

**Summary of the Basel Committee's Consultative Document:
"A New Capital Adequacy Framework"**

On June 3, 1999, the Basel Committee on Banking Supervision (Committee) released a consultative paper, "A New Capital Adequacy Framework," that solicits industry views on revisions to the 1988 agreement "International Convergence of Capital Measurement and Capital Standards" (Accord). The paper outlines many revisions to the Accord that will be of interest to U.S financial institutions. The Committee requests comments on the proposal through March 2000. The paper describes a framework for bank supervision and regulation that contains three "pillars" -- a regulatory capital minimum, an enhanced supervisory review process, and more effective use of market discipline through disclosure. The regulatory capital minimum pillar contemplates a standardized approach, which refines several of the features of the current Accord. The Committee also suggests that an internal ratings based approach could form the basis for setting capital charges at some sophisticated banks, and will, in consultation with the industry, develop this approach further in a forthcoming consultative document.

The Committee's proposal would apply to internationally active banks and to holding companies of banking groups on a consolidated basis. It also clarifies the treatment of bank subsidiaries.

REGULATORY CAPITAL MINIMUM

Standardized Approach

The largest portion of the paper describes several possible modifications to the calculation of a bank's risk-weighted assets under the standardized approach. The major issues raised by the proposal are outlined below.

- 1) Claims on Sovereigns -- The current framework applies a preferential risk weight on bank claims on the central governments of countries that are members of the Organization for Economic Cooperation and Development (OECD). Where the bank does not hold local currency liabilities, non-OECD governments (such as Hong Kong and Singapore) are currently risk-weighted in the 100 percent risk category. The problems associated with applying such a simple OECD/non-OECD distinction to setting risk weights have been well known for years, and the paper discusses an alternative that applies risk weights based on the external rating or credit assessment of the sovereign debt. The Committee also proposes that a favorable risk weight on a sovereign be conditional on that country subscribing to the IMF's Special Data Dissemination Standards.
- 2) Claims on Banks -- The current approach also applies the OECD/non-OECD distinction to bank holdings of other banks' liabilities. When a bank owns a deposit at, or has sold federal funds to, or otherwise lends to another bank that is incorporated in an OECD country, the bank weights that asset at 20 percent. However, for liabilities of non-OECD banks, the bank would weight those claims with remaining maturities of 1 year or less at 20 percent, and all other claims at 100 percent. The Committee's proposal discusses two alternative approaches for determining the risk weight. The first approach would apply a risk weight that is one category

higher than the risk weight that would be applied to the sovereign. The second approach would generally assign a 50 percent risk weight to claims on banks, but with higher or lower risk weights based on an external rating of the bank. Also, under the second approach, short-term claims (e.g., under 6 months) would be risk-weighted one category better than the bank's usual weight (but still subject to a 20 percent floor), with the restriction that no claim on a bank could receive a risk weight less than that applied to claims on its sovereign. Under both alternatives, a risk weight less than 100 percent would not be permitted unless the obligor bank's home supervisor has adopted the 25 Core Principles for Effective Bank Supervision published by the Committee.

3) Claims on Private Sector Borrowers -- Absent collateral or other third-party credit enhancements, a loan to a private sector borrower is currently risk-weighted at 100 percent. The paper proposes that a risk weight of 20 percent be applied to claims on borrowers that are in one of the two highest rating categories of recognized credit assessment entities (e.g., rating agencies). All other borrowers would remain in the 100 percent risk-weight category, except for claims on borrowers that are rated lower than B-. Those claims would be assigned a 150% risk weight. Unrated corporate borrowers would continue to be risk weighted at 100%.

4) Loan Commitments -- Currently, off-balance-sheet loan commitments are included in a bank's risk-weighted assets only if the original maturity exceeds 1 year. There is no risk-based capital charge for short-term commitments (1 year or less). The Committee is proposing a new 20 percent conversion factor, which would principally apply to short-term "business commitments" unless they are considered unconditionally cancellable. That is, 20 percent of the commitment would be assigned a risk weight and added to the bank's total risk-weighted assets.

5) Securizations -- The paper proposes that the risk weights used by a bank investing in asset-backed securities be assigned using the external ratings or credit assessments of those securities. Table 1 shows the proposed risk weights using the Standard & Poor's methodology for illustrative purposes.

Table 1

Risk Weights on Investments in Asset-Backed Securities

Rating	Risk Weight
AAA to AA-	20 percent
A+ to A-	50 percent
BBB+ to BBB-	100 percent
BB+ to BB-	150 percent
Rated B+ or below or unrated	Deducted from capital

In addition, the Committee proposes that supervisors have the discretion to require more capital for banks that sponsor certain revolving securitizations when uncontrolled early amortization provisions are present in the agreement. Specifically, the paper proposes discretion to apply a 20 percent credit conversion factor on managed assets in those securitizations.

6) Credit Risk Mitigation -- The current Accord does not fully capture the extent of the risk-reduction that can be achieved by certain credit risk mitigation techniques. The paper discusses the broad range of risk-reducing features of some transactions including (1) borrower-posted collateral, (2) arrangements to net multiple exposures with a single counterparty, and (3) third-

party credit enhancements (such as credit derivatives). The Committee is considering some recognition of such risk-reduction techniques in the calculation of risk-weighted assets. However, because many "risk reducing" transactions do not completely eliminate credit risk, the Committee contemplates developing some formula-based charge to account for this residual risk.

7) Other Risks -- The Committee is proposing to expand the range of risks for which there would be an explicit capital charge. The paper specifically highlights interest rate risk and operational risk as two areas that could be capitalized through a formula-based approach. For interest rate risk, the paper suggests that supervisors would have some discretion in measuring interest rate risk and identifying the outliers for which an explicit capital charge would be required. With respect to operational risk, the Committee is proposing consideration of a wide range of approaches, from simple add-ons that are a function of assets or revenues, to more complicated modeling approaches.

9) Banking versus Trading Book -- The Committee is concerned that the different approaches for determining regulatory capital for banking book and trading book assets present an opportunity for arbitrage. Banks may be recording certain transactions in their trading account instead of the banking book because of the lower regulatory capital allocation. Such a lower capital requirement is the result of the flexibility accorded some banks to model the risk of their trading portfolio instead of applying the formulaic risk-weight approach. The Committee will consider establishing liquidity criteria that a transaction must satisfy before a bank could book it in the trading account.

Internal Ratings-Based Approach

The consultative paper introduces the possibility of an internal ratings-based approach for more sophisticated banks. This alternative would allow banks to use their internal credit risk rating systems in determining regulatory capital requirements, conditional on the supervisor's acceptance of the rating process used by the bank. Subject to supervisory review, qualifying banks would be permitted to assign individual credits to distinct credit risk categories based on their internal ratings.

Through discussions with the industry, the Committee will be studying the feasibility of accepting internal ratings for regulatory capital purposes, and the design of such a capital regime. Two of the more significant issues involve (1) the comparability of credit risk assignments across banks, and (2) the adaptability of those systems for use in establishing prudent capital requirements.

ENHANCED SUPERVISION

The second pillar described in the consultative paper is an enhanced role for the supervision of a bank's internal evaluation of capital adequacy. The Accord would be modified to explicitly reference the subjective elements that comprise a supervisor's evaluation of an institution's capital adequacy and the need for a mechanism for early intervention when problems arise. This section of the paper also highlights the use of simple ratios (such as a leverage ratio) as an additional supervisory tool for some banks.

Supervisors would expect internationally active banks to have effective internal policies and practices for measuring their risks, allocating capital to the identified risks, and setting target capital ratios. These risk management practices should include a bank's forward-looking analysis of:

- its appetite for risk,
- the markets in which it operates,
- the rigor of its accounting, valuation and modeling,
- the volatility of its earnings and degree of diversification,
- its stress testing scenarios and internal capital allocation (and pricing) models, and
- internal and external auditor findings.

MARKET DISCIPLINE

The third pillar presented in the paper is market discipline, which emphasizes the private sector's role in reinforcing the supervisor's efforts to ensure capital adequacy. While the Committee's paper does not propose specific initiatives to promote market discipline, it does highlight the importance of improved transparency through better disclosures of risk positions (both on- and off-balance sheet) as well as capital levels (and its components). The paper notes that the Committee will provide detailed disclosure guidance later this year.

FUTURE WORK

In April 1999

, the Committee released a report on the status of credit risk modeling at banks, "Credit Risk Modeling: Current Practices and Applications." The Committee supports the industry's ongoing development of portfolio credit risk models. However, the Committee has identified several hurdles that must be overcome before such models could be considered for a regulatory capital framework. Although the Committee welcomes comments on that paper and will continue to monitor the industry's progress, the Committee sees difficulties in overcoming the hurdles in the timeframe envisioned for amending the Accord.

Domestically, the U. S. bank and thrift supervisors are working to develop a regulatory capital framework that considers the size, sophistication, and risk profile of the institution. Consistency with the key principles of the Accord would serve as the cornerstone for any such proposals.