BASEL COMMITTEE ON BANKING SUPERVISION

BANK FOR INTERNATIONAL SETTLEMENTS

Restricted

Update on Basel II

Caribbean Center for Monetary Studies

Port of Spain, 28 April 2006

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Deputy Secretary General

Final stages of Basel II development

- BCBS is currently analysing the results of 30 countries' impact studies/tests ("QIS 5") based on 2005 Q4 portfolios for 383 banks
- Common BCBS spreadsheets and workbooks were used
- Some countries have undertaken full tests, while others have adjusted results of QIS 4
- Results appear to be “in the ballpark“
- BCBS recognises need for regulatory pause

Recalibration options

- Recalibrate individual portfolio formulae
- Adjust the 1.06 “scaling factor”
- Adjust or extend the floors
- Wait for the parallel run and rely on the floors

What exactly is Basel II?

- It replaces an ***institutional*** approach to credit risk with a ***risk-based*** approach
- As such, it is about ***improving risk management*** and reducing the divergence between regulatory capital and economic capital - risk is now too ***complex*** for simple measurement methods
- It also provides direct incentives for ***stronger corporate governance and greater transparency***
- Target is mainly the ***systemically important*** banks, but broad equivalence needed for their competitors

Position of non-BCBS/EU member countries

- Australia, Hong Kong, Singapore and South Africa will be ready by end-2006
- Brazil, Chile, Malaysia, Mexico, Russia may be a bit slower
- China have already introduced Pillars 2 and 3 but will wait for an appropriate time to adopt Pillar 1
- India is now introducing market risk and intends to adopt Basel II subject to some local adjustments
- Kenya, Mauritius, Tanzania, Uganda, Zambia and Zimbabwe have established Basel II project teams
- But NO DEADLINE for any non-BC/EU country

What incentives does Basel II provide to improve risk management and corporate governance?

- There is a small but intentional advantage for banks using more accurate measurement systems
- However, to engage in the advanced methodologies, banks must demonstrate advanced risk management processes, and all advanced models will require supervisory approval
- Pillars 2 and 3 provide critical checks and balances

Basel Committee on Banking Supervision

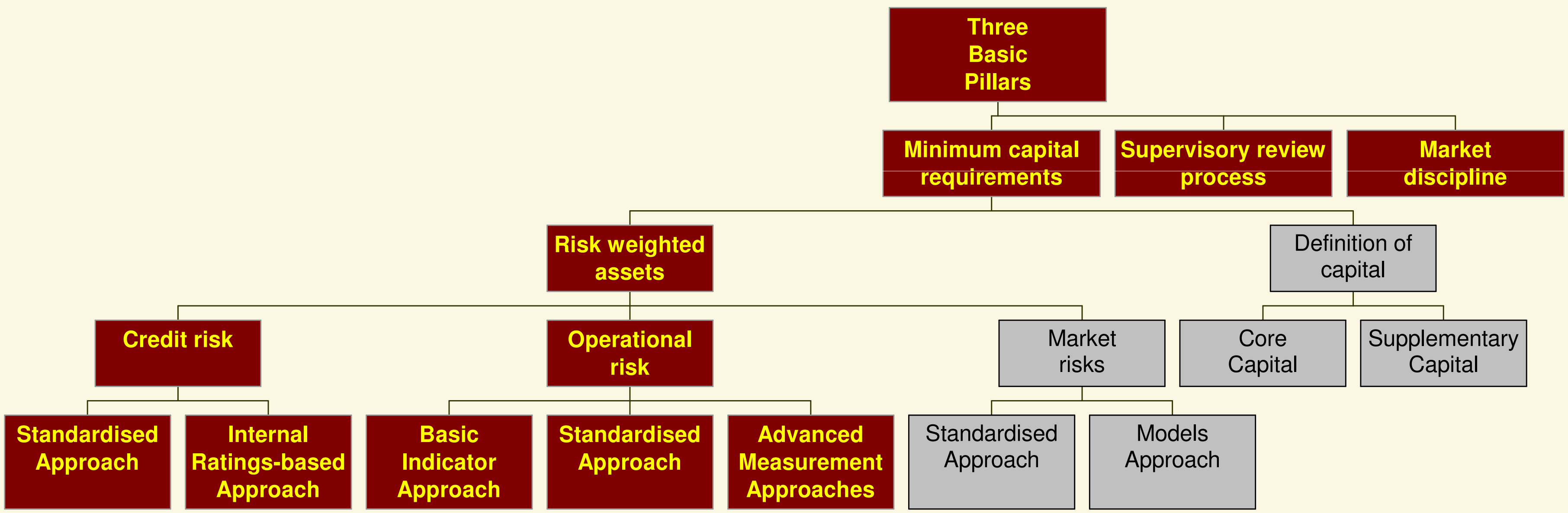
Parallel running and floors for IRB/AMA in the G10

	2006	**2007**	**2008**	**2009**	**2010**
Standardised	Basel I	Full Basel II	Full Basel II	Full Basel II	Full Basel II
Foundation IRB	Parallel run	95% floor (or parallel run)	90% floor	80% floor	No common floor planned
Advanced approaches	Parallel run	Parallel run	90% floor	80% floor	No common floor planned
United States (Advanced Approaches only)	Parallel run	Parallel run	Parallel run	95%	90% (85% in 2011)

The floor is expressed as a percentage of the bank's capital requirement under Basel I (United States may be different)

June 2004 paper said a “scaling factor“ of 1.06% looked probable

The New Accord - Basic Structure



Standardised Approach – Risk Weights

Claim		Assessment					
		AAA - AA-	A+ - A-	BBB+ - BBB-	BB+ - B-	Below B-	Unrated
Sovereigns (Export credit agencies)		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	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.

What do floors/changes in risk weightings mean?

- Not a lot if a bank has plenty of capital
- Many large banks already base their lending decisions on their internal capital models
- But there is always tension between the loan officers and the financial engineers
- At the end of the day the key will be the risk/return ratio

Lending to emerging markets

- Sovereign loans currently 100% risk weight, except for OECD countries and loans denominated in domestic currency
- Under Basel II, risk-based between 0% and 150% (Standardised Approach) and 0% to 250% (IRB approaches)
- ***But*** sovereign risk is already factored into pricing decisions and major banks are increasingly using internal models
- There have been some changes in anticipation of Basel II but they have mostly affected OECD countries (currently 0%)

Operational risk

Op risk is growing, both from unexpected external events and internal problems (ie “friendly fire”)

Choice of three approaches proposed:

- Basic indicator (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% of gross income)
- A range of advanced methods based on loss experience, subject to additional risk control criteria
- BCBS preparing "range of practices" paper on advanced methods

Pillars 2 and 3

- Critical to the “balance” of the proposal and to reduce the market’s obsession with Pillar 1 number
- Pillar 2 (Supervisory review) includes attention to risk management generally, including:
  - Concentration risk
  - Interest rate risk
  - Collateral management risk
- Pillar 3 (disclosure) is designed to enforce market discipline

Assistance for banks and supervisors in countries proposing to implement Basel II

- BCBS Accord Implementation Group is conducting extensive fact-finding
- Guidance being developed on many technical issues
- AIG is liaising extensively with other supervisors
- Trilateral conversations taking place with internationally active banks
- (Expensive) assistance from private consultants
- *Implementation of Basel II: practical considerations*

Work of the Accord Implementation Group

- Significant focus on home-host issues (3 papers so far)
- Operational risk implementation (range of practices paper due shortly)
- Downturn LGDs (July 2005)
- Trading book subgroup (includes SEC)
- Stress testing

Validation issues

- Vendor products
- Control expectations in the validation process
- Library for supervisors
- Guidance on the "use test"

Reporting issues

- Some countries will exchange reporting formats but BCBS is **not** aiming for harmonised reporting as each country's precise needs are likely to differ
- EU has developed a multi-level template which is being consulted on
- A "one-page" reporting form is being developed as a guideline for countries wishing to adopt the Simple Standardised Approach

Data pooling

- No objection in principle from supervisors but they will wish to ensure pooled data is appropriate input for the bank using it
- Some banking assocations acting as coordinator and industry-wide op risk loss data being collected
- Useful for
  - Smaller banks with many peers
  - Portfolios with little recent loss experience
  - Low default probability portfolios
- Supervisors will still want to see validation evidence

Enhanced information-sharing required for internationally active banks

- The AIG is conducting 50+ "live case studies"/forerunner "colleges" from which practical lessons for home-host and host-home information flows are being drawn
- All supervisors will seek to avoid performing redundant work but host supervisors have legal responsibilities
- Home supervisors have an implicit leading role in conducting and communicating the practical cooperation arrangements to banks and other competent supervisors
- Consultative paper on information-sharing between home and host supervisors currently being revised (comment period closed end February 2006)

Conducting cross-border case studies

Lessons learnt so far:

- Supervisory arrangements depend to a large extent on what approaches each bank intends to adopt
- Head offices need to communicate their plans to local offices, who need to be able to respond to their supervisors' questions
- Home supervisors need to plan effective communication with host supervisors, including those not in the "college"
- Host supervisors need to think carefully about what information they truly need
- "Systemic" cross-border entities need special attention
- Each situation is unique, so flexible and pragmatic solutions are required

"Practical considerations" published in July 2004

This paper is intended as a "roadmap" for implementation

- Basel II should not take precedence over other supervisory priorities such as the implementation of the Basel Core Principles
- Countries need to decide **soon** what banks or set of banks should move to Basel II and when
- National legislative/regulatory processes need to start in good time
- Supervisory resources and training will need strengthening

Deciding on the scope of application of Basel II

- Consider costs and benefits
- Consider banks' readiness, size and complexity
- Consider your own readiness
- Discuss implementation challenges

Key question: is a sound baseline supervisory system in place? If not, that should ***take priority*** over Basel II

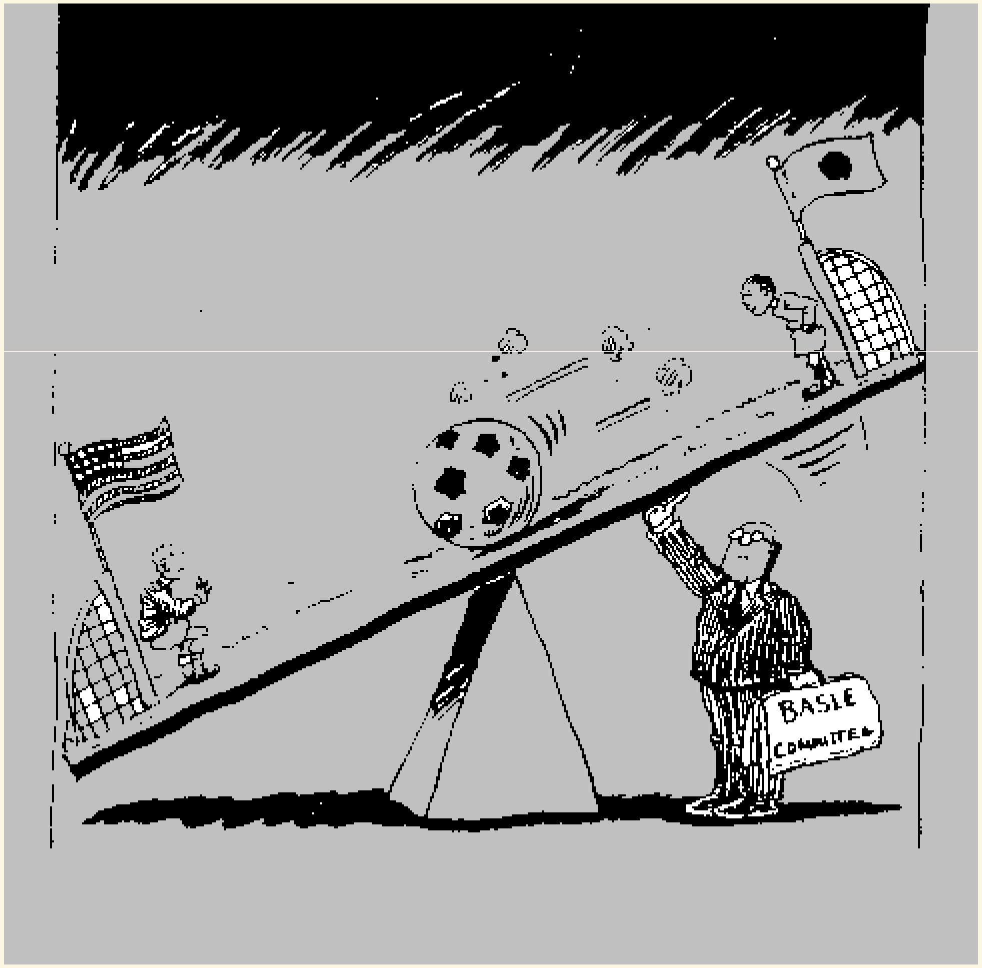
What banks now need to do

- Decide in principle which approaches they wish to apply and discuss their decision with the supervisor
- Appoint a project manager **NOW**
- If a bank has not ***already*** started collecting default and loss data, it will probably not be able to implement advanced methodologies on time
- Consider data pooling
- Examine operational risk methodologies

Conclusion

- If your banks plan to use one of the more advanced approaches any time in the future, they should start collecting the data ***now***
- However, for emerging market economies, it may ***not*** be beneficial to adopt more the risk-focused approaches
- Even if your country plans to take its time to adopt Pillar 1, Pillars 2 and 3 have merit
- It will ***not*** be wise to adopt Pillar 1 without adopting Pillars 2 and 3
- Do not be pushed into Basel II until you are ready

The level playing field!



Keep an eye on BCBS website

www.bis.org/BCBS