Basel Committee on Banking Supervision

Consultative Document

Overview of The New Basel Capital Accord

Issued for comment by 31 July 2003

April 2003
Introduction

1. The Basel Committee on Banking Supervision (the Committee) is releasing this overview paper as an accompaniment to its third consultative paper (CP3) on the New Basel Capital Accord (also known as Basel II). The issuance of CP3 represents an important step in putting the new capital adequacy framework in place. The Committee's goal continues to be to finalise the New Accord by the fourth quarter of this year with implementation to take effect in member countries by year-end 2006.

2. The Committee believes that important public policy benefits can be obtained by improving the capital adequacy framework along two important dimensions. First, by developing capital regulation that encompasses not only minimum capital requirements, but also supervisory review and market discipline. Second, by increasing substantially the risk sensitivity of the minimum capital requirements.

3. An improved capital adequacy framework 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 closely aligning banks’ capital requirements with prevailing modern risk management practices, and by ensuring that this emphasis on risk makes its way into supervisory practices and into market discipline through enhanced risk- and capital-related disclosures.

4. A critical component of the Committee’s efforts to revise the Basel Accord has been its extensive dialogue with industry participants and with supervisors from outside member countries. As a result of these consultations, the Committee believes the new framework with its various options will be suitable not only within the G10 but also for banks and for countries around the world to apply to their banking systems.

5. An equally important aspect to the Committee’s work has been the feedback received from banks participating in its impact studies. The aim of these studies has been to gather information from banks worldwide on the impact of the capital proposals on their existing portfolios. In particular, the Committee recognises the tremendous effort of the more than 350 banks of varying size and levels of complexity from more than 40 countries that participated in the most recent quantitative exercise known as QIS 3. As discussed in a separate paper, the QIS 3 results confirmed that the framework as currently calibrated produces capital requirements broadly consistent with the Committee’s objectives.

6. This overview paper is structured in two parts. The first part provides a summary of the new capital adequacy framework and also touches upon implementation considerations. It is targeted to readers that would like to increase their familiarity with the options available to banks in Basel II. The second part is more technical in nature. It outlines the specific modifications to the New Accord relative to the proposals embodied in the QIS 3 Technical Guidance released in October 2002.

Part I: Key Elements of the New Accord

7. The New Accord consists of three pillars: (1) minimum capital requirements, (2) supervisory review of capital adequacy, and (3) public disclosure. The proposals comprising each of the three pillars are summarised below.
Pillar 1: Minimum capital requirements

8. While the proposed New Accord differs from the current Accord along a number of dimensions, it is important to begin with a description of elements that have not changed. The current Accord is based on the concept of a capital ratio where the numerator represents the amount of capital a bank has available and the denominator is a measure of the risks faced by the bank and is referred to as risk-weighted assets. The resulting capital ratio may be no less than 8%.

9. Under the proposed New Accord, the regulations that define the numerator of the capital ratio (i.e. the definition of regulatory capital) remain unchanged. Similarly, the minimum required ratio of 8% is not changing. The modifications, therefore, are occurring in the definition of risk-weighted assets, that is in the methods used to measure the risks faced by banks. The new approaches for calculating risk-weighted assets are intended to provide improved bank assessments of risk and thus to make the resulting capital ratios more meaningful.

10. The current Accord explicitly covers only two types of risks in the definition of risk-weighted assets: (1) credit risk and (2) market risk. Other risks are presumed to be covered implicitly through the treatments of these two major risks. The treatment of market risk arising from trading activities was the subject of the Basel Committee’s 1996 Amendment to the Capital Accord. The proposed New Accord envisions this treatment remaining unchanged.

11. The pillar one proposals to modify the definition of risk-weighted assets in the New Accord have two primary elements: (1) substantive changes to the treatment of credit risk relative to the current Accord; and (2) the introduction of an explicit treatment of operational risk that will result in a measure of operational risk being included in the denominator of a bank’s capital ratio. The discussions below will focus on these two elements in turn.

12. In both cases, a major innovation of the proposed New Accord is the introduction of three distinct options for the calculation of credit risk and three others for operational risk. The Committee believes that it is not feasible or desirable to insist upon a one-size-fits-all approach to the measurement of either risk. Instead, for both credit and operational risk, there are three approaches of increasing risk sensitivity to allow banks and supervisors to select the approach or approaches that they believe are most appropriate to the stage of development of banks’ operations and of the financial market infrastructure. The following table identifies the three primary approaches available by risk type.

<table>
<thead>
<tr>
<th>Credit Risk</th>
<th>Operational Risk</th>
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<tbody>
<tr>
<td>(1) Standardised Approach</td>
<td>(1) Basic Indicator Approach</td>
</tr>
<tr>
<td>(2) Foundation IRB Approach</td>
<td>(2) Standardised Approach</td>
</tr>
<tr>
<td>(3) Advanced IRB Approach</td>
<td>(3) Advanced Measurement Approaches (AMA)</td>
</tr>
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*Standardised approach to credit risk*

13. The standardised approach is similar to the current Accord in that banks are required to slot their credit exposures into supervisory categories based on observable characteristics of the exposures (e.g. whether the exposure is a corporate loan or a residential mortgage loan). The standardised approach establishes fixed risk weights corresponding to each supervisory category and makes use of external credit assessments to enhance risk sensitivity compared to the current Accord. The risk weights for sovereign, interbank, and corporate exposures are differentiated based on external credit assessments. For sovereign exposures, these credit assessments may include those developed by OECD export credit agencies, as well as those published by private rating agencies.
14. The standardised approach contains guidance for use by national supervisors in determining whether a particular source of external ratings should be eligible for banks to use. The use of external ratings for the evaluation of corporate exposures, however, is considered to be an optional element of the framework. Where no external rating is applied to an exposure, the standardised approach mandates that in most cases a risk weighting of 100% be used, implying a capital requirement of 8% as in the current Accord. In such instances, supervisors are to ensure that the capital requirement is adequate given the default experience of the exposure type in question. An important innovation of the standardised approach is the requirement that loans considered past-due be risk weighted at 150%, unless a threshold amount of specific provisions has already been set aside by the bank against that loan.

15. Another important development is the expanded range of collateral, guarantees, and credit derivatives that banks using the standardised approach may recognise. Collectively, Basel II refers to these instruments as credit risk mitigants. The standardised approach expands the range of eligible collateral beyond OECD sovereign issues to include most types of financial instruments, while setting out several approaches for assessing the degree of capital reduction based on the market risk of the collateral instrument. Similarly, the standardised approach expands the range of recognised guarantors to include all firms that meet a threshold external credit rating.

16. The standardised approach also includes a specific treatment for retail exposures. The risk weights for residential mortgage exposures are being reduced relative to the current Accord, as are those for other retail exposures, which will now receive a lower risk weight than that for unrated corporate exposures. In addition, some loans to small- and medium-sized enterprises (SMEs) may be included within the retail treatment, subject to meeting various criteria.

17. By design the standardised approach draws a number of distinctions between exposures and transactions in an effort to improve the risk sensitivity of the resulting capital ratios. The same can also be said of the IRB approaches to credit risk and those for assessing the capital requirement for operational risk where capital requirements are more closely linked to risk. In order to assist banks and national supervisors where circumstances may not warrant a broad range of options, the Committee has developed the ‘simplified standardised approach’ outlined in Annex 9 of CP3. The annex collects in one place the simplest options for calculating risk weighted assets. Banks intending to adopt the simplified standardised methods are also expected to comply with the corresponding supervisory review and market discipline requirements of the New Accord.

**Internal ratings-based (IRB) approaches**

18. One of the most innovative aspects of the New Accord is the IRB approach to credit risk, which includes two variants: a foundation version and an advanced version. The IRB approach differs substantially from the standardised approach in that banks’ internal assessments of key risk drivers serve as primary inputs to the capital calculation. Because the approach is based on banks’ internal assessments, the potential for more risk sensitive capital requirements is substantial. However, the IRB approach does not allow banks themselves to determine all of the elements needed to calculate their own capital requirements. Instead, the risk weights and thus capital charges are determined through the combination of quantitative inputs provided by banks and formulas specified by the Committee.

19. The formulas, or risk weight functions, translate a bank’s inputs into a specific capital requirement. They are based on modern risk management techniques that involve a statistical and thus quantitative assessment of risk. Ongoing dialogue with industry
participants has confirmed that use of such methods represents an important step forward for developing a meaningful assessment of risk at the largest most complex banking organisations in today’s market.

20. The IRB approaches cover a wide range of portfolios with the mechanics of the capital calculation varying somewhat across exposure types. The remainder of this section highlights the differences between the foundation and advanced IRB approaches by portfolio, where applicable.

Corporate, bank and sovereign exposures

21. The IRB calculation of risk-weighted assets for exposures to sovereigns, banks, or corporate entities uses the same basic approach. It relies on four quantitative inputs: (1) Probability of default (PD), which measures the likelihood that the borrower will default over a given time horizon; (2) Loss given default (LGD), which measures the proportion of the exposure that will be lost if a default occurs; (3) Exposure at default (EAD), which for loan commitments measures the amount of the facility that is likely to be drawn if a default occurs; and (4) Maturity (M), which measures the remaining economic maturity of the exposure.

22. Given a value for each of these four inputs, the corporate IRB risk-weight function described in CP3 produces a specific capital requirement for each exposure. In addition, for exposures to SME borrowers defined as those with annual sales of less than 50 million of Euros, banks will be permitted to make use of a firm size adjustment to the corporate IRB risk weight formula.

23. The foundation and advanced IRB approaches differ primarily in terms of the inputs that are provided by the bank based on its own estimates and those that have been specified by the supervisor. The following table summarises these differences.

<table>
<thead>
<tr>
<th>Data Input</th>
<th>Foundation IRB</th>
<th>Advanced IRB</th>
</tr>
</thead>
<tbody>
<tr>
<td>Probability of default (PD)</td>
<td>Provided by bank based on own estimates</td>
<td>Provided by bank based on own estimates</td>
</tr>
<tr>
<td>Loss given default (LGD)</td>
<td>Supervisory values set by the Committee</td>
<td>Provided by bank based on own estimates</td>
</tr>
<tr>
<td>Exposure at default (EAD)</td>
<td>Supervisory values set by the Committee</td>
<td>Provided by bank based on own estimates</td>
</tr>
<tr>
<td>Maturity (M)</td>
<td>Supervisory values set by the Committee or At national discretion, provided by bank based on own estimates (with an allowance to exclude certain exposures)</td>
<td>Provided by bank based on own estimates (with an allowance to exclude certain exposures)</td>
</tr>
</tbody>
</table>

24. The table makes clear that for corporate, sovereign, and interbank exposures, all IRB banks must provide internal estimates of PD. In addition, advanced IRB banks must provide internal estimates of LGD and EAD, while foundation IRB banks will make use of supervisory values contained in CP3 that depend on the nature of the exposure. Advanced IRB banks will generally provide their own estimates of remaining maturity for these
exposures, although there are some exceptions where supervisors can allow fixed maturity assumptions to be used instead. For foundation IRB banks, supervisors can choose on a national basis whether all such banks are to apply fixed maturity assumptions described in CP3 or to provide their own estimates of remaining maturity.

25. Another major element of the IRB framework pertains to the treatment of credit risk mitigants, namely, collateral, guarantees and credit derivatives. The IRB framework itself, particularly the LGD parameter, provides a great deal of flexibility to assess the potential value of credit risk mitigation techniques. For foundation IRB banks, therefore, the different supervisory LGD values provided in CP3 reflect the presence of different types of collateral. Advanced IRB banks have even greater flexibility to assess the value of different types of collateral. With respect to transactions involving financial collateral, the IRB approach seeks to ensure that banks are using a recognised approach to assessing the risk that such collateral could change in value, and thus a specific set of methods is provided, as in the standardised approach.

Retail exposures

26. For retail exposures, there is only a single, advanced IRB approach and no foundation IRB alternative. The key inputs to the IRB retail formulas are PD, LGD and EAD, all of which are to be provided by the bank based on its internal estimates. In contrast to the IRB approach for corporate exposures, these values would not be estimated for individual exposures, but instead for pools of similar exposures.

27. In light of the fact that retail exposures address a broad range of products with each exhibiting different historical loss experiences, the framework divides retail exposures into three primary categories: (1) exposures secured by residential mortgages, (2) qualifying revolving retail exposures (QRRE), and (3) other non-mortgage exposures also known as ‘other retail.’ Generally speaking, the QRRE category captures unsecured revolving credits that exhibit appropriate loss characteristics, which would include many credit card relationships. All other non-mortgage consumer lending including exposures to small businesses falls into the ‘other retail’ category. A separate risk-weight formula for each of the three categories is provided in CP3.

Specialised lending

28. Basel II distinguishes several sub-categories of wholesale lending from other forms of corporate lending and refers to them as specialised lending. The term specialised lending is associated with the financing of individual projects where the repayment is highly dependent on the performance of the underlying pool or collateral. For all but one of the specialised lending sub-categories, if banks can meet the minimum criteria for the estimation of the relevant data inputs, they can simply use the corporate IRB framework to calculate the risk weights for these exposures. However, in recognition that the hurdles for meeting these criteria for this set of exposures may be more difficult in practice, CP3 also includes an additional option that only requires that a bank be able to classify such exposures into five distinct quality grades. CP3 provides a specific risk weight for each of these grades.

29. For one sub-category of specialised lending, ‘high volatility commercial real estate’ (HVCRE), IRB banks that can estimate the required data inputs will use a separate risk-weight formula that is more conservative than the general corporate risk-weight formula in light of the risk characteristics of this type of lending. Banks that cannot estimate the required inputs will classify their HVCRE exposures into five grades, for which CP3 also provides specific risk weights.
Equity exposures

30. IRB banks will be required to separately treat their equity exposures. Two distinct approaches are described in CP3. One approach builds on the PD/LGD approach for corporate exposures and requires banks to provide own PD estimates for the associated equity exposures. This approach, however, mandates the use of a 90% LGD value and also imposes various other limitations, including a minimum risk weight of 100% in many circumstances. The other approach is intended to provide banks with the opportunity to model the potential decrease in the market value of their equity holdings over a quarterly holding period. A simplified version of this approach with fixed risk weights for public and private equities is also included.

Implementation of IRB

31. By relying on internally generated inputs to the Basel II risk weight functions, there is bound to be some variation in the way in which the IRB approach is carried out. To ensure significant comparability across banks, the Committee has established minimum qualifying criteria for use of the IRB approaches that cover the comprehensiveness and integrity of banks’ internal credit risk assessment capabilities. While banks using the advanced IRB approach will have greater flexibility relative to those relying on the foundation IRB approach, at the same time they must also satisfy a more stringent set of minimum standards.

32. The Committee believes that banks’ internal rating systems should accurately and consistently differentiate between different degrees of risk. The challenge is for banks to define clearly and objectively the criteria for their rating categories in order to provide meaningful assessments of both individual credit exposures and ultimately an overall risk profile. A strong control environment is another important factor for ensuring that banks’ rating systems perform as intended and the resulting ratings are accurate. An independent ratings process, internal review and transparency are control concepts addressed in the minimum IRB standards.

33. Clearly, an internal rating system is only as good as its inputs. Accordingly, banks using the IRB approach will need to be able to measure the key statistical drivers of credit risk. The minimum Basel II standards provide banks with the flexibility to rely on data derived from their own experience, or from external sources as long as the bank can demonstrate the relevance of such data to its own exposures. In practical terms, banks will be expected to have in place a process that enables them to collect, to store and to utilise loss statistics over time in a reliable manner.

Securitisation

34. Basel II provides a specific treatment for securitisation, a risk management technique that the current Accord does not fully contemplate. The Committee recognises that securitisation by its very nature relates to the transfer of ownership and/or risks associated with the credit exposures of a bank to other parties. In this respect, securitisation is important in helping to provide better risk diversification and to enhance financial stability.

35. The Committee believes that it is essential for the New Accord to include a robust treatment of securitisation. Otherwise the new framework would remain vulnerable to capital arbitrage, as some securitisations have enabled banks under the current Accord to avoid maintaining capital commensurate with the risks to which they are exposed. To address this concern, Basel II requires banks to look to the economic substance of a securitisation transaction when determining the appropriate capital requirement in both the standardised and IRB treatments.
36. As elsewhere in the standardised approach to credit risk, banks must assign supervisory risk weights to securitisation exposures based on various criteria. One noteworthy point is the difference in treatment of lower quality and unrated securitisations vis-à-vis comparable corporate exposures. In a securitisation, such positions are generally designed to absorb all losses on the underlying pool of exposures up to a certain level. Accordingly, the Committee believes this concentration of risk warrants higher capital requirements. In particular, for banks using the standardised approach, unrated securitisation positions must be deducted from capital.

37. For IRB banks that originate securitisations, a key element of the framework is the calculation of the amount of capital that the bank would have been required to hold on the underlying pool had it not securitised the exposures. This amount of capital is referred to as $K_{IRB}$. If an IRB bank retains a position in a securitisation that obligates it to absorb losses up to or less than $K_{IRB}$ before any other holders bear losses (i.e. a first loss position), then the bank must deduct this position from capital. The Committee believes that this requirement is warranted in order to provide strong incentives for originating banks to shed the risk associated with highly subordinated securitisation positions that inherently contain the greatest risks. For IRB banks that invest in highly rated securitisation exposures, a treatment based on the presence of an external rating, the granularity of the underlying pool, and the thickness of an exposure has been developed.

38. Because of their importance in ensuring the smooth functioning of commercial paper markets and their importance to corporate banking generally, the Basel II securitisation framework includes an explicit treatment of liquidity facilities provided by banks. In the IRB framework, the capital requirement for a liquidity facility is dependent upon a number of factors including the asset quality of the underlying pool and the degree to which credit enhancements are available to absorb losses prior to use of the facility. Each is a critical input to the supervisory formula designed for use by originating banks to calculate capital requirements for unrated positions, such as liquidity facilities. A treatment of liquidity facilities in the standardised approach is also provided which sets out various criteria for ensuring that more preferential treatment is only provided to those liquidity facilities where the risks are lower.

39. Many securitisations of revolving retail exposures contain provisions that call for the securitisation to be wound down if the quality of securitised assets begins to deteriorate. The Basel II proposals include a specific treatment of securitisations with these ‘early amortisation’ features, given that such mechanisms can in effect partly shield investors from fully sharing in the losses of the underlying accounts. The Committee’s approach is based on a measure of the quality of the underlying assets in the pool. When this is high, the approach implies a zero capital requirement associated with the securitised exposures. As the quality deteriorates, however, the bank must increasingly hold capital as if future draws on existing credit card lines would remain on its balance sheet.

**Operational risk**

40. The Committee believes that operational risk is an important risk facing banks and that banks need to hold capital to protect against losses from it. Within the Basel II framework, operational risk is defined as the risk of losses resulting from inadequate or failed internal processes, people and systems, or external events. This is another area where the Committee has developed a new regulatory capital approach. As with credit risk, the Committee builds on banks’ rapidly developing internal assessment techniques and seeks to provide incentives for banks to improve upon those techniques, and more broadly, their management of operational risk over time. This is particularly true of the Advanced Measurement Approaches (AMA) to operational risk described below.
41. Approaches to operational risk are continuing to evolve rapidly, but are not likely in the near term to attain the precision with which market and credit risk can be quantified. This situation has posed obvious challenges to the incorporation of a measure of operational risk within pillar one of the New Accord. Nevertheless, the Committee believes that such inclusion is essential to ensure that there are strong incentives for banks to continue to develop approaches to operational risk measurement and to ensure that banks are holding sufficient capital buffers for this risk. It is clear that a failure to establish a minimum capital requirement for operational risk within the New Accord would reduce these incentives and result in a reduction of industry resources devoted to operational risk.

42. The Committee is prepared to provide banks with an unprecedented amount of flexibility to develop an approach to calculate operational risk capital that they believe is consistent with their mix of activities and underlying risks. In the AMA, banks may use their own method for assessing their exposure to operational risk, so long as it is sufficiently comprehensive and systematic. The extent of detailed standards and criteria for use of the AMA are limited in order to accommodate the rapid evolution in operational risk management practices that the Committee expects to see over the coming years.

43. The Committee intends to review progress in regard to operational risk approaches on an ongoing basis. It has been strongly encouraged by the advances made at those banks that have been developing operational risk frameworks consistent with the spirit of the AMA. Management at these banking organisations has concluded that it is possible to develop a flexible and comprehensive approach to operational risk measurement within their firms.

44. Internationally active banks and banks with significant operational risk exposure (for example, specialised processing banks) are expected to adopt over time the more risk sensitive AMA. Basel II contains two simpler approaches to operational risk: the basic indicator and the standardised approach, which are targeted to banks with less significant operational risk exposures. In general terms, the basic indicator and standardised approaches require banks to hold capital for operational risk equal to a fixed percentage of a specified risk measure.

45. In the basic indicator approach, the measure is a bank’s average annual gross income over the previous three years. This average, multiplied by a factor of 0.15 set by the Committee, produces the capital requirement. As a point of entry for the capital calculation, there are no specific criteria for use of the basic indicator approach. Nevertheless banks using this approach are encouraged to comply with the Committee’s guidance on sound practices for the management and supervision of operational risk, which was released in February 2003.

46. In the standardised approach, gross income again serves as a proxy for the scale of a bank’s business operations and thus the likely scale of the related operational risk exposure for a given business line. However, rather than calculate capital at the firm level as under the basic indicator approach, banks must calculate a capital requirement for each business line. This is determined by multiplying gross income by specific supervisory factors determined by the Committee. The total operational risk capital requirement for a banking organisation is the summation of the regulatory capital requirements across all of its business lines. As a condition for use of the standardised approach, it is important for banks to have adequate operational risk systems that comply with the minimum criteria outlined in CP3.

47. Banks using the basic indicator or standardised approaches to operational risk are not permitted to recognise the risk mitigating impact of insurance. As discussed in Part II of this overview paper, banks using the AMA are permitted to do so subject to certain conditions.
Pillar 2: Supervisory review & Pillar 3: Market discipline

Supervisory review

48. The second pillar of the New Accord is based on a series of guiding principles, all of which point to the need for banks to assess their capital adequacy positions relative to their overall risks, and for supervisors to review and take appropriate actions in response to those assessments. These elements are increasingly seen as necessary for effective management of banking organisations and for effective banking supervision, respectively.

49. Feedback received from the industry and the Committee’s own work has emphasised the importance of the supervisory review process. Judgements of risk and capital adequacy must be based on more than an assessment of whether a bank complies with minimum capital requirements. The inclusion of a supervisory review element in the New Accord, therefore, provides benefits through its emphasis on the need for strong risk assessment capabilities by banks and supervisors alike. Further, it is inevitable that a capital adequacy framework, even the more forward looking New Accord, will lag to some extent behind the changing risk profiles of complex banking organisations, particularly as they take advantage of newly available business opportunities. Accordingly, this heightens the importance of, and attention supervisors must pay to pillar two.

50. The Committee has been working to update the pillar two guidance as it finalises other aspects of the new capital adequacy framework. One update is in relation to stress testing. The Committee believes it is important for banks adopting the IRB approach to credit risk to hold adequate capital to protect against adverse or uncertain economic conditions. Such banks will be required to perform a meaningfully conservative stress test of their own design with the aim of estimating the extent to which their IRB capital requirements could increase during a stress scenario. Banks and supervisors are to use the results of such tests as a means of ensuring that banks hold a sufficient capital buffer. To the extent there is a capital shortfall, supervisors may, for example, require a bank to reduce its risks so that existing capital resources are available to cover its minimum capital requirements plus the results of a recalculated stress test.

51. Other refinements focus on banks’ review of concentration risks, and on the treatment of residual risks that arise from the use of collateral, guarantees and credit derivatives. Further to the pillar one treatment of securitisation, a supervisory review component has been developed, which is intended to provide banks with some insight into supervisory expectations for specific securitisation exposures. Some of the concepts addressed include significant risk transfer and considerations related to the use of call provisions and early amortisation features. Further, possible supervisory responses are outlined to address instances when it is determined that a bank has provided implicit (non-contractual) support to a securitisation structure.

Market discipline

52. The purpose of pillar three is to complement the minimum capital requirements of pillar one and the supervisory review process addressed in pillar two. The Committee has sought to encourage market discipline by developing a set of disclosure requirements that allow market participants to assess key information about a bank’s risk profile and level of capitalisation. The Committee believes that public disclosure is particularly important with respect to the New Accord where reliance on internal methodologies will provide banks with greater discretion in determining their capital needs. By bringing greater market discipline to bear through enhanced disclosures, pillar three of the new capital framework can produce significant benefits in helping banks and supervisors to manage risk and improve stability.
53. Over the past year, the Committee has engaged various market participants and supervisors in a dialogue regarding the extent and type of bank disclosures that would be most useful. The aim has been to avoid potentially flooding the market with information that would be hard to interpret or to use in understanding a bank’s actual risk profile. After taking a hard look at the disclosures proposed in its second consultative package on the New Accord, the Committee has since scaled back considerably the requirements, particularly those relating to the IRB approaches and securitisation.

54. The Committee is aware that supervisors may have different legal avenues available in having banks satisfy the disclosure requirements. The various means may include public disclosures deemed necessary on safety and supervision grounds or information that must be disclosed in regulatory reports. The Committee recognises that the means by which banks will be expected to share information publicly will depend on the legal authority of supervisors.

55. Another important consideration has been the need for the Basel II disclosure framework to align with national accounting standards. Considerable efforts have been made to ensure that the disclosure requirements of the New Accord focus on bank capital adequacy and do not conflict with broader accounting disclosure standards with which banks must comply. This has been accomplished through a strong and co-operative dialogue with accounting authorities. Going forward, the Committee will look to strengthen these relationships given that the continuing work of accounting authorities may have implications for the disclosures required in the New Accord. With respect to potential future modifications to the capital framework itself, the Committee intends to also consider the impact of such changes on the amount of information a bank should be required to disclose.

Implementation of the New Accord

Transition to the New Accord

56. The Committee believes the proposals contained in CP3 are suitable for a wide range of banks in different countries. Within the G10, Committee members have agreed to a common implementation date for the New Accord of year-end 2006. In these countries, the implementation of the new Accord is intended to encompass internationally active banks, and other significant banks as national supervisors deem appropriate. In a number of G10 countries, the Basel II framework will be applied to the entire banking system. National supervisors in the G10 will ensure that banks not implementing Basel II will be subject to prudent capital adequacy regulation.

57. While the New Accord has been designed to provide options for banks and banking systems worldwide, the Committee acknowledges that outside the G10 moving to the new framework in full in the near future may not be the first priority for all supervisors in terms of what they need to do to strengthen their supervision. Where this is the case, each national supervisor should consider carefully the benefits of the new framework in the context of its domestic banking system when developing a timetable and approach to implementation.

58. Given resource constraints and other priorities, it should be neither surprising nor inappropriate for these timetables, particularly in non-G10 countries, to extend beyond 2006. That said, supervisors should consider implementing key elements of the supervisory review and market discipline components of the New Accord even if the Basel II minimum capital requirements will be implemented after year-end 2006.

59. Many national supervisors have already begun to plan for the transition to Basel II. To assist in this process, the Committee has asked a group of supervisors from around the world, with IMF and World Bank participation, to develop a framework for assisting non-G10
supervisors and banks in the transition to both the standardised and foundation IRB approaches of the New Accord. The Committee believes that continued co-operation along these lines is essential to ensuring a successful transition to the New Accord.

**Forward looking aspects**

60. The Committee sees frequent exchanges of information between banks and supervisors and between supervisors in different jurisdictions as critical for the successful implementation of Basel II. To promote consistency in the implementation of the New Accord across jurisdictions, the Committee established the Accord Implementation Group (AIG) for national supervisors to exchange information on the practical implementation challenges of Basel II and on the strategies they are using to address these issues. The AIG also will work closely with the Committee’s Capital Task Force (CTF), the body responsible for considering substantive modifications to and interpretations of the New Accord.

61. The Committee believes that the Accord will continue to evolve following the implementation of Basel II. This evolution is necessary to ensure that the framework keeps pace with emerging market developments and advances in risk management practices. Nonetheless, it is not the intent of the Committee for the New Accord to be a moving target prior to implementation. Priorities in the period prior to end-2006 will include reconciling any major, unintended inconsistencies in the treatment of similar exposures across the approaches for determining capital for a given risk. Additionally, the Committee will seek to close any loopholes and unintended effects of the new framework.

62. The Committee recognises that the need for such actions may only come to light after banks have begun to rely on the Basel II requirements. Those banks adopting the more advanced approaches to risk assessment (the IRB approach for credit risk and the AMA for operational risk) will be required to run them in parallel with the existing Accord for one year prior to the implementation of Basel II. The Committee believes that this parallel calculation 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.

63. The CTF will take responsibility for considering new banking products and implications of advances in risk management processes on the new framework beyond year-end 2006. The Committee is aware that industry practices change over time with some areas evolving more rapidly than others do. In particular, the IRB approaches and the AMA are meant to reflect sound industry practice. Other areas of the new framework, for example, the capital treatment of securitisation should be flexible enough to adapt to new developments when necessary. The Committee also intends to consider issues, such as a revised treatment of potential exposures associated with OTC derivatives, that it was unable to include in Basel II.

64. The Committee has benefited greatly from its ongoing and extensive dialogue with industry participants. As a means of continuing this productive interaction, it will look for enhanced opportunities for the industry to assist in the development of proposals for aligning regulatory capital requirements with sound industry practice. Future exchanges of views between banks and supervisors on developments in risk management will help the Committee to make decisions that will keep the new framework relevant for years to come.

**Cross-border implementation**

65. Effective supervision of large banking organisations necessarily entails a closer more co-operative partnership between industry participants and supervisors. Under the New Accord, cross-border issues are likely to receive even greater attention than they do today.
The Committee believes existing cross-border responsibilities of supervisors, as set out in the Basel Concordat and Minimum Standards documents will continue to apply as the New Accord is being implemented. Nevertheless, the New Accord will require enhanced cooperation between supervisors on a practical basis, especially for the cross-border supervision of complex international banking groups. In particular, the Committee believes that, wherever possible, supervisors should avoid performing redundant and uncoordinated approval and validation work in order to reduce the implementation burden for banks, and to conserve supervisory resources. Consequently, in implementing the New Accord, the Committee believes that supervisors should communicate as clearly as possible to affected banking groups about the respective roles of home- and host-country supervisors so that practical arrangements are understood.

66. Cross-border implementation of the New Accord will not change the legal responsibilities of supervisors for the regulation of their domestic banking organisations and the arrangements of consolidated supervision. This said, the Committee recognises that home country supervisors may not have the ability alone to gather the information necessary for effective implementation of the revised Accord. Consequently, the AIG is developing a set of principles to facilitate closer practical co-operation and information exchange among supervisors.

67. The Committee broadly supports the principle of “mutual recognition” for internationally active banks as a key basis for international supervisory co-operation. This principle implies the need for recognising common capital adequacy approaches when considering the branching of internationally-active banks into host jurisdictions, as well as the desirability of minimising differences in the national capital adequacy regulations between home and host jurisdictions so that subsidiary banks are not subjected to excessive burden.

Next steps

68. The Committee is issuing the current package of proposals for a three-month comment period. Comments on CP3 should be submitted by 31 July 2003 to relevant national supervisory authorities and central banks and may also be sent to the Basel Committee on Banking Supervision at the Bank for International Settlements, CH-4002 Basel, Switzerland. Comments also are invited by e-mail: [BCBS.Capital@bis.org](mailto:BCBS.Capital@bis.org) or by fax: 41 61 280 9100, and should be directed to the attention of the Basel Committee Secretariat.

69. The Committee intends to publish on its website comments received during the consultation period. Those that are clearly marked as confidential will not be published. Based on the responses received, the Committee will consider the need for further modifications to its proposals. It anticipates that this process will again provide valuable input and will contribute to an improved Accord that enhances the stability of the international banking system. The Committee aims to finalise the Basel II framework in the fourth quarter 2003, so that member countries will be able to implement it on the envisioned timetable.

Part II: Modifications Relative to the QIS 3 Technical Guidance

Introduction

70. Since release of the QIS 3 Technical Guidance, the Committee has spent considerable time refining its proposals for the New Accord. Each round of industry consultation has led to modifications aimed at enhancing the risk sensitivity of the new
framework and at producing capital requirements that are broadly consistent with the 
Committee’s stated objectives. The changes reflected in CP3 also are provided in this spirit.

71. Throughout its process to revise the current Accord, the Committee has taken 
various steps to communicate decisions reached. For example, modifications made to the 
proposals described in the Committee’s second consultative package on the New Accord 
were discussed in a 10 July 2002 press release. Additionally, a significant portion of the 
overview paper to the QIS 3 Technical Guidance focused on the rationale for those changes. 
Accordingly, the overview paper now only addresses changes to the pillar one (minimum 
capital requirement) proposals made relative to those provided in the QIS 3 Technical 
Guidance of October 2002. It is meant to enable readers that have been following the 
Basel II developments to hone in on the substance of the most recent modifications.

Recognition of provisions

72. In the IRB framework, banks are permitted to recognise provisions in offsetting the 
expected loss (EL) of risk weighted assets. For most exposures, the EL portion of risk-
weighted assets is defined as 12.5 times PD times LGD times EAD. The Committee has 
further assessed the treatment of general provisions outlined in the QIS 3 Technical 
Guidance. It is now proposing to adjust the criteria for recognising provisions in excess of the 
amount that may be included in Tier 2 capital. Provisions in excess of this cap can continue 
to be used as a one-for-one offset to IRB capital requirements, but only to the extent that the 
expected loss portion of the IRB capital requirement also exceeds the maximum amount of 
provisions eligible for inclusion in Tier 2.

73. The Committee recognises that there are different perspectives on the interaction 
between general provisions and expected losses, in particular, those general provisions 
currently included in Tier 2 capital. An alternative treatment of such provisions, however, 
would impact a bank’s Tier 1 and Total Capital ratios differently. In practical terms, this 
impact would be indistinguishable from a redefinition of the elements of regulatory capital. 
This is a step the Committee had decided not to take as part of the Basel II revision process. 
The Committee remains of the view that any modifications to the definition of capital should 
only be considered as part of a comprehensive review of all aspects of that definition.

74. The Committee has also amended the treatment of past due loans under the 
standardised approach to allow for some recognition of provisions. The risk weights for past 
due loans (net of specific provisions and any eligible collateral or guarantees) differ 
depending on the size of the specific provision relative to the outstanding amount of the loan. 
For example, a risk weight of 100% applies when specific provisions are not less than 20% of 
the outstanding amount of the loan. Without any level of specific provision, past due loans 
are risk weighted at 150%. In addition, where a past due loan is fully secured by those forms 
of collateral not otherwise recognised in the standardised approach, a 100% risk weight may 
be applied to the loan when provisions reach 15% of the outstanding amount of the loan.

See paragraphs 342 to 348, and paragraphs 48 to 51, respectively.

Qualifying revolving retail exposures

75. The slope of the risk weight curve for qualifying revolving retail exposures (QRRE) 
has been modified in light of the impact study results. The maximum correlation has been 
adjusted to 0.11 from the 0.15 value stated in the QIS3 Technical Guidance. Further, the 
function now effectively allows for 75% of expected losses to be covered by future margin 
income.
76. The Committee recognises that particularly lower capital requirements for QRRE may provide an incentive for banks to change how they lend to consumers. In particular, this treatment may induce banks to structure retail lending in the form of revolving exposures, such as credit cards, rather than make unsecured personal term loans.

77. The third quantitative impact study did not ask banks to anticipate the potential impact of issuing credit cards in lieu of unsecured personal loans. Such shifts in retail lending could therefore reduce capital requirements to below the level the Committee judged to be acceptable in its consideration of its results of the QIS 3 exercise. The impact of such changes will be considered by the Committee as part of its continuous review of Basel II and of its review of the transitional floor on the overall level of capital.

78. More generally, the member countries of the Committee intend to monitor carefully the way in which banks classify lending facilities and will seek to ensure consistent implementation through the examination process or other means. In particular, they will seek to ensure that banks do not reclassify lending facilities in a way designed solely to minimise capital requirements.

See paragraphs 202 to 203 and paragraphs 299 to 300.

Residential mortgages

79. The Committee is also proposing as a transitional measure a minimum LGD value of 10% for retail exposures secured by residential property. Owing to the potential for very long-run cycles in house prices that short term data may not adequately capture, during the three year transition period following implementation of the IRB approaches, LGDs for retail exposures secured by residential properties cannot be set below 10% for any sub-segment of the exposure. The Committee intends to revisit the need for this floor as the transition period progresses.

80. The Committee has also taken steps to better align the amount of capital required for residential mortgages under the standardised and IRB approaches. Lending that is fully secured by mortgages on residential property that is or will be occupied by the borrower, or that is rented, will now receive a 35% risk weight in the standardised approach.

See paragraphs 235 and 45, respectively.

Specialised lending

81. The IRB framework identifies specialised lending (SL) as a subsector of a bank’s corporate portfolio. SL generally refers to the financing of individual projects where the repayment is highly dependent on the performance of the underlying pool or collateral. Within SL, CP3 outlines a separate treatment of commercial real estate that exhibits higher loss rate volatility compared to other forms of SL. Financing of this type is referred to as high volatility commercial real estate (HVCRE).

82. As outlined in the QIS 3 Technical Guidance, banks that do not meet the requirements for the estimation of PD under the corporate IRB approach are required to map their internal rating grades for SL into five supervisory categories, each of which is associated with a specific risk weight. The supervisory risk weights for HVCRE are higher than those applied to other SL exposures given the greater risk potential. Slotting criteria are provided to assist banks in the mapping process.
83. At national discretion, CP3 also allows banks using the supervisory categories to assign preferential risk weights to exposures identified as ‘strong’ and ‘good.’ Conditions for doing so include that the SL exposure has a remaining maturity of less than 2.5 years or the supervisor has determined that the bank’s underwriting and other risk characteristics are substantially stronger than specified in the slotting criteria for the relevant supervisory risk category.

See paragraphs 244 to 246 and paragraphs 249 to 251.

**High volatility commercial real estate**

84. As mentioned, the treatment described above also applies to HVCRE. CP3 goes a step farther by also introducing foundation and advanced IRB approaches to be available at national discretion. Their introduction is intended to achieve greater risk sensitivity in this area. The foundation and advanced IRB approaches to HVCRE are similar in all respects to the general IRB approaches for corporate exposures with the exception of a separate risk weight function. Banks that do not meet the requirements for estimation of LGD and EAD for HVCRE exposures must use the supervisory parameters for corporate exposures.

See paragraphs 252 and 253.

**Credit derivatives**

85. The Committee has decided to make a significant change to the credit risk mitigation framework after extensive and fruitful consultation with the industry. Going forward, banks will be permitted to recognise for capital purposes credit derivatives that do not reference restructuring as long as they have complete control over the decision of whether or not there will be a restructuring of the underlying obligation. During the CP3 consultative period, the Committee also intends to explore alternative regulatory capital treatments for credit derivatives that do not include restructuring as a credit event triggering payout.

See paragraph 162(a).

**Securitisation**

86. Following release of its second working paper on securitisation in October 2002, the Committee has engaged the industry in extensive dialogue particularly with respect to the IRB treatment of securitisations. During this consultation, banks have expressed support for the technical underpinnings of the supervisory formula (SF). However, they questioned the supervisory overrides pertaining to highly subordinated positions and those of the highest seniority and, by extension, of the highest credit quality. By way of background, the SF was primarily designed for originating banks to determine the capital requirements on certain unrated securitisation exposures. Other banks may also use the SF provided they have detailed information about the underlying pool of exposures, and supervisory approval to use it, because it relies on the IRB capital charge as a primary input.

87. In CP3, the Committee reaffirms the need for banks to deduct from capital positions that are highly subordinated. Originating banks must deduct all positions that fall below the $K_{IRB}$ threshold. Similarly, banks that invest in securitisations established by third-party organisations must deduct those that are unrated or of low credit quality. The Committee views this requirement as necessary in order to create strong incentives for banks not to retain or to assume the risk associated with these positions that inherently contain the greatest risk. With respect to the most senior position in a securitisation, the credit risk
models underlying the SF suggest a capital requirement of zero. The Committee believes that all securitisation positions expose banks to some degree of credit risk and, therefore, continues to keep in place the floor capital requirement of 56 basis points when the SF is used. In general, the Committee has simplified application of the SF in response to industry consultation.

88. Changes have been made to the securitisation framework concerning the treatment of liquidity facilities. Criteria for recognising eligible liquidity facilities have been amended. A further change to the capital treatment has been introduced for IRB banks. Such bank providers of liquidity facilities are required to calculate $K_{IRB}$ for exposures in the underlying pool on an ongoing basis. Otherwise, the exposure in question must be deducted. The method for calculating the $K_{IRB}$ depends on the underlying exposure type. For example, banks must calculate the IRB capital for each individual corporate exposure making up a pool (known as a ‘bottom-up’ approach). In comparison, the capital charge can be calculated at the level of a pool as a whole (known as the ‘top-down’ approach) if it comprises retail exposures or eligible purchased corporate receivables.

89. Industry representatives have welcomed the possibility of using the ‘top-down’ approach for determining capital requirements through use of the SF for liquidity facilities. However, they had concerns with its narrow application since it only applied to unsecured receivables with a remaining maturity of one year or less. Otherwise the receivables had to be secured. In recognition that securitisations typically involve longer dated unsecured receivables, the one-year requirement has been relaxed on an exceptional basis. Banks may use the ‘top-down’ approach for calculating the IRB capital requirement when supervisors have determined, among other factors, that use of the ‘bottom up’ approach for liquidity facilities would be unduly burdensome. The one-year requirement remains in place when the ‘top-down’ approach is applied outside the securitisation framework.

90. When it is not practical for a bank to use either the ‘bottom-up’ or ‘top-down’ approach for calculating $K_{IRB}$, it may, on an exceptional basis and subject to supervisory consent, be allowed temporarily to use a method similar to that outlined for standardised banks when determining the capital requirement for eligible liquidity facilities.

See paragraphs 574 and 603.

Operational risk

91. To facilitate the adoption by large internationally active banks and banks with significant operational risk exposures of the more risk-sensitive AMA, the Committee is prepared to allow for its partial adoption. As proposed in CP3, banks may use either the basic indicator approach or the standardised approach to operational risk for some parts of its operations and an AMA for others provided that all material risks are captured within the banking organisation on a global, consolidated basis. A bank will not, however, be permitted to revert to the simpler approaches once it has been approved to use one of the more advanced operational risk approaches unless advised to do so by its supervisor.

92. Another change to the AMA allows banks using this approach to recognise insurance as an operational risk mitigant when calculating regulatory capital. Subject to the minimum criteria outlined in CP3, a bank may recognise insurance in an amount not to exceed 20% of its total operational risk capital requirement.

93. The results of the Committee’s third quantitative impact study showed that for G10 banks, the simpler approaches (basic indicator and standardised) to operational risk resulted in capital charges broadly in line with the target of 12% of current minimum regulatory capital.
However, there was significant variability in the results across banks located in different countries. Further analysis suggests that the variability stems from the link between gross income and credit risk via the level of margin banks receive on loans. For some banks, a gross income based charge would double count the credit risk capital requirement.

94. To avoid this situation, at national discretion, supervisors may permit their banks to use an alternative standardised approach to the extent supervisors are satisfied that it provides an improved basis by, for example, avoiding double counting of risks. The alternative introduces a volume-based factor (loans and other banking book assets rather than gross income) for retail banking and commercial banking under the assumption that the factors for other business activities would remain unchanged. Further, as an alternative to splitting gross income among the remaining six business lines (those other than retail banking and commercial banking), banks may apply a more conservative beta factor of 18% to the corresponding aggregate amount of gross income to obtain a more conservative capital requirement.

See paragraphs 610, 611, 637 and footnote 91.