Basel Committee on Banking Supervision
BANK FOR INTERNATIONAL SETTLEMENTS

Core principles for effective banking supervision

October 2003

Next steps in the New Basel Capital Accord

The Committee is pleased to have received over 200 comments on its Third Consultative Paper ("CP3"), which can be found on the website of the Bank for International Settlements. The responses indicate that there is continued broad support for the structure of the New Accord and agreement on the need to adopt a more risk-sensitive capital framework.

All members of the Committee agreed on the importance of finalising the New Accord expeditiously and in a manner that is technically and prudentially sound. Such an Accord should offer considerable benefits over the existing system. Moreover, it is important in the near term to provide banks with as much certainty as possible while they plan and prepare for the adoption of the new rules. Committee members committed to work promptly to resolve the outstanding issues by no later than mid-year 2004.

The Committee also acknowledges the importance of national rule-making processes underway in several jurisdictions and that it will need to consider the outcome of these national processes within this timeframe.

The Committee welcomes the efforts of banks in preparing for implementation and encourages them to continue. The ongoing further discussions by the Committee as outlined in this press release are not expected to alter the need for banks to continue improving databases and risk management systems in preparation for the New Accord.

Areas of focus

The principal areas in which the Committee has identified opportunities to improve the framework include the following:

- changing the overall treatment of expected versus unexpected credit losses;
- simplifying the treatment of asset securitisation, including eliminating the "Supervisory Formula" and replacing it by a less complex approach;
- revisiting the treatment of credit card commitments and related issues; and
- revisiting the treatment of certain credit risk mitigation techniques.

The Committee and its working groups have developed a plan for concluding these issues.

Treatment of expected and unexpected losses

With respect to the internal ratings-based ("IRB") treatment of credit losses, the existing proposals called for banks to hold enough capital to absorb expected and unexpected credit losses with a particular treatment for provisions. Committee members recognise that this approach represented a practical compromise to address differences in national accounting practices and supervisory authority regarding provisioning. However, in the light of the public comments received on CP3 and subsequent research undertaken by its working groups, the Committee decided to revisit the issue and to adopt an approach based on unexpected losses.

The broad direction of the approach that the Committee has directed its working groups to develop further is described in the attachment to this press release. The Committee invites interested parties to comment on this proposal by year-end 2003. Although the Committee does not believe that this proposal would change substantially the mechanics of the New Accord, from a conceptual point of view, the Committee considers it sufficiently important to merit additional public consideration.

At this time, the Committee does not foresee the need for changes to the standardised approach.

At the Committee's January 2004 meeting, it will evaluate the outcome of the consultation on the expected/unexpected loss issue, assess further related work on the calibration of the IRB approach, and review the progress made in resolving the other technical issues mentioned above. It will also assess related work on the calibration of the IRB approach in light of the Committee's objectives on overall capital. At that time, the Committee will provide a further update on the status of its discussions.

Calibration of the New Accord

The Committee also discussed the importance of ensuring that the calibration of the New Accord achieves the Committee's objectives. Accordingly, the Committee agreed that prior to implementation, a further review of the calibration of the New Accord will be conducted on the basis of additional information, for example, further impact assessments that are planned in some jurisdictions and the monitoring of banks' parallel calculations. If necessary, the Committee will propose additional adjustments to the calibration of the New Accord based on this review. These adjustments are not expected to alter the fundamental structure of the New Accord.

Implementation efforts

The Committee notes that it has intensified its efforts to facilitate implementation of the New Accord. In August 2003, the Committee published a set of principles for the cross-border application of the New Accord to promote closer practical co-operation and information exchange among supervisors. The Accord Implementation Group ("AIG"), which was established to promote consistency through the exchange of information between supervisors on approaches to implementation, is accelerating its work. The AIG's work also includes home-host implementation issues associated with the advanced approaches to operational risk.

Appointment of a new Secretary General

Upon the completion of Madame Danièle Nouy's term as Secretary General of the Basel Committee, the Committee has named Mr Ryozo Himino of the Japanese Financial Services Agency as the new Secretary General. He will assume his new duties on 1 November 2003. The Secretariat is hosted by the Bank for International Settlements in Basel, Switzerland, and provides technical and administrative support to the Committee and its working groups.

At their meeting in Madrid, Committee members expressed their great appreciation for Madame Nouy's service to the Committee, which spans seven years, and her stewardship of the negotiation process for the New Accord as Secretary General.

Attachment

Proposed Treatment of Expected and Unexpected Losses

On the basis of its public consultation process, the Basel Committee is convinced that a major improvement in the New Accord is possible in relation to the treatment of expected losses. This note summarises the conclusions that the Committee has reached in this regard. In light of the value that the Committee places on transparency and public consultation, as well as important implications of these decisions, the Committee is requesting public comment on this proposed modification to its framework by 31 December 2003.

The internal ratings-based ("IRB") approach produces a statistical measurement of both the unexpected losses and the expected losses that banks face in relation to their credit risk exposures. The Third Consultative Paper's ("CP3") framework incorporated both expected and unexpected loss components into the IRB capital requirement.

The Committee now believes that a separation of the treatment of unexpected and expected losses within the IRB approach would lead to a superior and more consistent framework. Under this modified approach, the measurement of risk-weighted assets (that is, the IRB capital requirement) would be based solely on the unexpected loss portion of the IRB calculations. Accordingly, certain offsets within the IRB framework, in particular future margin income, would no longer be necessary.

Importantly, however, the Committee believes that it is critical to put into place a separate treatment of expected losses with the objective of ensuring strong incentives for banks to provision properly against expected losses. Under this separate treatment, banks will compare the IRB measurement of expected losses with the total amount of provisions that they have made, including both general and specific provisions. For any individual bank, this comparison will produce a "shortfall" if the expected loss amount exceeds the total provision amount, or an "excess" if the total provision amount exceeds the expected loss amount.

The Committee is proposing that shortfall amounts, if any, be deducted from capital. This deduction would be taken 50% from Tier One capital and 50% from Tier Two capital, in line with other deductions from capital included in the New Accord.

Excess provision amounts, if any, are proposed to be eligible as an element of Tier Two capital, similar to the current treatment of general provisions. The Tier Two eligibility of such excess amounts is further proposed to be subject to limitation at supervisory discretion, but in no case would be allowed to exceed 20% of Tier Two capital of a bank. In proposing this treatment, the Committee recognises that banks may have valid reasons for setting provisions in excess of the expected loss amount calculated by the IRB approach and wishes to avoid discouraging banks from doing so where appropriate.

This treatment of shortfall and excess amounts would be in lieu of the current inclusion of general provisions in Tier Two capital.

It is important to note that the incorporation of this new approach into the IRB framework may require some re-calibration of that framework to ensure that the overall impact of its proposals is consistent with the Committee's objectives. The Committee is undertaking further efforts to identify where such adjustments may be needed.

Although the Committee does not believe that adjustments to the standardised approach to credit risk are necessary in conjunction with this proposal, the Committee welcomes comments on this issue.

The Committee invites interested parties to provide comment on all aspects of this specific proposal by 31 December 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 are also invited by e-mail: BCBS.Capital@bis.org or by fax: +41 61 280 9100, and should be directed to the attention of the Basel Committee Secretariat.