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Background Paper

The New Basle Accord: Challenges for Asia's Banks and Regulators

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Banks' lending practices played a central role in the Asian financial crisis of 1997-98. While lax prudential rules and financial oversight have been cited by the IMF as major factors behind the crisis, a closer examination shows that the regulatory framework governing the standards of bank capital itself badly needed an overhaul.

The 1988 Basel accord – the current framework - made the concept of risk-weighted capital adequacy the global standard and introduced uniformity in capital measurement. It was, however, flawed, harboring incentives that encouraged widespread risky lending practices, which eventually led to financial troubles, including the Asian financial crisis of 1997-98.

The accord attempted to link the capital that banks must set aside with the risks that they are running. Ideally, banks would have to increase their holdings of capital as the riskiness of their assets increase. This goal, however, was not achieved due to certain factors.

First, the rules did not sufficiently discriminate between different levels of risk, and in certain areas rewarded risky lending and investing. The amount of capital that the accord requires banks to put aside against loans to corporations is the same, regardless of whether they are lending to robust or shaky borrowers.

Second, the accord has not kept pace with the growing sophistication of risk management, which has increasingly enabled banks to structure their portfolios in ways that go around the capital standard. Incentives for risky lending and wider use of capital arbitrage contributed to the deteriorating quality of bank loan portfolios in recent years. This was reflected in the bad lending decisions on the part of both local and global banks that led to the Asian crisis and the bad loan problems that continue to beset several Asian economies today.

AN OVERVIEW OF THE NEW BASEL CAPITAL ACCORD

The proposed new accord being formulated by the Basel Committee, in dialogue with the global banking and regulatory community, seeks to redefine the regulatory approach to bank supervision and encourage banks to improve their risk measurement procedures in three major ways.

- The proposed new accord makes the setting of a regulatory minimum for capital, on which the 1998 accord solely relied, part of a more elaborate three pillar-structure, which now also includes increased supervisory review of banks' assessments of their own capital adequacy and additional public disclosure of bank risk profiles.
- It seeks to replace the previous accord's "one-size-fits-all" approach (the use of only one option for measuring appropriate capital) with a flexible and incentive-compatible menu-based approach that encourages banks to continue improving their internal risk management practices.
- It seeks to introduce greater risk sensitivity, to put capital requirements more in line with underlying risks, while retaining the overall level of regulatory capital. Replacing the 1988 accord's broad-brush structure with a more risk-sensitive one would facilitate the measurement of relative risk, which is critical for avoiding capital arbitrage.

The proposed new accord contains the following significant innovations:[1]

- In measuring the riskiness of assets to determine the minimum capital requirement, operational risk has been added to credit and market risk in order to reflect the broader set of risks involved in bank operations[2].
- Major changes are being introduced in measuring credit risk, which remains the most important factor in determining banks' minimum capital requirements. The new accord proposes a menu of approaches from which banks could choose. It provides incentives for large and complex banking organizations to migrate to the more advanced approaches.
- It reserves crucial roles for supervisory authorities and disclosure rules, reflecting the necessity of adjusting to the increasing sophistication of markets and complexity of modern banking organizations.

The new accord is structured along three mutually reinforcing "pillars."

Pillar One - Minimum Capital Requirements

This maintains the current definition of capital, as well as the minimum requirement of 8% of capital to risk-weighted assets contained in the 1998 Accord. The proposed new accord would allow banks to choose from a menu of approaches to measure credit, market and operational risks.

Alternative approaches to measuring credit risk

Standardized Approach – This is a modified version of the 1988 accord's method for measuring credit risk according to a risk weighting schedule. It has been refined by linking risk weights to ratings given to sovereigns, financial institutions and corporations by external credit assessment institutions (e.g., credit rating agencies, export credit agencies), meeting strict standards. A fifth risk weight "bucket" of 150% has been added for application to low-rated claims (claims on sovereigns and banks rated B- and below and corporates rated BB- and below, or their equivalents). Greater risk sensitivity would be achieved by taking into account collateral, guarantees, credit derivatives and securitization.

The bank allocates a risk weight to each asset and off balance sheet position, producing a sum of risk-weighted assets. Each individual risk weight is allocated based on the broad category of the borrower - sovereign, bank or corporate - refined by reference to a rating provided by an external credit assessment institution, and made more risk-sensitive with regard to collateral, guarantees, credit derivatives and securitization.

Foundation Internal Ratings Based (IRB) Approach - The new accord introduces the use of banks' own internal ratings, in consideration of the fact that banks are supposed to

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[1] This is based on the current consultative paper (as of January 2002), which was circulated by the Basle Committee on January 2001 as a revised version of the original June 1999 consultative paper. More than 250 comments on the January 2001 paper were received by the Basel Committee from the banking industry, regulators and other institutions. The Committee is expected to release a revised paper in the second half of 2002, although it has indicated that the overall structure and the principal features of the proposed accord would remain largely intact.

[2] These risks are defined as follows: credit risk-the risk of loss arising from default by a creditor or counterparty; market risk-the risk of losses in trading positions when prices move adversely; operational risk-the risk of direct or indirect loss from inadequate or failed internal processes, people and systems, or from external events.

have more information than credit rating agencies about their borrowers. The IRB approach constitutes a single framework for using banks' own assessment of various risk components associated with an exposure to calculate minimum capital requirements. Banks would be allowed to use this approach, subject to supervisory approval and review and to strict disclosure requirements. This approach introduces additional risk sensitivity by making possible a finer differentiation of risks than what can be achieved with the five risk weight buckets under the standardized approach.

Under the foundation approach the bank estimates the probability of default associated with each borrower, and the supervisor supplies other inputs. The results are translated into estimated amounts of potential future loss and used as a basis for calculating the minimum capital requirement.

Advanced Internal Ratings Based (IRB) Approach - Under this approach, the bank supplies other necessary inputs in addition to those already specified in the Foundation IRB Approach. Both Foundation and Advanced IRB approaches are subject to strict methodological and disclosure standards established by the BCBS and to supervisor approval based on these standards. The design of regulatory capital requirements is supposed to contain incentives for banks to migrate from the standardized to the IRB approach, and from the Foundation IRB to the Advanced IRB Approach.

In line with the BCBS's evolutionary approach, the IRB framework is expected to evolve, mirroring the ongoing evolution of credit risk management, to some point in the future where banks would be allowed to calculate capital requirements based on their own or vendor portfolio credit risk models, once problems with regard to data quality and the ability of banks and supervisors to validate model outputs have been sufficiently addressed.

Alternative approaches to measuring market risk (unchanged from the1988 Accord, as amended)

Standardized Approach - Banks measure market risks according to a standardized measurement method establishing market risk capital requirements for banks not using the internal models approach.

Internal Models Approach – Banks are allowed to use proprietary in-house models for measuring market risks, subject to fulfillment of a number of strict quantitative and qualitative criteria.

Alternative approaches to measuring operational risk

Basic Indicator Approach – This uses one indicator of operational risk for a bank's total activity.

Standardized Approach – This specifies different indicators for different business lines.

Internal Measurement Approach - This requires banks to utilize their internal loss data to estimate required capital.

Pillar Two - Supervisory Review Process

The supervisory review process is explicitly recognized as an integral part of the new accord. It is needed to ensure that banks meet the necessary requirements for the recognition of internal methodologies, credit risk mitigation techniques, and asset securitization for regulatory purposes, and monitor their ongoing compliance with these requirements. It is a means to encourage banks to meet the disclosure recommendations set out in Pillar Three. Lastly, it is used to address areas that are not taken into account nor fully captured by the Pillar One process.

The new accord sets out four key principles as the basis of the supervisory review process[3] and endorses other principles related to banking supervision identified in other documents issued by the BCBS. Pillar Two entails more detailed dialogue between banks and supervisors. The BIS Financial Stability Institute and the Accord Implementation Group newly established by the BCBS are expected to provide assistance to promote the required expertise among supervisors.

Pillar Three - Market Discipline

Pillar Three proposes an overarching principle that banks should have a formal disclosure policy and implement a process for assessing the appropriateness and frequency of disclosure. It sets out disclosure recommendations and requirements[4] for banks in the following areas, where disclosures are classified as core or supplementary disclosures:[5]

- Scope of application of the new accord (which corporate entities within a banking group are captured within this scope, and the approach used to capture these entities)
- Structure of capital (nature, components and features)
- Risk exposures and assessment for credit risk in the banking book, market risk, operational risk, and interest rate risk in the banking book
- Capital adequacy

Pillar Three also discusses the role of materiality of information[6] and frequency of disclosures.

THE PROPOSED NEW ACCORD FROM THE PERSPECTIVE OF ASIA'S BANKING COMMUNITY

[3] These principles are as follows: (1) Banks should have a process for assessing their overall capital adequacy in relation to their risk profile and a strategy for maintaining their capital levels. (2) Supervisors should review and evaluate banks' internal capital adequacy assessments and strategies, as well as their ability to monitor and ensure their compliance with regulatory capital ratios. Supervisors should take appropriate supervisory action if they are not satisfied with the result of this process. (3) Supervisors should expect banks to operate above the minimum regulatory capital ratios and should have the ability to require banks to hold capital in excess of the minimum; and (4) Supervisors should seek to intervene at an early stage to prevent capital from falling below the minimum levels required to support the risk characteristics of a particular bank and should require rapid remedial action if capital is not maintained or restored.

[4] While the BCBS in general is introducing disclosure recommendations, Basel 2 also includes requirements which are preconditions for the use of particular methodologies or instruments for regulatory capital purposes.

[5] Core disclosures are defined as "those which convey vital information for all institutions and are important to the basic operation of market discipline," while supplementary disclosures are those which "are important for some, but not all, institutions." Supplementary disclosures, however, are not to be regarded as optional whenever they contain significant information for the operation of market discipline in relation to a particular institution. The distinction is made for the purpose of reducing the disclosure burden on institutions."

[6] Materiality drives the decision on which disclosures are made. Information is considered material "if its omission or misstatement could change or influence the assessment or decision of a user relying on that information."

The Basle Committee on Banking Supervision (BCBS) issued the first consultative document in June 1999. Reflecting initial comments received from various quarters, the BCBS issued a second consultative package in January 2001. Much progress has been made since the first consultative paper, and there is wide support for the objectives and the general approach of the proposed new accord. More than 250 comments on the second package were received by the BCBS from within the industry, regulators and other market participants. Among the remaining major issues raised by banks, industry associations and regulators in Asia are the following:

- The negative impact on small and medium enterprises of the charge on capital exposures to SMEs, which was viewed as too high, as well as the exclusion of property collateral for use in credit risk mitigation;
- Higher capital requirements for banks arising from the introduction of a capital charge for operational risk and insufficient consideration of the conservatism contained in measures already being implemented by some banks, such as dynamic provisioning and economic loss provisioning.
- Insufficient recognition of collateral, as the new accord is viewed as giving too little capital relief for common collateral types and treating loans secured for commercial real estate in the same way as unsecured loans.
- Overly high (20%) proportion of regulatory capital allocated to operational risk, especially for financial institutions whose operations are largely conventional in nature and much less complex than those of large international banks.
- Problems with methodologies in measuring operational risk, such as an overly complicated internal measurement approach, the view that the basic indicator and standardized approaches are not risk-driven, double counting with regard to operational and credit losses, and the view that forward-looking indicators and the quality of a bank's internal control environment are better indicators than historical factors.
- Problems with the regulatory use of external credit assessment institutions, including the small number of rated entities in most markets, problems with the reliability of rating agencies' practices and their access to reliable financial information, and the existence of a disincentive for borrowers to be rated through the lower risk weight (100%) given to unrated claims as compared with the 150% weight given to low-rated claims.
- Insufficient incentives for banks to migrate to more advanced approaches in measuring credit risk arising from the higher costs of improving IT system and risk rating models compared with the 2-3% estimated reduction in risk-weighted assets that would result from migrating to the Foundation IRB approach from the standardized approach, and the floor on the Advanced IRB approach equal to 90% of the capital requirements which would result under the Foundation IRB approach, which discourages migration from the Foundation to the Advanced approach.
- Problems with detailed disclosure requirements, arising from the view that voluminous and complex information would not add value for the general user, but would only allow banks to learn more about their competitors and could lead to misinterpretations and erroneous conclusions.
- Conservatism in the treatment of securitization under the standardized approach for measuring credit risk, in comparison with exposures to corporates and other

counterparties, which several banks argue would be a disincentive for them to utilize securitization and potentially reduces its value as a viable balance sheet and risk management tool.

Accordingly, the BCBS announced its intention to issue a third consultative paper in late 2002, indicating probable revisions in the following areas, among others yet unspecified, under Pillar One:

- Reductions in the basic calibration of the Foundation IRB approach, both for corporate and retail portfolios, to ensure that there is adequate incentive for banks to adopt more advanced approaches to credit risk.
- Reduction of the target proportion of regulatory capital related to operational risk from the proposed 20%, which has been considered as too large
- Modifications of the treatment of credit exposures related to SMEs, with a view to achieving lower capital for SME lending.

IMPLICATIONS FOR BANK SUPERVISION AND REGIONAL COOPERATION

A much greater challenge lies ahead, however, as regulatory and supervisory authorities and banks prepare themselves for its implementation. The adoption of the new accord entails an indispensable role for supervisory authorities and market discipline in encouraging banks to continually improve their risk management practices. As a consequence, it would require extensive preparation on the part of financial regulatory and supervisory authorities, significant legal and regulatory changes, and intensified international cooperation among relevant authorities.

Specifically, the adoption of the new accord will result in the following challenges to authorities throughout the region:

- As good supervision is a necessary requirement for the effective implementation of the new accord, additional resources need to be devoted to attain a significant upgrading of expertise and skills among staff of supervisory authorities in many emerging economies. Much work is also required in amending banking legislation and further developing supervisory policies and guidelines in many jurisdictions.
- There is a need to address problems of comparability of practices across jurisdictions. It is important that the discretion allowed national supervisors to implement the new accord is based on similar standards. For comparability of the capital base used in the computation of the capital adequacy ratio, all jurisdictions need to comply with standard provisioning requirements for loan losses. There could be problems in applying the new accord to international banking groups on a consolidated basis across different jurisdictions if supervisors adopt different approaches for calculating capital charges, or if discretion is exercised by supervisory authorities using inconsistent standards.
- While there is a need to ensure the implementation of the new accord on a consistent, transparent and fair basis across jurisdictions, there may also be situations under which supervision should be able to override certain aspects of the accord in order to maintain its relevance.
- The new accord requires a lot of work in establishing infrastructure for data collection and credit rating systems in emerging markets. In many cases supervisory

authorities in emerging markets do not maintain the time series data needed in the IRB approach, while most banks in these markets do not have robust rating systems and the required historical data.

- Much work also needs to be done in ensuring effective and meaningful disclosure of financial information through improved accounting and auditing standards and in promoting comparability of financial information across jurisdictions.

There remains a wide scope for international cooperation in addressing these issues. Among possible measures that relevant authorities could undertake are the promotion of best practices and convergence in approaches among supervisors, development of model supervisory guidelines and banking legislation to help domestic authorities make the necessary changes, and the strengthening of programs for training staff of supervisory authorities in implementing the new accord. How authorities in the region respond to these challenges in the months ahead would determine the extent to which the region's banking community could benefit from improved risk management practices that the new capital adequacy framework hopes to promote.

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