# Press release

Press enquiries: +41 61 280 8188
press.service@bis.org
www.bis.org

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## Basel Committee Reaches Agreement on New Capital Accord Issues

During its 10 July 2002 meeting, members of the Basel Committee on Banking Supervision reached agreement on a number of important issues related to the New Basel Capital Accord that the Committee has been exploring since releasing its January 2001 consultative paper. In its discussions, the Basel Committee has considered a range of issues related to both the standardised and internal ratings-based (IRB) approaches to credit risk. In this context, the Committee reaffirmed the importance of the revised standardised approach to be used by the majority of banks worldwide. The Committee appreciates the constructive input and feedback provided by market participants and others on each of these important topics.

- The Committee approved the creation of a new IRB risk-weight curve that should provide a more risk-sensitive treatment of certain revolving retail exposures, including many credit card exposures.
- The Committee confirmed that banks using the most advanced IRB approaches will need to take account of a loan's remaining maturity when determining regulatory capital, but that national supervisors may exempt smaller domestic borrowers from this requirement.
- The Committee approved new elements of the corporate and retail IRB frameworks and the standardised approach designed to ensure a more appropriate treatment of small- and medium-sized enterprises (SMEs) under the new Accord.
- The Committee reaffirmed that there will be a Pillar One capital treatment for operational risk, but recognised the need for significant flexibility in the development of bank measurement and management systems under the advanced measurement approaches (AMA). The Committee agreed to eliminate the separate floor capital requirement that had been proposed for the AMA.
- The Committee agreed to narrow the gap between the amount of capital required in the foundation and advanced IRB approaches. It has also agreed to revise the structure of the floor capital requirements to base them on Current Accord requirements and, with the elimination of the operational risk floor, to move to a

single overall floor that would apply for the first two years following implementation.

- To help address potential concerns about the cyclicality of the IRB approaches, the Committee agreed that meaningfully conservative credit risk stress testing by banks should be a requirement under the IRB approaches as a means of ensuring that banks hold a sufficient capital buffer under Pillar Two of the new Accord.

## Timetable

On the basis of the agreements reached on these issues, as well as the substantial progress that has been made in technical discussions concerning the treatment of asset securitisation and specialised lending, the Basel Committee today confirmed its timetable for finalising the new Accord.

Further, the Basel Committee, in conjunction with national supervisors in both G10 and non-G10 countries, will launch a Quantitative Impact Survey (QIS 3) on 1 October 2002, which will allow banks to perform a concrete and comprehensive assessment of how the Committee's proposals will affect their particular firm. Banks will be asked to submit their findings by 20 December 2002. To this end, next week the Committee plans to provide a QIS information package to banks aimed at enabling them to prepare for the October impact study.

The final QIS 3 instructions will provide a full picture of the Committee's proposed framework and quantitative requirements and will be made publicly available at that time. In addition, the Committee will release an overview paper which will address a number of broad issues and themes (e.g. complexity vs. risk-sensitivity, pro-cyclicality) that the Committee has been considering throughout its process to revise the Accord.

The capital requirements for the various exposures included in QIS 3 have been designed to be consistent with the Committee's goal of neither significantly decreasing nor increasing the aggregate level of regulatory capital in the banking system. Assessment of the QIS 3 results will allow the Committee to determine whether any adjustments need to be made prior to the release of an updated revision of its proposals for public comment in the second quarter of 2003.

The Committee intends to finalise the New Capital Accord in the fourth quarter of 2003, allowing for implementation of the new framework in each country at year-end 2006. During this three-year period banks and supervisors are expected to adapt and develop necessary systems and processes in conformance with the standards of the new Accord. Banks adopting the IRB and AMA approaches will be required to conduct parallel calculations with the current Accord for one year prior to implementation.

The Committee recognises that most supervisors may wish to introduce the new Accord. At the same time, the Committee realises that of the more than 100 countries which have implemented the 1988 Basel Accord, some have done so only fairly recently and may need more time beyond 2006 to implement the new framework. The Committee encourages countries to continue laying the groundwork necessary for the effective implementation of the new Accord. It is also encouraged by the positive response thus far from banks and supervisors from around the world that have expressed an interest in participating in the QIS 3 exercise.

Following are more detailed descriptions of the Committee's decisions regarding some of the issues mentioned above.

## Treatment of SMEs

In recognition of the different risks associated with SME borrowers, under the IRB approach for corporate credits, banks will be permitted to separately distinguish loans to SME borrowers (defined as those with less than Euro 50 mn in annual sales) from those to larger firms. Under the proposed treatment, exposures to SMEs will be able to receive a lower capital requirement than exposures to larger firms. The reduction in the required amount of capital will be as high as twenty percent, depending on the size of the borrower, and should result in an average reduction of approximately ten percent across the entire set of SME borrowers in the IRB framework for corporate loans.

In addition, banks that manage small-business-related exposures in a manner similar to retail exposures will be permitted to apply the retail IRB treatment to such exposures, provided that the total exposure of a bank to an individual SME is less than Euro 1 mn. A similar threshold will be established in the standardised approach.

## Treatment of Maturity

Banks using the advanced IRB framework for corporate lending, as well as banks using the foundation IRB approach in a jurisdiction where the supervisor so decides, will be required to incorporate maturity adjustments calculated using a mark-to-market methodology. However, in recognition of the unique characteristics of national markets, supervisors will have the option of exempting smaller domestic firms (defined as those with consolidated sales and consolidated assets of less than Euro 500 mn) from the maturity framework. Application of the exemption will occur at the national level, rather than on a bank-by-bank basis. If the exemption is applied, all exposures to qualifying smaller domestic firms will be assumed to have an average maturity of 2.5 years, as under the foundation IRB approach.

## Retail Framework

In an effort to achieve greater risk sensitivity in the treatment of non-mortgage retail lending, two distinct IRB risk-weight curves will now be available for this set of exposures. The first curve for “other retail” lending will produce capital requirements modestly higher than those proposed last November and will apply to those exposures that do not qualify for use of the second curve. The second curve will apply to qualifying revolving exposures and will produce capital requirements materially below those previously proposed by the Committee.

In an effort to maintain consistency with likely changes in capital requirements under the retail IRB framework, risk weights for residential mortgage exposures under the standardised approach will be reduced from 50% to 40%. Risk weights for non-mortgage retail exposures (including SME exposures less than Euro 1 mn) will be reduced from 100% to 75%.

## Operational Risk

Many firms have made substantial progress in developing approaches that have the potential to improve their management of operational risk, as well as to provide measurements of the capital needed for this risk.

The Basel Committee anticipates that this progress will continue and strongly encourages further work on the details of the different approaches to operational risk that are being explored. In particular, the Committee believes that industry cooperation and information-sharing are important elements in further enhancing approaches to operational risk.

Against this background of significant progress, the Committee reaffirms its intention to proceed with a Pillar One approach to operational risk. However, in the light of the continuing evolution of analytical approaches for operational risk, the Committee intends that the AMA will provide significant flexibility to banks in the development of operational risk measurement and management systems. Accordingly, the Committee will no longer mandate a floor capital requirement on operational risk in conjunction with the AMA. The Committee intends to work closely with the industry and monitor its progress in regard to operational risk approaches.

## Overall Capital

One concern that has been identified in the Committee's prior impact surveys has been the potential gap between the capital required under the foundation and advanced IRB approaches. To modestly narrow this gap, the average maturity assumption in the foundation approach will be modified from 3 years to 2.5 years, and the majority of the supervisory "loss-given-default" (LGD) values in the foundation IRB approach will be reduced by five percentage points (e.g. for senior unsecured exposures from 50% to 45%). These changes will be combined with offsetting changes to the IRB risk-weight function for corporate lending.

More fundamentally, the Committee is proposing to alter the structure of the minimum floor capital requirements in the revised Accord. Under the new approach, there will be a single capital floor for the first two years following implementation of the new Accord. This floor will be based on calculations using the rules of the existing Accord. Beginning year-end 2006 and during the first year following implementation, IRB capital requirements for credit risk together with operational risk capital charges cannot fall below 90% of the current minimum required, and in the second year, the minimum will be 80% of this level. Should problems emerge during this period, the Committee will seek to take appropriate measures to address them, and, in particular, will be prepared to keep the floor in place beyond 2008 if necessary.

The capital requirements for the various exposures included in QIS 3 have been designed to be consistent with the Committee's goal of neither significantly decreasing nor increasing the aggregate level of regulatory capital in the banking system. Nevertheless, it is possible that the QIS 3 study may indicate the need for some adjustments. It is important to note that the Committee is prepared to make both upward and downward adjustments to the amount of required capital prior to release for comment of the third consultative paper.

## Stress Testing

To address potential concerns about the cyclicality of the IRB approaches, the Basel Committee in November 2001 adopted a considerably flatter risk-weight curve for corporate credits and is modifying its guidance for ratings processes to encourage banks to take more account of uncertainty over the full economic cycle. The Committee has agreed to supplement these measures through the addition of a credit risk stress-testing requirement in conjunction with the IRB approaches.

Banks adopting an IRB approach to credit risk will be required to perform a meaningfully conservative credit risk stress test of their own design with the aim of estimating the extent to which their IRB capital requirements could increase during such a stress scenario. Banks and supervisors will use the results of such stress tests as a means of ensuring that banks hold a sufficient capital buffer under Pillar Two of the new Accord.

## Structure of the New Framework

The Committee has taken strides to clarify and simplify the structure of the revised Accord. Particular attention has been given to the market discipline component (Pillar Three) of the new framework. The Committee aims to provide investors with enough information to understand a bank's risk profile without imposing an undue burden on any institution. Accordingly, the disclosure requirements have been streamlined to focus on elements needed to accomplish this objective.

Another area of emphasis has been in streamlining the minimum standards for the IRB approach. These requirements were developed to ensure an appropriate degree of credibility and consistency in banks' use of internal ratings for capital purposes. The Committee has recently revisited the minimum standards. Modifications have been made to allow for consistent application of the requirements, as well as to allow for innovation and appropriate differences in the way in which banking organisations operate. Changes have also been made to permit greater flexibility to banks in implementing the IRB approaches across their various portfolios, in terms of both timing and scope.

The Committee will continue to look for ways to further streamline the new capital framework where appropriate.

The Committee is pleased with the progress made and looks forward to the successful finalisation of the new Accord by the end of next year.