BASEL COMMITTEE ON BANKING SUPERVISION

BANK FOR INTERNATIONAL SETTLEMENTS

Update on work on the New Basel Capital Accord

Issue 2 21 September 2001

The purpose of this update is to inform the banking industry, the supervisory community and other interested parties about the work under way on the New Basel Capital Accord by the Basel Committee on Banking Supervision's Capital Group. The Capital Group is responsible for work on various components of the New Basel Capital Accord, including the development of the standardised approach and the treatment of credit risk mitigation (CRM) techniques. It has also been evaluating the large amount of constructive and helpful comments received on the second Consultative Package released in January 2001.

As part of its continuing dialogue with the banking industry and other relevant parties, the Capital Group believes it would be beneficial at this stage to provide information on the direction of its work on the treatment of CRM techniques such as collateral, guarantees and credit derivatives. This newsletter also provides information on a slight change to the current Accord as it pertains to the treatment of non-domestic OECD public sector entities in certain circumstances.

There are several other streams of work on the New Basel Accord that are being conducted by other Working Groups and Task Forces of the Basel Committee. The Basel Committee is planning to release working papers on a variety of topics, including operational risk, disclosure, asset securitisation and specialised lending (e.g. project finance) in the coming weeks.

Focus: credit risk mitigation (CRM) techniques

In designing the new CRM framework, the Basel Committee is pursuing three objectives:

- improving the incentives for banks to manage credit risk in a prudent and effective manner;
- continuing to offer a prudent and simple approach for recognising CRM that may be adopted by a wide range of banks; and
- relating capital treatments to the economic effects of different CRM techniques, and at the same time delivering greater consistency and flexibility in the treatment of different forms of CRM techniques.

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Residual risks in credit risk mitigation techniques

In the January 2001 Consultative Package, the Basel Committee emphasised the importance of residual risks arising from the possibility that the process by which credit protection is realised may not function as the protection buyer expects. These risks are present in both collateralised transactions and guarantees/credit derivatives and raise serious concerns about whether credit risk has truly been reduced through collateral or effectively transferred to third-parties through guarantees and credit derivatives. The near-collapse of LTCM in 1998 demonstrated the risks that can be involved.[1]

In order to treat such risks, the Committee proposed in January the application in certain cases of a so-called w-factor for both collateral and guarantees/credit derivatives. The Committee has received extensive comments on how such risks could be treated within a capital adequacy framework and the Capital Group has been continuing its work on this issue. After further consideration, the Capital Group believes the most effective way forward would be to treat this residual risk under the proposed framework's second pillar, i.e. the supervisory review process, rather than using the w-factor under the first pillar, i.e. minimum capital requirements. The Capital Group believes that this approach will allow for a fairly simple, practical and risk sensitive framework for treating CRM techniques. This view mirrors that adopted earlier by the Committee in respect of interest rate risk in the banking book and would similarly involve the development of additional detailed guidance. The Capital Group will be working in the coming months to provide an overall framework which ensures effective risk management of CRM techniques and provides sufficient capital to cover the risks involved.

Treatment of credit risk mitigation techniques in the trading book

One area in particular where the Committee has received a lot of questions in the consultation process is the treatment of CRM techniques in the trading book, in particular, collateralised transactions such as repos, and credit derivatives.

The January proposals provided two options for the treatment of collateral in the banking book - a comprehensive approach and a simple, albeit slightly more conservative, approach. The January 2001 consultative paper did not include proposals for the treatment of collateral in the trading book. The Basel Committee seeks to provide equivalent treatment for equivalent types of risks. Currently repo-style transactions (i.e. repos, reverse repos, securities lending and securities borrowing) may be booked in the banking book or the trading book depending accounting rules within individual jurisdictions. Therefore, the Capital Group is proposing to apply the comprehensive approach to calculate the counterparty credit risk charge for repo-style and collateralised OTC derivative transactions in the trading book. This framework will provide consistent treatment across the two

[1] See *Sound Practices for Banks' Interactions with Highly Leveraged Institutions* and *Banks' Interactions with Highly Leveraged Institutions*, Basel Committee on Banking Supervision, January 1999.

books. Naturally, for positions in the trading book, the general market risk and specific risk charge based on the Market Risk Amendment[2] will continue to apply.

With regard to credit derivatives in the trading book which are taken on simply for trading purposes, the current rules under the Market Risk Amendment will remain largely unchanged (along the lines of the proposals in paragraphs 583 to 585 of the January document).

One of the Basel Committee’s objectives in considering the treatment of credit derivatives in the trading book is to minimise the possibility of regulatory arbitrage. Specifically, the concern relates to the situation where a bank might use a credit derivative in its trading book to hedge an exposure in the banking book in order to reduce capital requirements by comparison to that arising from banking book treatment. The bank’s actual risk profile would be the same regardless of where the credit derivative is booked.

The Capital Group is planning to specify a rule that is already implemented by many supervisors. This rule provides that when a bank conducts an internal hedge of a banking book exposure using a credit derivative in its own trading book, in order to receive any regulatory capital benefit it must transfer the credit risk to an outside third party (i.e. an eligible credit protection provider). The banking book treatment for credit derivatives proposed in the January proposals will be used to calculate the capital requirements for the hedged banking book position.

Finally, the current Accord’s add–on matrix for potential future exposure calculations does not explicitly cover credit derivatives and rules differ across countries. The Capital Group is working to provide proposals to harmonise this treatment.

Calculation of haircuts for repo-style transactions

The proposals in the second Consultative Package for collateralised transactions were structured to apply on a transaction-by-transaction basis. Many industry comments noted that, although this framework would work for typical secured loans, repo-style transactions were usually managed at the counterparty level on a portfolio basis under master netting agreements. In such circumstances, the proposed framework would result in higher capital charges compared to the actual economic risks. The use of a master netting agreement allows a firm to manage variation margin payments due from a counterparty across the range of repo-style transactions covered by the agreement, and to deliver netting of exposures in the event of the failure of the counterparty. The Group is working to see how the effects of these arrangements could be reflected better in the framework for CRM techniques. Banks also commented that the risk of price changes of various securities involved in these transactions was often evaluated using VaR models. The Capital Group has had discussions with the industry and is evaluating how such use of VaR models could be recognised under the comprehensive approach.

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2 *Amendment to the capital accord to incorporate market risks*, Basel Committee on Banking Supervision, January 1996.

Risk weighting of OECD public sector entities under the current Accord

Under the current Accord, supervisors in OECD countries may apply a 0% or 10% risk weighting to bank exposures to domestic non-central government public sector entities while only a 20% risk weight can be applied to claims on non-domestic OECD public sector entities. The Committee feels that this raises level playing field issues between domestic banks and banks established in foreign countries. It has therefore decided that if a supervisor in an OECD country applies a 0% or 10% risk weighting to a domestic public sector entity, foreign supervisors can allow their banks to apply the same risk weighting.

Notes for editors

The Basel Committee on Banking Supervision

The Basel Committee on Banking Supervision is a Committee of banking supervisory authorities established by the central bank Governors of the Group of Ten countries in 1975. It consists of senior representatives of bank supervisory authorities and central banks of Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom and the United States. The European Commission and European Central Bank also participate in the discussions as observers. The Basel Committee's current chairman is Mr William J McDonough, President and Chief Executive Officer of the Federal Reserve Bank of New York. The Committee usually meets at the Bank for International Settlements (BIS) in Basel, where its permanent Secretariat is located.

The Capital Group

The Basel Committee's Capital Group has the lead responsibility in the maintenance work on the current Accord as well as developing the standardised approach and rules for credit risk mitigation techniques in the New Basel Capital Accord. It is currently chaired by Mr Oliver Page, Director, Major Financial Groups at the UK Financial Services Authority and a member of the Basel Committee.

Earlier updates

The first update in this format was released in November 1999, and is available on the BIS website (www.bis.org).