BANK FOR INTERNATIONAL SETTLEMENTS

Basel II and East Asian Economies

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Overview

I. Why revise the old Accord?

II. Outline of new Accord.

III. Issues for East Asia.

IV. The way forward.

Capital: fundamental thing worth having

- Banks should hold capital against the uncertainties of their business: “it is the duty of a bank to be rich”.
- Major banks do not report minimum capital but rather sufficient capital for AA-rating: Accord produces a summary measure but market sets level?
- Accord sets out a framework to align capital with banking risks to
  - Promote the safety and soundness of individual banks and overall financial system.
  - Diminish competitive inequalities.

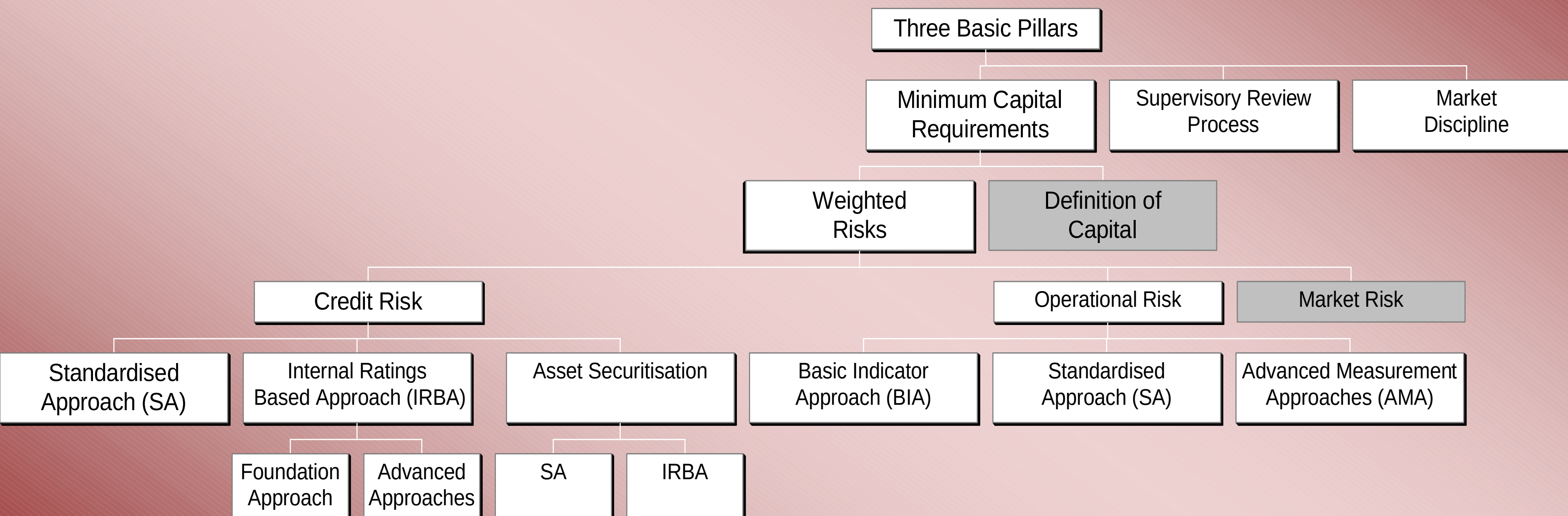
I. Why revise the old Accord?

- Enhance the risk sensitivity of capital requirements: 1988 Accord set only four broad risk weighting categories
  - Created incentive to take high quality assets off the balance sheet.
  - Distinguished sovereign risks crudely.
- Cover risks comprehensively:1988 Accord addressed just credit risk and 1996 amendment addressed market risk.
- Offer a menu of options:1988 1-size fits all.

Why revise the old Accord? - 2

- Take account of global diffusion of standard: 1988 Accord intended to apply only to internationally active banks in G10.
- Recognise power of supervisors and the market:1988 Accord focused narrowly on minimum capital requirements.
- Revise subject to constraint to maintain the overall level of capital in the system.

II. Outline of new Accord



This presentation concentrates on credit risk, as background for issues in East Asia.

Enhanced risk sensitivity

- Major objective: more risk sensitivity.
- Greater risk sensitivity requires judgement
  - Current Accord – supervisors judge.
  - Standardised approach – third parties judge.
  - Internal ratings approach – banks judge.
- Evolutionary approach
  - Current Accord
  - Standardised approach
  - Foundation internal ratings-based approach
  - Advanced internal ratings-based approach

Increasing risk sensitivity

- Better risk management,less capital required.

Determinants of credit risk

- Borrower risk ⇒ Probability of default
- Facility risk ⇒ Loss given default
- Actual exposures ⇒ Exposure at default
- Time dimension ⇒ Maturity risk
- Diversification of portfolio ⇒ Concentration risk

Evolutionary structure for credit risk

Approaches

- Simple standardised
  - No external assessments
    - Preferential treatment for domestic business
- Standardised
  - Risk weight based on external assessment
  - Credit Risk Mitigation
    - Simple approach
    - Comprehensive approach
- Foundation IRB
  - PD, (M) based on banks' own assessments
- Advanced IRB
  - PD, LGD, EAD, M based on banks' own assessments
- Full credi risk models
  - Recognition of correlations

PD = Probability of default, LGD = Loss given default,

EAD = Exposure at default, M = Maturity

Treatment of credit risk determinants in standardised approach

Driver	Recognition
Probability of default	Credit assessment institutions
Loss given default	Credit risk mitigation
Exposure at default	Credit conversion factors
Maturity	Limited recognition in credit risk mitigation
Concentration	No recognition in Pillar I

Eligibility criteria for external credit assessment institutions

- Objectivity
- Independence
- Transparency
- Resources
- Credibility

Credit risk mitigation for standardised & foundation internal ratings approaches

- Comprehensive approach
  - Focuses on the cash value of the collateral taking into account price volatility.
  - Partial collateralization recognised.
- Simple approach
  - To be used by banks that only engage to a limited extent in collateralised transactions.
  - Maintains the approach in the current Accord.
  - Generates higher capital requirements than the comprehensive approach.

Eligible financial collateral

Standardised & foundation IRB approaches

- Cash on deposit with the lending bank.
- Government securities rated BB- and above (includes public sector enterprises treated as sovereigns by national supervisor).
- Bonds rated BBB- and above.
- Equities included in a main index.
- Certain mutual funds, gold.

Advanced internal ratings approach: No limits.

Eligible physical collateral

Standardised.

- Residential real estate: risk weight *50* 40%.
- Commercial real estate: generally not eligible (only when meets very strict criteria risk weight 50%).

Foundation IRB

- Both residential and commercial real estate.
- LGD could go down to *40* 35% .

Advanced IRB: No limits.

Internal ratings based approach

- Wider application than originally anticipated.
- Approach differs by type of exposure:
  - Corporate, bank, sovereign, retail.
  - Project finance, equities, asset securitisation.
- Based on three main elements.
  - Risk components or inputs.
  - Risk-weight function.
  - Minimum requirements.
- Plus requirement for market discipline.
- Subject to supervisory validation and approval.
- Reflects evolutionary approach.

Parameters

	Standard Approach	Internal Rating		Credit Risk Models
		Foundation Approach	Advanced Approach	
Risk weights	~~5~~ 6	More	More	More
PD	Supervisor	Bank	Bank	Bank
LGD	Supervisor	Supervisor	Bank	Bank
EAD	Supervisor	Supervisor	Bank	Bank
Correlations	No	No	No	Yes

III. Issues for East Asia

- Complexity, timing and/or standardised approach as second-class?
- Higher capital requirements?
- Tilt against business lending?
- Procyclicality?

Complexity, timing, standardised approach as second-class?

- *Complexity:* reflects evolutionary approach and recognition of different starting points? Simplicity unattainable, so goal is intrinsic complexity of best practice rather than extrinsic side constraint.
- *Timing:* Effective date has been pushed back to 2006, giving all more time to adapt. Some countries will implement after 2006.
- *Tiering*: While standardised approach will be viewed as adequate by official sector, market participants' views hard to forecast.

Higher capital requirements?

- In general, banks will reduce required capital against credit risks, offsetting new capital vs operational risk.
- But in Asia, several factors may raise required capital on the credit side:
  - Wide use of real estate as collateral for business loans.
  - Wide use of standardised approach.
  - Restrictions on real estate collateral as credit risk mitigant.
  - Exacerbated by 150% weight on non-performing loans (substantial share of loans X restricted recognition of real estate collateral).
- But new 75% weight for retail & SMEs and lowering of home mortgage weight to 40% reduce req'd capital.

Higher capital requirements? New 75% weight for retail and SMEs

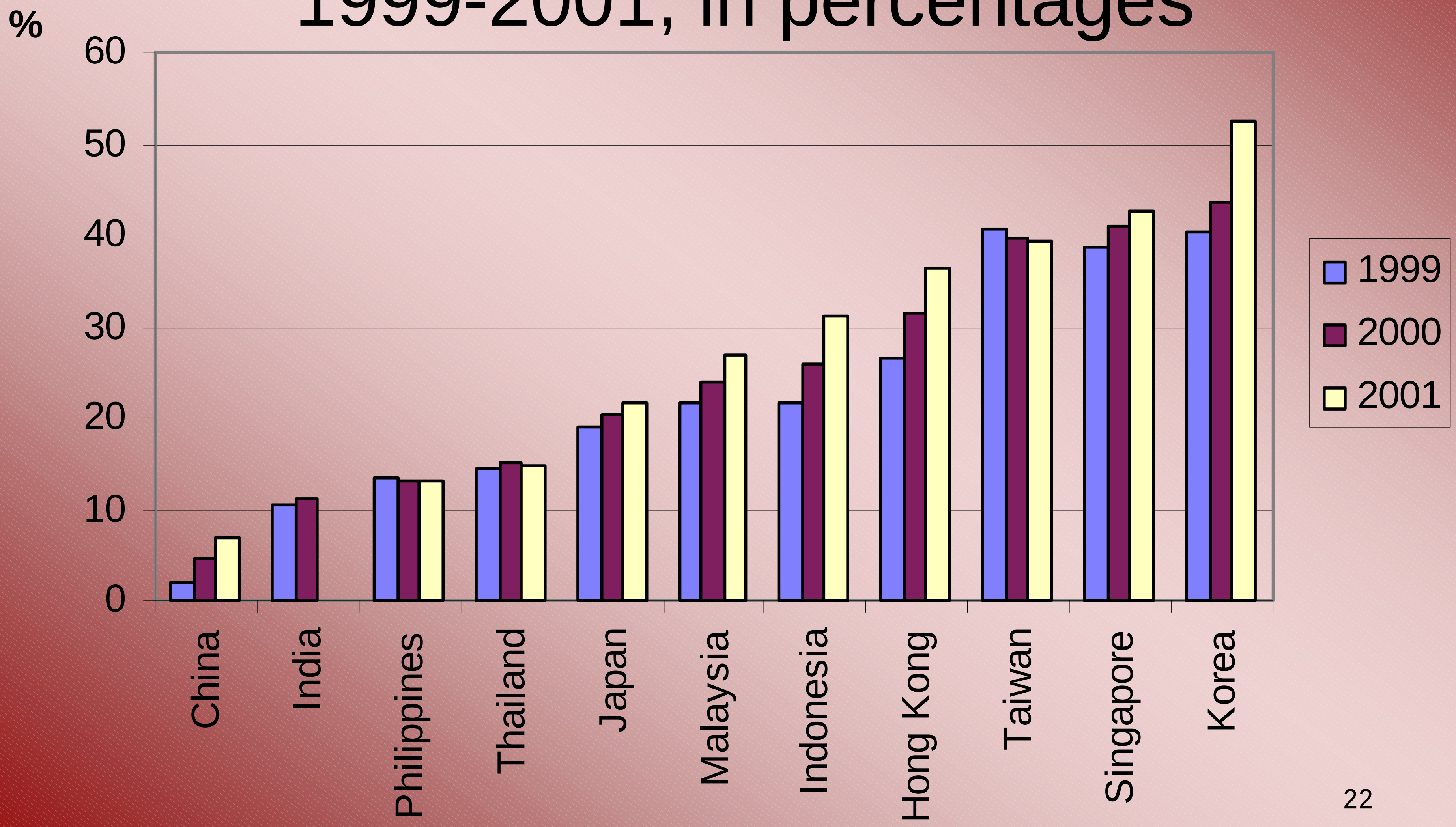
- Four criteria:
  - Orientation: personal or small business.
  - Products: revolving credits, lines of credit, overdrafts, credit cards, personal term loans and leases, auto loans, student loans and loans to SMEs.
  - “Granular” pool of small loans (max exposure 0.2%).
  - Maximum exposure of 1 million euro.
- Agreement on this led to 6 buckets in the stardardised approach.

Tilt against business lending?

- If home mortgages treated as good collateral under standardised approach, while no recognition of commercial real estate as collateral, then banks may tilt away from business to household loans.
- Originally thought to hit SMEs hard, but now 75% weight for businesses if exposure less than E 1 m.
- Question that arises is whether the legal and political system permit timely seizure and sale of collateral.
- Banks in East Asia in any case already focusing on household lending.

Household Loans / Total Loans

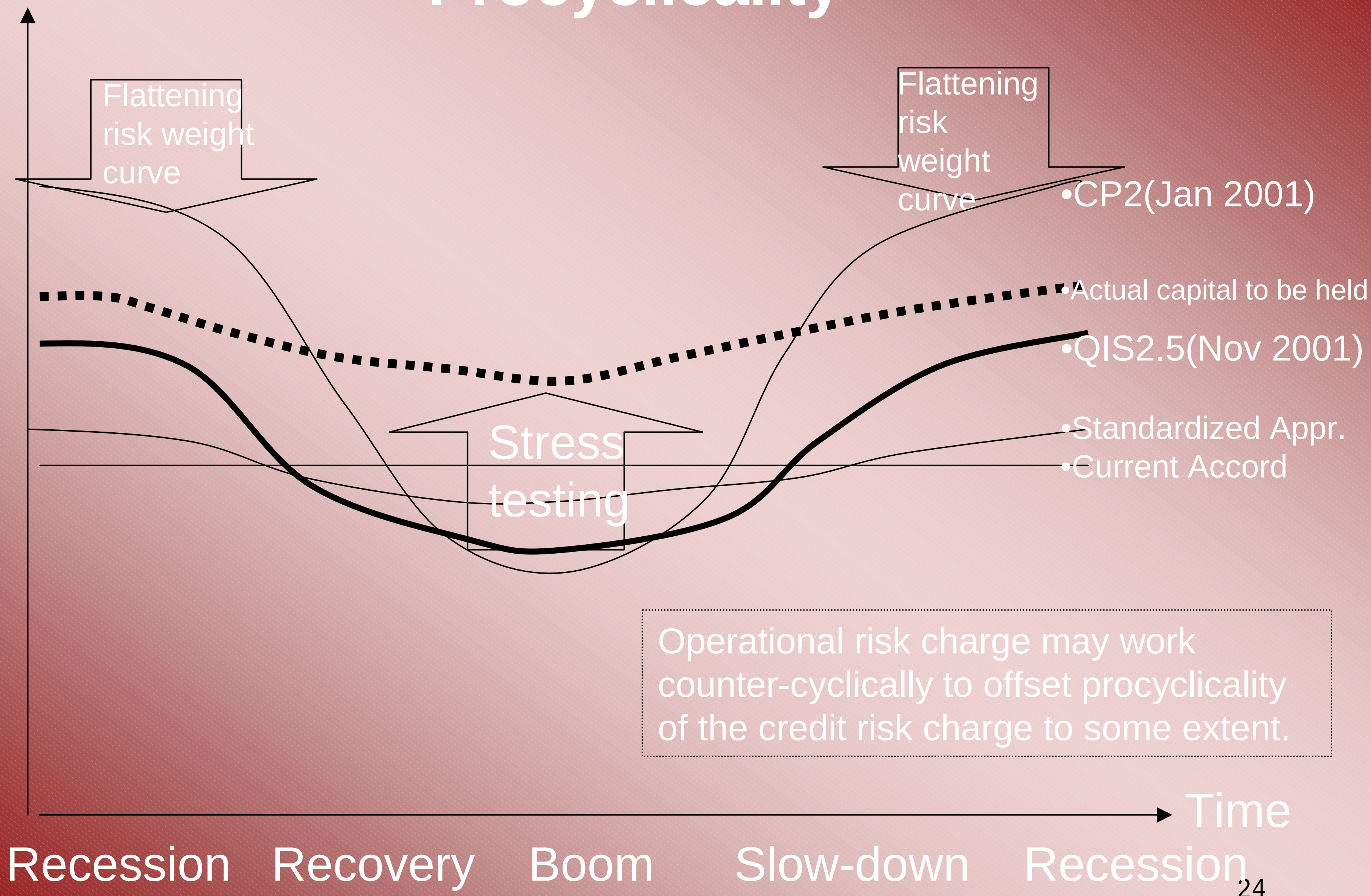
1999-2001, in percentages



Procyclicality?

- Concern that rules loosen capital constraints in upswing and tighten them in downswing.
- With standardised approach, reliance on external credit assessments recall the rapid downgrades of East Asian credits during the crisis.
- With IRB apprach

Procyclicality



IV. The way forward

- Basel Committee sponsors quantitative impact study (QIS) to help callibrate proposals.
- These both crunch the numbers and provide an opportunity for dialogue between regulators and banks.
- Current schedule calls for a fully fleshed out capital calculation in October, followed by QIS3.
- East Asian central banks are invited to participate.
- Capital proposal III next spring will take results of QIS3 into account.

In conclusion…

- Nobody knows the effect of Basel II on East Asia.
- But with the QIS late this year, East Asia could find out.
- While there is still time to change Basel II if the QIS3 turns up something untoward.

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What is the Bank for International Settlements?

- Established in 1930.
- Accepts deposits of official foreign exchange reserves, representing a substantial share of global reserves.
- Compiles, analyses statistics, including triennial survey of foreign exchange turnover; publishes *Annual Report, Quarterly* and other research.
- Serves as meeting place for central bankers and others promoting financial stability.

References

- Letter from David Carse, Chairman, EMEAP Working Group on Banking Supervision, to Danielle Nouy, Secretary General, Basel Committee on Banking Supervision, 28 May 2001.
- Letter from David Carse, Deputy Chief executive, Hong Kong Monetary Authoriity, to Danielle Nouy, Secretary General, Basel Committee on Banking Supervision, 31 May 2001.
- Letter from Tharman Shanmugaratnam , Managing Director, Monetary Authority of Singapore, to William J. McDonough, Chairman, Basel Committee on Banking Supervision, 5 June 2001.