TABLE OF CONTENTS

	Page
INTRODUCTION	2
1988 BASEL CAPITAL ACCORD AND ITS LIMITATIONS	3
THE NEW BASEL CAPITAL ACCORD (STRUCTURE OF THE NEW ACCORD: THE THREE PILLARS)	
Pillar 1 – Minimum Capital Requirements	4-6
Pillar 2 – Supervisory Review Process	7
Pillar 3 – Market Discipline	8
OVERALL CONCLUSION AND INDUSTRY IMPACT (LATIN AMERICA BANKS)	9-10

INTRODUCTION

The Basel Committee comprises and was implemented by the central-bank Governors of the G-10 countries at the end of 1974. The Committee's members are represented from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, United Kingdom and United States. Countries are represented by their central bank and also by the authority with formal responsibility for the rational supervision of banking business where this is not the central bank.

The Committee does not possess any formal supranational supervisory authority, and its conclusions do not, and were never intended to, have legal force. Rather it formulates broad supervisory standards and guidelines and recommends statements of best practice in the expectation that individual authorities will take steps to implement them through detailed arrangements - statutory or otherwise - which are best suited to their own national systems. In this way, the Committee encourages convergence towards common approaches and common standards without attempting detailed harmonisation of member countries' supervisory techniques.

The Committee reports to the central bank Governors of the Group of Ten countries and seeks the Governors' endorsement for its major initiatives. In addition, however, since the Committee contains representatives from institutions, which are not central banks, the decisions it takes carry the commitment of many national authorities outside the central banking fraternity. These decisions cover a very wide range of financial issues.

The Committee has issued a number of documents since 1975. In 1988, the Committee decided to introduce a capital measurement system commonly referred to as the Basel Capital Accord. This system provided for the implementation of a credit risk measurement framework with a minimum capital standard of 8% by end-1992. Since 1988, this framework has been progressively introduced not only in member countries but also in virtually all other countries with active international banks.

In June 1999, the Committee issued a proposal for a New Capital Adequacy Framework to replace the 1988 Accord. The proposed capital framework consists of three pillars: minimum capital requirements, which seek to refine the standardized rules set forth in the 1988 Accord; supervisory review of an institution's internal assessment process and capital adequacy; and effective use of disclosure to strengthen market discipline as a complement to supervisory efforts.

Following extensive interaction with banks and industry groups, a second consultative document (package) taking into account comments and incorporating further work performed by the Committee, was issued in January 2001, with the objective of banks implementing a new framework by 2004. The complete Basel Committee package includes an overview paper, the proposed new Basel Capital Accord (Accord), and seven technical supporting papers which are available on the Bank for International Settlements site at www.bis.org. Comments on the proposal are due on May 31, 2001 and it is the intention of the committee to finalize the Accord by 2001 year-end.

1988 BASEL CAPITAL ACCORD AND ITS LIMITATIONS

1988 Basel Capital Accord defines what types of capital are acceptable for supervisory purposes and stresses the need for adequate levels of core capital (in the accord this capital is referred to as tier one capital) consisting primarily of permanent shareholders' equity and disclosed reserves that are created or maintained by appropriations of retained earnings or other surplus (e.g. share premiums, retained profit, general reserves and reserves required by law). The accord also acknowledges other forms of supplementary capital (referred to as tier two capital), such as other forms of reserves and hybrid capital instruments that should be included within a system of capital measurement. The accord assigns risk weights to on-and off-balance sheet exposures according to broad categories of relative riskiness. The framework of weights has been kept as simple as possible (0, 10, 20, 50, 100%). The accord sets minimum capital ratio requirements for internationally active banks of 4% tier one capital and 8% total (tier one + tier two). These ratios are still in use and are considered minimum standards to be followed.

The 1988 Basel Capital Accord has been facing increasing criticism due to its flawed approach of not taking into consideration the full spectrum of risks that banks face. As an example, all corporate credits are assigned the same risk weight (100%) regardless of the obligator's credit quality. Additionally, the Basel Accord is seen as "discriminatory" since the settings of risk weights for sovereign and bank credits are based on a country's membership or a bank's domicile in the Organization for Economic Cooperation and Development (OECD). Where the risk weights will be 0% for members or 100% for non-members.

THE NEW BASEL CAPITAL ACCORD (STRUCTURE OF THE NEW ACCORD: THE THREE PILLARS)

The Basel Committee recognizes that ultimate responsibility for managing risks and ensuring that capital is held at a level consistent with a bank's profile remains with that bank's management. The new proposed Accord has three mutually reinforcing "pillars" that make up the framework for assessing the capital adequacy in a bank. The first pillar of the new Accord is the "Minimum Capital Requirements," the second is the "Supervisory Review Process," and the third is "Market Discipline." As stated before the main objectives of this new accord are to foment safety and soundness in the financial system, enhance the competitive quality of the banks, include approaches to capital adequacy that are appropriately sensitive to the degree of risk involved in a bank's position and activity. Although the new Accord is primarily focused on internationally active banks, it will indirectly impact smaller, less complex institutions.

Pillar 1 – Minimum Capital Requirements

CAPITAL, defined as equity that provides for a permanent source of revenue for shareholders and funding for the bank to base for further growth, ratio will remain at a minimum requirement of 8%. Additionally, capital is used to bear risk and absorb losses; and it is used as an incentive that shareholders ensure that a bank is managed in a safe and sound manner.

TOTAL CAPITAL / Credit Risk + [12.5 *(Market Risk + Operational Risk)] ≥ 8%

For credit risk, a standardised approach building upon the 1988 Accord and introducing the use of external credit assessments will be available for less complex banks. Banks with more advanced risk management capabilities, which can meet rigorous supervisory standards, can make use of internal ratings-based (IRB) approaches (foundation and advanced). Under this approach, some of the key elements of credit risk, such as the probability of default of the borrower, will be estimated internally by a bank.

This is one of the areas which has drawn significant attention from banks. By allowing capital charges to be calculated based on internal risk ratings, means that the use of internal ratings will not be restricted. Under the proposal, Banks will be able to take on a range of approaches of varying degrees of sophistication, with increased sophistication and data quality potentially leading to lower capital charges. There are three basic elements to the IRB approach:

1. The obligor's estimated one year probability of default.
2. The facility's loss given default and the exposure at default.
3. Estimates of probability of default could make use of either the bank's own estimates based on historical experience or the probability of default implicit in external credit ratings.

To be eligible to adopt an IRB approach, a bank will need to demonstrate that its internal rating system and processes are in accordance with the supervisory standards set by the Basel Committee. There are six key principles underlying these standards:

1. <u>Structure of the rating system</u> - To be eligible, banks must have a rating that separately distinguishes borrower risk and transaction risk. This allows differences in collateral, seniority or other attributes to be recognised on loans to the same obligor.
2. <u>Number of grades</u> - Banks should have at least six grades for performing loans and two for problem loans with a meaningful distribution of exposures across grades and no excessive concentration in any particular grade.
3. <u>Integrity of process</u> - Whilst the standards to ensure integrity of the rating assignment and review process are still being developed, these would include a requirement that a borrower must have a rating before credit is granted and should be reviewed periodically by an independent source.

4. Criteria for rating assignment and loss quantification - Banks must have specific criteria for assigning borrowers a rating and documentation on how these criteria are established. The criteria should be able to differentiate risk, have predictive and discriminatory power and be specific enough to enable third-party assessment of an exposure.
5. Internal validation - Banks need to have robust systems in place to validate the accuracy and consistency of rating systems, processes and the quantification of internal ratings.
6. The use test - Bank management needs to demonstrate that they themselves rely on these ratings for key internal processes and decisions. Therefore, these ratings must be an integral part of the daily credit risk measurement and management processes of banks.

The current proposals stop short of allowing banks to use their own portfolio credit risk models to determine regulatory capital requirements. Therefore, even the advanced IRB approach will not allow for bank-specific adjustments to measures of credit risk to reflect risk correlation between different borrowers. However, the document is part of what Basel Committee itself has described as "an evolutionary approach" that will, ultimately lead to the recognition of portfolio risk models for regulatory purposes. It is expected for Basel Committee to begin reexamining the use of models later this year.

The Committee is also proposing an explicit capital charge for operational risk. A number of possible options for this calculation are elaborated on in the consultative package. Varying degrees of sophistication in monitoring and controlling operational risk will be permitted. At the Basic Indicator Approach level, the current proposal will require banks to hold capital equal to a fixed percentage of its gross income. This methodology is crude and simplistic and will only be used by the least sophisticated institutions. At a more sophisticated level, banks will need to track key risk indicators in seven predefined business lines (i.e., retail banking, commercial banking, corporate finance, trading and sales, payment and settlement, retail brokerage and asset management), and capital charges will be calculated based on these. The most complex option proposed (the Internal Measurement Approach) allows banks more direct input into calculating the operational risk capital charge under each of the predefined business lines. Most institutions will also face a challenge to have systems in place to avoid the potentially penal charges levied under the most basic of the calculation methods envisaged.

With respect to the overall level of capital, the Committee's primary goal is to deliver a more risk-sensitive methodology that on average neither raises nor lowers regulatory capital for banks, after including the new operational risk capital charge. Naturally, capital requirements may increase or decrease for an individual bank depending on its risk profile.

Potential impact to Latin American Banks:

FAVORABLE:

- Improves a bank's risk management techniques
- Fosters equality within a very competitive environment. A bank will be obliged to maintain levels of capital in accordance to their risk appetite

UNFAVORABLE:

- Smaller, less complex banks will have to comply with guidelines dictated by the regulatory body which could become costly.
- Low rated countries and borrowers in Latin America will be penalized as funding costs will increase and accessibility to bank financing will deteriorate as international banks will have to assign more capital (based on risk factor of 150%) to lend to these low rated borrowers.
- Operational risk capital charges could be burdensome and will pose a readiness challenge to most institutions. Like the internal ratings, it is expected that banks will be able to choose from a range of approaches in calculating the capital charge for operational risk. Basel Committee expects that the operational risk charge would, on average, represent 20% of the minimum regulatory capital charge. Those institutions which have focused little attention on measuring operational risk in the past may find it very difficult to quickly establish systems and procedures necessary to avoid capital charges for operational risk calculated under the Basic Indicator Approach.

Pillar 2 – Supervisory Review Process

This pillar encourages regulators to assess banks' internal approaches to capital allocation and assessments of capital adequacy and provides a means for supervisors to improve bank internal controls and risk management techniques. Subject to the regulatory minimum, banks

themselves will set appropriate internal capital targets to cover their particular risk profile. Supervisors will then be responsible for checking that the internal capital targets are suitable for the bank's risk profile and are adequately monitored. Banks are expected to hold capital above the regulatory minimum and supervisors must intervene at an early stage if capital levels become insufficient.

Potential impact to Latin American Banks:

FAVORABLE:

- Fosters cooperation with the regulatory body.
- Intervention by the Central banks at an early stage of a problematic bank.

UNFAVORABLE

- Smaller banks will have to rely on the regulatory body or third parties to fully understand and embrace these new changes.
- Impact of these reforms depends on regulator discretion and there is a risk of them being implemented differently - this could introduce or reinforce competitive inequalities. It is clear that while some countries intend to apply the rules arising from this Accord to all banks, others will apply them only to internationally active banks. This raises the prospect of an uneven playing field across different jurisdictions.

Pillar 3 – Market Discipline

The Committee is proposing a much greater range of disclosure initiatives designed to make risk and capital positions of a bank more transparent. The aim is to bolster market discipline through significantly increased disclosure to ensure that market participants can better understand banks' risk profiles

FAVORABLE:

- Promotes transparency given the increased reliance on internal assessments.

UNFAVORABLE:

- Cumbersome and costly for small/medium banks.
- Possible release of information deemed sensitive.
- Disclosure requirements may need to change. In theory, having access to more important information, markets will reward well-managed banks and punish poorly run ones. However, it has not been decided, yet, or addressed, the context of developing international accounting disclosure standards, nor has a distinction been made between disclosure to regulators and disclosure to the public.

OVERALL CONCLUSION AND INDUSTRY IMPACT (LATIN AMERICA BANKS)

The proposals are complex and will have far-reaching implications for banks' capital requirements, risk management and financial disclosure. The complexity is likely to increase compliance costs, but the Accord should be embraced since it rewards best banking practices. The Accord emphasises banks' own assessment of risks in the calculation of regulatory capital. Capital incentives for the more advanced capital calculation methods are deliberately included and it is hoped this will motivate banks to continuously improve their risk management capabilities. Over time, more banks are expected to move from the simpler to the more complex calculation methods.

The main premise is that total bank capital will be unchanged, but capital will be allocated more appropriately to underlying risks in the sector. Listed banks will be more accurately priced by the stock market, so banks who use this Accord to demonstrate good risk management should be able to raise capital more affordably. At the same time, banks that are disadvantaged by these proposals will either need to reduce risk or consider raising additional capital.

The cost of short term funding is currently cheaper for banks with higher credit ratings. The proposed regulations may exacerbate this as it is possible that those banks which calculate capital using the more sophisticated methods within the Accord will see a reduction in funding costs. Financial institutions using the simpler capital calculations, which may include the smaller banks, might see these costs rise.

All banks will need to decide whether to use the simpler or more complex capital calculations. This is a cost benefit analysis weighing potential capital savings against additional risk management costs. Also, the necessary systems and operational changes needed to meet the new reporting requirements will need to be identified.

Banks' minimum capital ratios will remain at 8% and the goal is to leave aggregate regulatory capital unchanged. But those banks with higher risk portfolios can expect to see their capital requirements increase and vice versa.

For the first time, a capital charge is proposed for operational risk, which is expected to represent approximately 20% of capital requirements. It is questionable whether offsetting capital savings will be found in the new rules to maintain current capital ratios. In Latin America the impact on banks' capital adequacy is uncertain because the relatively risky loan portfolios, which include a low level of rated exposures, are unlikely to benefit from the new rules.

The New Accord is a significant step forward for regulators and banks. The focus on banks' risk management practices and the longer term goal of trying to use banks' full internal credit models to calculate capital are to be commended; however only time will tell whether the capital incentives in the New Accord are sufficient to drive risk management improvement at an industry level.

This is both a wide-ranging and ambitious reform that seeks to better align regulatory capital with economic risk. It represents a real advance on the 1988 Capital Accord and the proposals mark a decisive step away from a "one size fits all" supervisory approach to capital. Rather than imposing a single method for calculating capital requirements, institutions will be able to select from a range of approaches for capturing, measuring and controlling credit and operational risks. More sophisticated control structures will be rewarded by lower capital charges. If the Basel proposals are implemented as planned, they will have important effects both on individual banks and on markets. Banking supervisors are not seeking to raise the overall level of regulatory capital backing the financial system, but instead to reallocate this capital between institutions according to more risk-sensitive measures. So some institutions will see the level of required capital rise, while others will see a reduction.

The Accord is a major document, totalling, up to now, over 500 pages, which will substantially change the way banks will be required to calculate their regulatory capital requirements, with resulting changes in the way banks manage capital. This will entail substantial changes to systems and in some cases the whole credit grading system. It will also present many challenges to regulators in the period up to the 2004 implementation date.