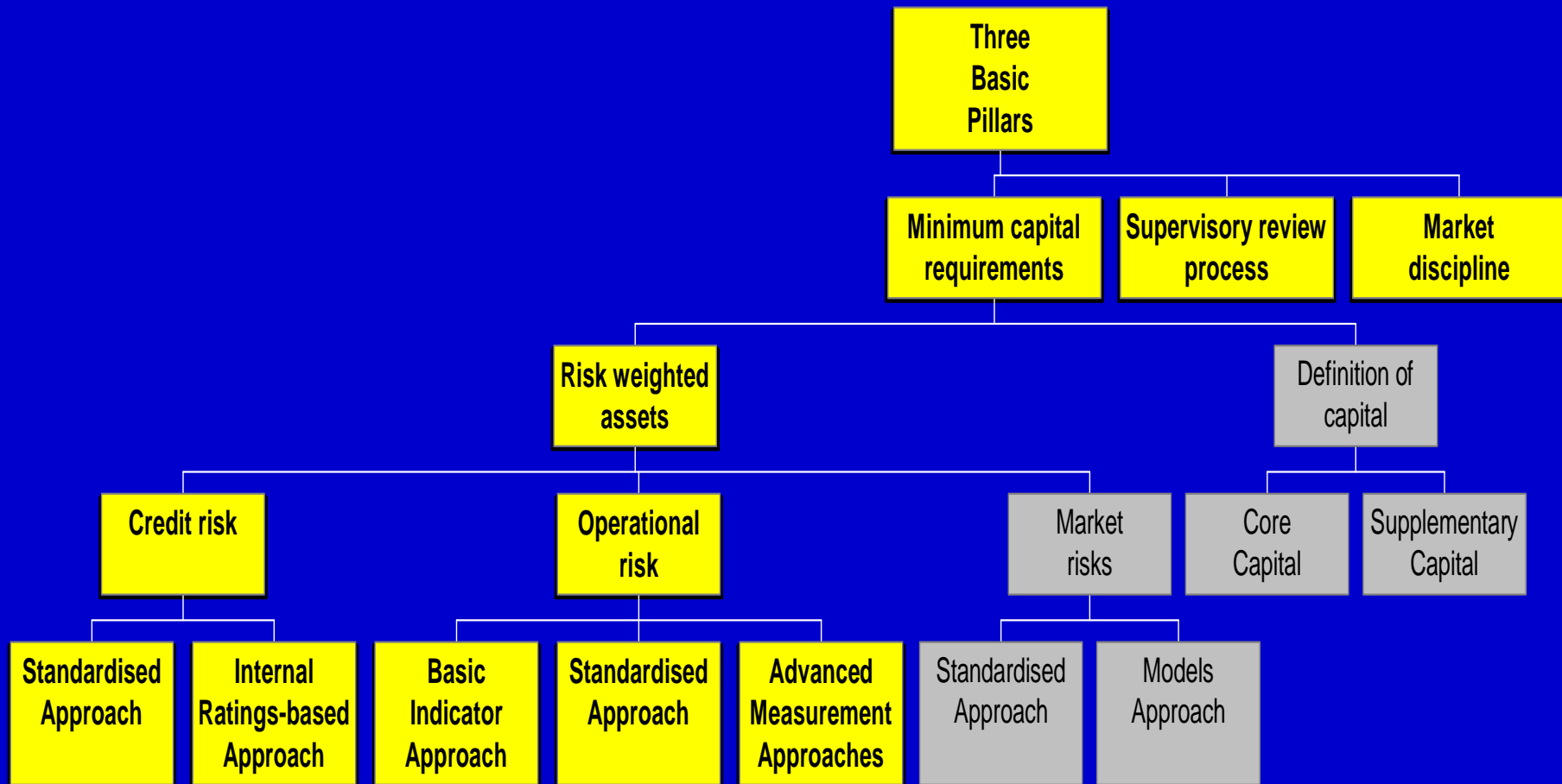
A: Overview

Pillar 3 and disclosure requirements

Following industry comments **Pillar 3 has been completely redrafted:**

- The magnitude of information to disclose has been significantly reduced to focus on “core disclosure” relevant for market discipline,
- But the language, and the periodicity of disclosure, are more appropriate; namely there are more requirements and less recommendations, and quarterly disclosure is the rule for internationally active banks

A: Overview – the Basic Structure



B: Pillar 1 – Minimum Capital Requirements:focus on credit risk

B. Pillar 1 – Minimum Capital Requirements

Credit Risk: Standardised Approach

Claim	Assessment						
		AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to B-	Below B-	Unrated
Sovereigns (If Export Credit Agencies)		0% (1)	20% (2)	50% (3)	100% (4-6)	150% (7)	100%
Banks	Option 1¹	20%	50%	100%	100%	150%	100%
	Option 2²	20% (20%) ³	50% (20%) ³	50% (20%) ³	100% (50%) ³	150% (150%) ³	50% (20%) ³
Corporates		20%	50%	100%	BB+ to BB- 100%	Below BB- 150%	100%

¹ Risk weighting based on risk weighting 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 a short original maturity, less than three months, would generally receive a weighting that is one category more favourable than the usual risk weight on the bank's claim.

B: Pillar 1 – Minimum Capital Requirements

Credit Risk – The Standardised Approach

Treatment of Multilateral Development Banks

- Risk Weights generally be based on external credit assessments as set out under option 2 for claims on banks but without the possibility of using the preferential treatment for short-term claims.
- A 0% risk weight will be applied to claims on highly rated MDBs that fulfil to the Committee's satisfaction certain criteria:
 - very high quality long-term issuer ratings (largely AAA)
 - Shareholder structure: Generally comprised of AA- rated sovereigns or better;
 - strong shareholder support;
 - adequate level of capital and liquidity;
 - strict statutory lending requirements and conservative financial policies.

B: Pillar 1 – Minimum Capital Requirements

Credit Risk – The Standardised Approach

The Treatment of MDBs (continued)

MDBs eligible for a 0% Risk Weight are:

- World Bank Group comprised of the International Bank for Reconstruction and Development (IBRD) and the International Finance Corporation (IFC), the Asian Development Bank (ADB), the African Development Bank (AfDB), the European Bank for Reconstruction and Development (EBRD), the Inter-American Development Bank (IADB), the European Investment Bank (EIB), the Nordic Investment Bank (NIB), the Caribbean Development Bank (CDB), and the Council of Europe Development Bank (CEDB).

Pillar 1 – Minimum Capital Requirements

Credit Risk: Internal Ratings Based Approach

Key Steps:

- Assignment of borrower to a rating grade based on bank's assessment of the borrower's riskiness
- Estimation of the average **probability of default** (PD) of borrowers in each grade
- A separate consideration of the transaction risk (**loss given default** (LGD)), either through supervisory rules or based on banks' own assessment,
- A measure of the amount of **exposure at default** (EAD),
- A **maturity adjustment** (either implicit or explicit),
- Risk Weights are a function of PD, LGD, M

B: Pillar 1 – Minimum Capital Requirements

Summary of Pillar 1 Credit Risk: Current focus of work

- Incentives and the overall level of capital
- Treatment of SMEs
 - IRB approach*
 - The corporate risk weight function has been modified. Asset correlations are now a decreasing function of PDs (between 10 and 20%),
 - The list of eligible collateral has been increased with financial receivables and physical collateral (including through leasing),
 - Evaluating whether to add a size parameter in the risk weight curve
 - Small sized firms may be eligible for treatment under retail under IRB.
 - Standardised Approach*
 - Additional risk weight bucket for retail exposures in the standardised approach
- Work on securitisation
- IRB: Specialised lending, treatment of equity exposures, definition of default.

C: Specific Issues Related to CRM/SL

(i) Specialised Lending

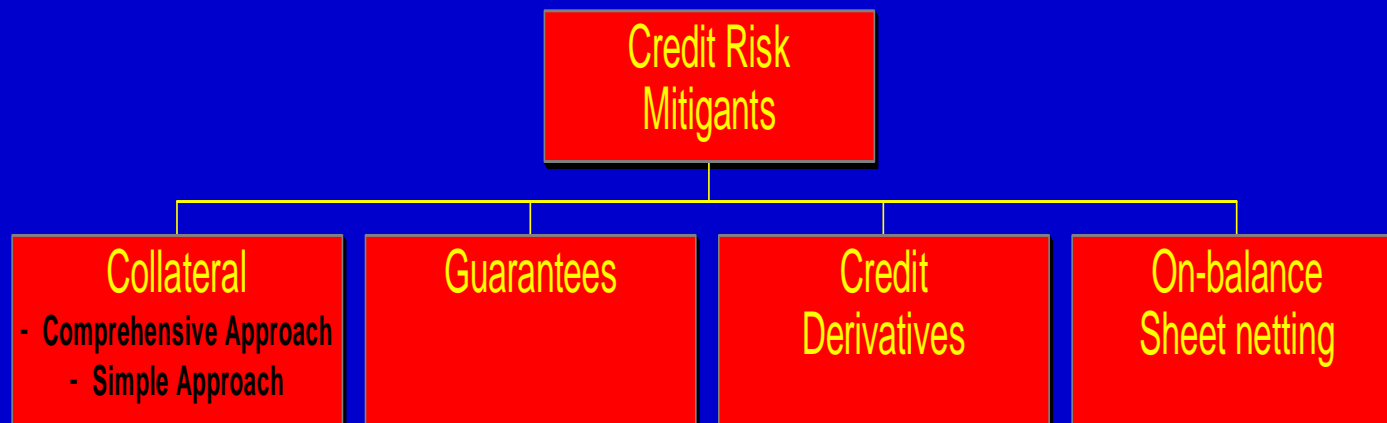
- **Definition:** Transaction where the value of the asset and the incomes it produces are the primary source of repayment of the loan;
- **Four product lines:** project finance, object finance (planes, ships, etc., quite often financed by leasing), income producing real estate, and commodities trading;
- **The methodology:** SL to be treated within the corporate portfolio, with some special features, in particular for the foundation approach.
 - Slotting Criteria
 - Supervisory Risk Weights

--The use of this framework might be optional to a certain extent.

C. Specific Issues Related to CRM/SL

(ii) Credit Risk Mitigation Techniques

Recognition of **wider range of credit risk mitigants**, subject to meeting some **minimum requirements** regarding legal certainty and robust risk management process. Incentive-compatible.



C. Specific Issues Related to CRM/SL

(ii) CRM Techniques, continued

Treatment of Guarantees

- *Substitution Approach*

Two options for Collateral

- *Comprehensive and Simplified Approaches.*
- Risks addressed through *W* factor now addressed in Pillar 2

D: Specific Issues Related to the Preferred Creditor Status (PCS) of Multilaterals

Issue: Majority of claims attracting PCS feature are unrated.

- Under CP2 proposals, only rated claims would receive recognition of PCS feature.
- In CP2, claims in form of sub-participations would be treated as unrated claims, or according to borrower's foreign currency rating:
 - Where exposures are risk weighted on the basis of being equivalent to a rated issue of that borrower, the general expectation is that foreign currency ratings would be used for exposures in foreign currency. Domestic currency ratings, if they are separate, would only be used to risk weight claims denominated in the domestic currency.

Specific Issues Related to the Preferred Creditor Status (PCS) of Multilaterals

Revised Proposal

- Convertibility and transfer risk can be considered by supervisory authorities to be mitigated when the exposure arises through a bank's sub-participation in a loan that has been extended by a Multilateral Financial Institution whose status as a preferred creditor is recognised in the market.
- If so, for risk weighting purposes, a bank could use a borrower's domestic currency rating for claims that are part of such programs.
 - Recognition possible even if claims are unrated or denominated in a foreign currency.
 - Condition: That the PCS is effectively transferred to sub-participants.

Concluding Remarks

- The next quantitative impact study (**QIS 3**), together with precise instructions to calculate the new capital requirements (very close to CP 3 rules) and national instructions for the items allowing for national discretion, is now scheduled for **1 October 2002**.
- The next consultative document (**CP 3**) should be out during **Spring 2003**,
- The following consultation should be short (something like three months),
- Therefore, **the final proposals** should be available sometime in **Fall 2003**, to be **implemented at the end of 2006**.