Basel Committee
on Banking Supervision

Overview Paper for the Impact Study

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BANK FOR INTERNATIONAL SETTLEMENTS

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Overview Paper for the Impact Study

1. Executive Summary

1. The Basel Committee on Banking Supervision (the Committee) has developed a new more comprehensive framework for capital regulation based on three pillars – minimum capital requirements, supervisory review and market discipline. The Committee is now releasing a comprehensive "field test" of its proposals for revising the minimum capital requirements. The field test referred to as the third quantitative impact survey, or QIS 3, represents a significant step in the Committee's efforts to develop an improved capital adequacy framework. More than 200 banks from over 40 countries are expected to participate.

2. An improved Capital Accord is intended to foster a strong emphasis on risk management and to encourage ongoing improvements in banks' risk assessment capabilities. The Committee believes that minimum capital requirements can and should be closely aligned with prevailing strong risk management practices. On the basis of risk-sensitive minimum capital requirements, bank capital can be more efficiently used to protect against risk.

3. Another major difference between the draft proposals and the current Accord is the fact that the new framework will comprise multiple options from which banks and supervisors will select when calculating minimum capital requirements. There is no longer a one-size-fits all approach to capital adequacy. Going forward, banks will be expected to employ the method most appropriate to their risk management systems.

4. In the area of credit risk, the options for calculating regulatory capital include a revised standardised approach that is similar in form to the current Accord. There is also a foundation and an advanced internal ratings-based (IRB) approach to credit risk, both of which make use of banks' own estimates of key parameters. However, rather than rely on an external rating as in the revised standardised approach, IRB banks will provide key qualitative measures that express their own internal assessments of their exposures.

5. The new Accord also introduces a minimum capital requirement for operational risk. The Basel Committee believes operational risk is an important risk facing banks, and that banks need to protect against the potential loss from it.

6. The member countries of the Basel Committee intend a common implementation of a revised Accord for their internationally-active banks at year-end 2006. The Committee recognises that more than 100 countries have implemented the current Accord, some only fairly recently. The Committee, therefore, does not wish to imply that all such countries should seek to implement the revised Accord by 2006. National supervisors should carefully consider the issues involved in implementing the revised Accord in the context of their banking systems in choosing an appropriate timetable for implementation, particularly in regard to banks that are not considered to be internationally-active, and, therefore, not necessarily subject to the terms of the current Accord even in member countries. The Committee continues to work with non-G10 emerging market supervisors about the application of the New Accord in such countries.

7. In revising the Accord, the Committee has confronted numerous challenges. The Committee has responded to each new challenge by engaging in active dialogue with banks and other market participants, and, wherever possible, has tried to borrow from leading industry practice.

8. A central challenge facing the Committee is the complexity of the new risk based rules. The Committee has a strong preference for providing simple alternatives where possible. In several areas, it has chosen to pare back its proposals in the interest of less complexity. However, in other areas, industry feedback has convinced the Committee that simple proposals cannot effectively or fairly treat the risks associated with important business activities. Moreover, industry best-practices include sophisticated risk measurement systems. To respond, the Committee has developed a range of options.

9. Recent significant changes to the Committee's proposals reflect the desire to work cooperatively with industry participants to develop practical approaches to difficult issues. In the area of loans to small- and medium-sized enterprises (SMEs), the Committee determined that an approach where all businesses – large and small – are treated identically would ignore important aspects of the risks associated with SME lending. The Committee believes that the approach agreed in July 2002 and summarised below provides an improved basis for evaluating the risks associated with this important form of lending.

10. Another major challenge for the Committee has been the treatment of operational risk, which is continuing to undergo significant evolution within the banking industry itself. A range of options for calculating regulatory is provided. Under the advanced measurement approaches (AMA), also agreed by the Committee in July, banks are provided with maximum flexibility in developing improved methods for assessing an operational risk charge. By design, AMA is a reflection of the evolutionary nature of operational risk assessment.

11. The Committee has devoted considerable resources to questions regarding the overall level of capital generated by the proposed new rules. As indicated on numerous occasions, the Committee is not intending for the revisions to result in material increases or decreases in aggregate banking system minimum capital levels. This said, the Committee recognises the need to provide tangible incentives for banks to adopt the more advanced approaches to capital measurement. The QIS 3 process is designed to provide critical information in support of these calibration efforts.

12. The Committee and others have already begun to focus on implementation and the challenge of maintaining a global level playing field under Basel II. Banks have expressed some concern about the potential for uneven implementation across national jurisdictions. They have wondered whether supervisors in one jurisdiction might seek to apply a more stringent approach than those in other countries. In response, a working group of senior line supervisors has been formed under the auspices of the Basel Committee with the objective of sharing information and promoting consistency in implementation approaches.

13. The process for taking forward the development of the new Accord will involve consideration of the feedback received from the QIS 3. Banks are asked to submit their QIS 3 responses by no later than 20 December 2002. After which, the Committee intends to spend time assessing the results and, where appropriate, refining its proposals. It currently anticipates releasing for public comment a full consultative package in spring of 2003.

II. Introduction

14. The Basel Committee on Banking Supervision (the Committee) is releasing this overview paper as an accompaniment to the launch of a comprehensive "field test" of its proposals for revising the Capital Accord. The field test referred to as the third quantitative impact survey, or QIS 3, represents a significant step in the Committee's efforts to develop an improved capital adequacy framework. The QIS 3 focuses on the proposed minimum capital requirements under pillar one of the new Accord. It is being undertaken with the goals

of ensuring the quality of the Committee's proposals and gathering information helpful to making further modifications prior to the release of a formal package for consultation in spring of 2003.

15. This paper is intended to provide an overview of the Committee's perspective to revise the Capital Accord, including major elements of the draft proposals that will be tested by the banking industry during the QIS 3. The paper also discusses some of the major challenges that have confronted the Committee as part of the process of revising the Accord.

III. Benefits of the New Basel Capital Accord

16. The Committee believes that important public policy benefits can be obtained by improving the capital adequacy framework along two primary dimensions. The first is by expanding the nature of the framework to more fully encompass the "three pillars" of capital adequacy – minimum requirements, supervisory review, and market discipline. The second is by increasing substantially the risk-sensitivity of the minimum capital requirements. From the outset, these objectives have been at the heart of the Committee's efforts to revise the 1988 Capital Accord, and there is widespread agreement among market participants that these are desirable goals.

17. Financial market developments continually underscore the importance of risk assessment as a key mechanism for ensuring the stability of individual participants as well as the system as a whole. An improved Basel Accord is intended to foster a strong emphasis on risk management and to encourage ongoing improvements in banks' risk assessment capabilities. The Committee believes this can be accomplished by aligning the rules that determine minimum capital requirements more closely with prevailing strong risk management practices, and by ensuring that this emphasis on risk is incorporated into supervisory practices through pillar two of the new Accord and into market discipline through enhanced risk and capital-related disclosures.

18. Improvements in the risk sensitivity of the minimum capital requirements will provide benefits through a stronger and more accurate incentive structure. The broad-brush nature of the current Accord – where required capital generally does not differ by the degree of risk – can artificially discourage certain types of lending and encourage transactions whose sole benefit is regulatory capital relief (i.e. capital arbitrage). More broadly, a risk-sensitive capital framework holds out the promise that if banks invest in enhanced risk management, the regulatory framework will support such investments.

19. Risk-sensitive capital requirements also provide more meaningful and informative measures of capital adequacy. Capital adequacy ratios are widely used by supervisors, counterparties, investors, market analysts, and banks themselves as critical indicators of financial health. As banks become larger and their activities more complex, the need for such indicators to keep pace and remain effective likewise becomes more urgent. Unless the capital framework is reformed and made more risk-sensitive, the Basel Committee believes that current trends will over time undermine the value of capital adequacy ratios for the largest and most systemically important banking organisations.

20. The second pillar of the revised Accord focuses on the need for banks to conduct their own internal assessments of capital relative to risk and for supervisors to review and respond such assessments. These elements are increasingly seen as necessary for effective management of banking organisations and for effective banking supervision, respectively. Judgements of risk and capital adequacy must be based on more than an assessment of whether a bank complies with the pillar one regulatory minimum. The inclusion of pillar two in

the revised Accord will therefore provide benefits through its emphasis on the need for strong risk assessment capabilities by banks and by supervisors alike.

21. There is also an important role to be played by market participants in evaluating the adequacy of bank capital. Greater disclosure of key risk elements and capital will provide important information to counterparties and investors who need these data to form an informed view of a bank's risk profile. By bringing greater market discipline to bear through enhanced disclosures, the Committee believes that pillar three of the new Accord can produce significant benefits in helping banks and supervisors to manage risk and improve stability.

IV. Key Elements of the Proposals

22. The Basel Committee has been working closely with market participants to develop concrete pillar one proposals that fulfil its objectives. The Committee is now at the stage of having a complete set of draft proposals and is launching a comprehensive quantitative field test involving more than 200 banks from over 40 countries. While most of the elements of the draft proposal have been described previously and have been discussed extensively with the industry, this is the first time that the Committee has been able to undertake a quantitative assessment of a complete set of proposed minimum capital requirements.

23. Perhaps the most important difference between the draft proposals and the current Accord is fact that Basel II comprises multiple options from which banks and supervisors will select various approaches to calculating the minimum capital requirement. Given substantial differences across banking organisations, it is not possible for a one-size-fits-all framework to meet the Committee's objectives. Thus, the Committee has adopted an approach in which different options are available to banks depending on their needs and on their willingness to invest in improved risk assessment systems. The decision of necessity to make multiple options available under the revised Accord implies that the new framework is more difficult to summarise and describe than the current Accord, but also ensures that it is more flexible.

24. A second major innovation is the introduction of a minimum capital requirement related to operational risk. Thus, the new framework will encompass three areas of risk within the minimum capital requirement: (1) credit risk (included in the 1988 Accord), (2) the market risk of trading activities (introduced in a 1996 amendment to the Accord) and (3) operational risk. The measurement of operational risk and the proposed approaches to its incorporation in the framework have posed formidable challenges and are discussed further in the following section below. On the basis of risk-sensitive minimum capital requirements, bank capital can be more efficiently used to protect against risk.

25. Regarding the treatment of credit risk, the proposals contain three potential approaches from which a bank may choose, in some cases subject to meeting various criteria. The three approaches are (1) the revised standardised approach, (2) the foundation internal ratings-based (IRB) approach, and (3) the advanced IRB approach. The revised standardised approach is most similar to the current Accord. In this approach, credit exposures are divided on the basis of the type of exposure (e.g. loans to sovereigns vs. loans to corporates) and a few other observable characteristics, most notably whether the obligor has a public credit rating.

26. The revised standardised approach represents a material development from the existing Basel Accord. While it will not be as fully risk-sensitive as the IRB approaches, it incorporates important improvements, e.g. in the treatment of credit mitigation techniques and asset securitisations. It also provides a solution to the problem of the current so-called

club rule for the risk weighting of sovereign exposures. The Committee will be working closely with supervisors from a number of non G-10 jurisdictions during the QIS 3 period to ensure that the revised standardised approach can be implemented effectively in a broad range of circumstances, also in cases where the scope for use of external credit ratings for corporate exposures is limited.

27. The introduction of the two IRB approaches to credit risk capital represents a significant innovation in the calculation of minimum capital requirements. As the IRB label implies, the key feature of both approaches is reliance on measures of borrower creditworthiness generated internally by banks as primary inputs to the capital requirement calculation. To ensure that the internal estimates are robust and meaningful, banks using either approach will be required to comply with a series of qualitative criteria covering the comprehensiveness and integrity of their internal credit risk assessment capabilities.

28. Both IRB approaches require that banks sub-divide their credit exposures into several categories (e.g. corporate loans vs. residential mortgages). Within each category, banks will provide key quantitative measures that express their internal assessments of the exposures. Under the foundation IRB approach, banks will need to provide quantitative assessments of the probability of default of a borrower and, in some jurisdictions, the effective maturity of their exposures. Under the advanced IRB approach, banks will also provide estimates of loss-given-default exposure at default and will be required to consider effective maturity in most cases.

29. For each exposure category, the IRB proposals specify a formula that translates the necessary quantitative inputs into a specific capital requirement. The formulas as well as the definitions of the specific inputs required vary somewhat across exposure categories. For example, within the retail exposure categories, there is only a single, advanced IRB approach and no foundation IRB alternative.

30. For the wholesale exposure categories, the primary difference between the two IRB approaches lies in the fact that banks are allowed to supply more quantitative inputs themselves in the advanced IRB approach. In the foundation IRB approach, these additional inputs are instead assumed to take on fixed specific values depending on various characteristics of the exposure. Thus, the advanced IRB approach is more flexible and allows greater leeway for banks to evaluate elements, such as the likelihood that a loan commitment will be drawn or the value to be derived from various types of collateral. At the same time, the minimum entry standards associated with the advanced IRB approach are likewise more stringent than for the foundation IRB approach.

31. Because the IRB approaches are based on internal assessments of credit risk and therefore allow for gradations as fine as those internal assessments produced, the potential for increased risk sensitivity under these approaches is substantial. Importantly, however, the IRB approaches do not allow banks to themselves directly determine the applicable capital requirements. Instead, these are determined through the combination of quantitative inputs provided by banks and the formulas specified by the Committee.

32. A major element of the IRB approaches as well as the revised standardised approach relates to the treatment of “credit risk mitigation”. This term is intended to broadly cover the use of various types of collateral, guarantees, and credit derivatives. Banks rely on a wide variety of credit risk mitigants to protect themselves from credit losses; however, under the current Accord, quite narrow restrictions are placed on banks’ abilities to achieve lower capital requirements through their use. A major element of the Basel II proposals to credit risk involves significantly expanded recognition of collateral, guarantees and credit derivatives. The Committee has tried to build on industry practice in prudently evaluating the benefits and residual risks associated with them. For example, the proposed framework will

require banks to capture the potential future exposure arising from a wider range of permissible collateral types.

33. Another significant element of the draft proposals involves the treatment of securitisation. Here as well, the existing Accord contains very little specific guidance on the treatment of such transactions. However, given the large and growing market in such transactions, as well as the fact that their very nature relates to the transfer of ownership and/or risk associated with credit exposures, it is essential that Basel II incorporate a robust treatment of securitisation. Without such a treatment, the new Accord would remain highly vulnerable to capital arbitrage and would fail to achieve the objectives set out by the Committee.

34. In tandem with QIS 3, the Committee is for the first time releasing its proposals for a comprehensive securitisation framework. There is a standardised and IRB treatment, both of which focus on the risks stemming from securitisations rather than simply on their legal forms. For a more complete description of the new proposals, see the forthcoming working paper on the securitisation framework.

35. A final element of the credit risk proposals that needs to be highlighted involves the treatment of loans to small- and medium-sized enterprises (SMEs). In this area, the Committee has sought to ensure that its proposals result in appropriate capital requirements for such borrowers. Under certain circumstances, banks may treat loans made to SMEs as retail loans under both the revised standardised and IRB approaches. In addition, under the IRB approaches, SME loans treated as corporate exposures will be assessed lower capital requirements than loans to larger companies with otherwise similar characteristics.

V. Major Challenges

Complexity of the new Accord

36. The Basel Committee believes that the revised Accord should be as simple and straightforward as possible, but not so simple as to compromise its core objectives of risk sensitivity and flexibility. Taken together, these objectives necessarily imply that the new Accord will be more comprehensive and more complex than the existing Accord. Multiple approaches to credit and operational risk are critical to maintaining the flexibility and thus the broad applicability of Basel II. In short, multiple options have been provided to address the spectrum of banks' risk management practices. The Committee also saw as essential robust, risk-sensitive proposals regarding important elements such as securitisation and credit risk mitigation techniques.

37. The Committee has made significant efforts to clarify and simplify the structure of the new Accord and its application wherever possible. In several cases, this has involved significant refinement of previous proposals. Based on extensive feedback from a variety of interested parties, the Committee is now proposing to allow a phased rollout of the IRB approaches. The aim is to allow for greater flexibility in the way banks implement them across their various portfolios, both in terms of timing and scope. To this end, banks will be expected to draw-up an implementation plan for discussion with national supervisors, specifying to what extent and when they intend to rollout the IRB approaches across significant business exposure classes and business units over time.

38. Other simplifications have been made to pillar one. Banks and supervisors will now be expected to look to pillar two -- where the onus is on banks to assess their capital adequacy relative to their risks and for supervisors to evaluate banks own assessments --

when considering credit concentration and residual risks associated with credit risk mitigation techniques. More recently, the Committee has decided to simplify the IRB treatment of project finance and other forms of specialised lending under Basel II. Many banks will now be able to treat these forms of lending identically to other corporate exposures.

39. The Committee has also carefully evaluated the minimum standards banks must satisfy in order to be eligible for the IRB approaches. The requirements were developed to ensure an appropriate degree of credibility and consistency in banks' use of internal estimates for determining capital requirements. During recent consultations, it became apparent that the standards as originally written might not allow for innovation or differences in the way banks operate and thus could be overly restrictive in practice. The Committee has spent considerable effort to re-craft the minimum standards. They are now in a form that should result in consistent measures of internal estimates across institutions while also allowing for differences in the way banking organisations work.

40. In other areas, industry feedback has convinced the Committee that simpler proposals would not effectively or appropriately treat the risks associated with important business activities. In these instances, the Committee has developed proposals to reflect different risks. One such example concerns the treatment of small- and medium-sized enterprises (SMEs) as described above. Analysis conducted by the Committee suggested that SMEs pose different risks as compared to those of larger borrowers. The Committee therefore decided that the treatment of SMEs should be differentiated from that of larger borrowers, even though this results in a more complex proposal.

41. The Committee's underlying principle has been to introduce complexity where it makes sense to give banks options and to address their individual business strategies and systems. This aim has resonated with members of the industry, some of which have called for even greater risk differentiation in various areas.

Operational risk

42. The Basel Committee believes that operational risk is an important risk facing banks and that banks need to hold capital to protect against potential losses from it. This view is shared by a number of globally-active financial institutions, which have been at the forefront of analysing and assessing operational risk. The Committee proposes to define operational risk as the risk of loss resulting from inadequate or failed internal processes, people and systems, or external events, and therefore includes legal risk.

43. Approaches to the measurement of operational risk continue to evolve rapidly, but are unlikely to attain the precision with which market and credit risk can be quantified. This poses obvious challenges to the incorporation of a measure of operational risk within the minimum capital requirement. Nevertheless, the Committee believes that such inclusion is essential to ensure that strong incentives exist for the continued development of approaches to operational risk measurement and management and to ensure that banks are holding sufficient capital buffers for operational risk. It is clear that a failure to treat operational risk within the minimum capital requirement (pillar one) would reduce these incentives and result in a reduction of industry resources devoted to operational risk issues.

44. On the other hand, the Committee is prepared to allow an unprecedented amount of flexibility to banks in choosing how to measure operational risk and the resulting capital requirement. Under the advanced measurement approaches (AMA), banks will be permitted to choose their own methodology for assessing operational risk, so long as it is sufficiently comprehensive and systematic. The extent of detailed standards and criteria for use of the AMA are minimal in an effort to spur the development of innovative approaches, although the

Committee intends to review progress in regard to operational risk approaches on an ongoing basis.

45. Another change concerns elimination of specific quantitative limits (i.e. the proposed capital floor) on the outcome of the AMA. This development underscores the willingness of the Committee to allow banks maximum flexibility to develop an approach to calculate operational risk capital that they believe is consistent with their mix of activities and underlying risks. The Committee has been strongly encouraged by those banks that have been developing operational risk frameworks consistent with the spirit of the AMA. Such banks believe that these frameworks will provide important benefits for their own risk management processes and have credited the Committee's proposals with spurring the development. Most importantly, those bankers that have made a serious effort to do so have concluded that it is possible to develop a flexible and comprehensive approach to operational risk measurement within their firms. Further, banks have indicated that the results will be a meaningful and useful addition to the assessment of risk and capital adequacy within their organisations.

Calibration of the new Accord

46. A key issue throughout the process of developing the new Accord has been the potential impact on minimum capital levels compared with those required under the current Accord. As indicated on a number of occasions, the Basel Committee has not undertaken these revisions with the purpose of achieving significant changes – either increases or decreases – in the aggregate amount of minimum regulatory capital in the banking system. The Committee well recognises, however, the potential impact that a more risk-sensitive framework could have on minimum capital levels at individual banks.

47. An additional challenge in calibrating the new Accord relates to the existence of multiple approaches and the Committee's desire to ensure that tangible incentives exist for banks to adopt the more advanced ones. Accordingly, the Committee has devoted considerable effort to questions related to the overall level of capital and to empirical estimates of the impact of its proposals. Primary to this work has been the data and feedback provided by the industry on the way in which the proposals would impact their current portfolios. These efforts have, for example, been essential in leading the Committee to make various changes in the calibration of the standardised approach, in particular the reductions in the capital requirements applied to various retail exposures.

48. One focus of the work of the Committee has been on the technical details of the formulas used to determine capital requirements in the various parts of the new framework. Here the Committee has sought to understand prevailing market practice and to be sensitive to the impact of its proposals on individual business lines. Such interaction with market participants can be expected to continue.

49. A second focus has been on assessing the overall impact on banks from the totality of the Committee's proposals. From this vantage point, the Committee has assessed the manner in which the revised standardised approach and the IRB approaches compare with each other. The Committee's prior impact studies have been extremely useful in this regard, even though each of them has only focused on a portion of the new framework.

50. The comprehensive nature of the QIS 3 exercise that the Committee is now launching should significantly improve its ability to undertake further comparisons on the basis of a robust data set. The Committee has, therefore, planned the QIS 3 with great care. In spite of these ongoing efforts to ensure that the Committee's primary aims in respect of

calibrating its proposals can be achieved, there remains a risk that outcomes in practice will not be consistent with the field tests that the Committee is now conducting.

51. To protect against this risk, the Committee plans to adopt a prudent approach in transitioning to the new framework. First, those banks adopting the more advanced approaches to risk assessment (i.e. the IRB approaches to credit risk or the AMA with respect to operational risk) will be required to run such approaches in parallel with the existing Accord for a year prior to formal implementation of Basel II. The Committee believes that this will provide banks and supervisors with valuable information on the potential impact of the new Accord and allow issues to be brought up prior to formal implementation.

52. In addition, the Committee has proposed that banks using these approaches also be subject to a declining floor on their new capital requirement for the first two years following formal implementation. This floor is calculated using the rules of the existing Accord and would equal 90% of the calculation in the first year and 80% in the second year. This transitional approach is intended to balance the desire to provide tangible incentives for banks to adopt these advanced approaches with the need to protect against the risk of mis-calibration and to provide the Committee with the opportunity to correct such problems should they occur. More generally, the Committee believes that the parallel calculation of Basel I and Basel II for these two years will provide a valuable opportunity for market participants to better understand the nature of the differences between the two regimes.

Potential for cyclicality

53. Related to issues of overall calibration has been the question of whether a more risk-sensitive capital framework would result in more cyclical behaviour by banking organisations. The Committee believes that such questions deserve careful attention by supervisors and market participants, but that concerns about cyclical impacts should not impede the development of risk-sensitive regulatory approaches.

54. A major objective of enhancing of risk awareness and emphasising the importance of sound risk assessment is to encourage banks to take a more dynamic and forward-looking view of their activities. Banks have historically experienced problems when they have failed to appreciate the risks associated with various activities and have expanded such activities too rapidly. Moreover, continuing failures to recognise the true nature of the risks involved – even after problems have surfaced – have too frequently led to circumstances where problems increase to levels requiring official intervention.

55. The Basel Committee is of the view that a robust emphasis on risk can lead banking organisations to better avoid problems in the first place and to deal with them more rapidly and effectively when they do occur. The Committee believes that if such changes in behaviour can be achieved, the net result on financial stability and economic stability will certainly be a positive one.

56. The challenge will be to ensure that banks and other market participants adopt a more dynamic and forward-looking approach to the evaluation of risks and to their own behaviour. The Committee therefore believes that substantial ongoing attention to such issues will be essential to a successful implementation of the new Accord. For example, it is certainly true that bank capital ratios are likely to fluctuate more over the course of the business cycle under a risk-sensitive regime than they do today, although the Committee has taken various steps to limit the extent to which they could be excessive under Basel II. The steps include adoption of a considerably flatter risk-weight curve for corporate lending and the development of guidance to encourage banks to take more account of uncertainty over the full economic cycle in their ratings processes.

57. There is nothing inherently problematic with the fact that capital ratios may fluctuate over time under the new Accord, as long as banks and other market participants appropriately recognise this possibility and plan for it effectively in advance. That is, the dynamic properties of the new framework are simply going to be different than under the existing framework and thus it is hoped that banks and those who assess their financial condition incorporate such changes into their own assessment procedures.

58. It is for this reason that the Committee believes that banks adopting the IRB approaches should undertake meaningful stress tests. These stress tests – which banks will have the flexibility to design for themselves – are intended to focus the attention of both banks and supervisors on the dynamic nature of the IRB approach and the possibility that IRB requirements can increase during adverse economic conditions. Banks should therefore ensure that their capital planning process takes into account this possibility, in particular the potential need for a capital buffer under pillar two of the new Accord. Supervisors will review the stress test results when undertaking their responsibilities under pillar two of the new Accord.

59. The Committee believes that such an approach is far preferable to either of the two alternative possibilities. Namely, to abandon the potential benefits of a more risk-sensitive regime, or attempt to "hard-wire" the degree to which banks' capital requirements should vary over the course of business cycles, which would doubtless prove an impossible task.

Implementation considerations

60. Banks, supervisors and others have already begun to consider how their existing systems and practices will have to change in the lead-up to the new Accord's implementation. In particular, questions have been raised about how the entry criteria for the various Basel II approaches should be applied, and whether supervisors in one jurisdiction may be inclined to implement all three pillars of the new Accord more stringently than elsewhere. The Committee sees frequent exchanges of information between banks and supervisors and between supervisors in one jurisdiction and those in another as critical for the successful implementation of Basel II. This will particularly be important for banks seeking to adopt the more advanced approaches -- those that allow for greater reliance on banks' own-estimates as in the IRB approaches to credit risk or the AMA for operational risk.

61. Implementation of the new Accord will require a resource commitment on the part of banks and supervisors alike. On the supervisory front, the Accord Implementation Group (AIG) has been created under the auspices of the Basel Committee. Comprised of senior line supervisors, the AIG is charged with fostering a significant measure of consistency in the way the new framework is implemented. The approach will be a practical one, taking into consideration the real life challenges banks may face.

62. An important set of issues for many countries that have adopted the Basel Accord will relate to the timetable for adoption of Basel II, as well as the extent of its application. The member countries of the Basel Committee intend to implement the new Accord for their internationally-active banks on a common basis at year-end 2006. The Committee appreciates that such a timetable may not reflect the priorities of all countries that apply the current Basel Accord. The Committee therefore wishes to clarify its view that each national supervisor should consider carefully the benefits of the revised Accord in the context of its domestic banking system in developing a potential timetable for implementation. Given resource constraints and other priorities, it should be neither surprising nor inappropriate for these timetables to extend beyond 2006.

63. The Basel Committee is keenly interested in understanding the impacts that its proposals could have on banks located outside the member countries of the G-10. The Committee welcomes strong participation in the QIS 3 exercise by non-G-10 banks and supervisors, which will help ensure that the effects on such banks will be incorporated in the Committee's deliberations. The Committee greatly appreciates the input that non-G-10 supervisors and the Core Principles Liaison Group have already provided.

64. In this context, an important aspect relates to the treatment of banks that are not considered to be internationally-active in their jurisdictions. Consistent with its Core Principles on Banking Supervision, the Basel Committee believes that all banks should be subject to minimum capital adequacy regulation. Importantly, however, the Basel Accord is intended primarily for those banks that are considered to be internationally-active and typically engaged in a more complex array of activities. Accordingly, the Committee has recently initiated work, jointly with non-G-10 supervisors, to develop practical guidance on potential approaches to the capital regulation of banks that are not internationally-active. Such guidance will be focused on helping supervisors in emerging markets understand the issues and challenges involved as they select an approach suitable for their domestic banking systems.

Next steps

65. Going forward, the Basel Committee's process for revising the Capital Accord will involve consideration of the feedback received from the QIS 3. Banks have been asked to submit their responses by no later than 20 December 2002. After which, the Committee intends to spend time assessing the results and, where appropriate, refining its proposals.

66. The Committee currently anticipates releasing for public comment any further changes it may propose during the second quarter of 2003. The Committee does not envision a lengthy consultation period. The rationale being that the Committee has consulted with industry participants and other interested parties throughout the revision process and will continue to do so going forward. Industry responses will be requested within a time frame that allows for implementation of the new Accord in each country by year-end 2006.