"BANK CAPITAL REGULATION UNDER BASEL II : A CRITIQUE"

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OUTLINE OF PRESENTATION

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OBJECTIVES OF THE ORIGINAL BASLE CAPITAL ACCORD

Primary Objective:

to help stabilise the international banking system

Subsidiary Objective:

to contribute to the “levelling of the playing field” for internationally-active banks

A REVIEW OF THE CURRENT "RULES" UNDER THE BASLE CAPITAL ACCORD

- Since 1 January 1993, all internationally-active banks incorporated in G10 countries have been obliged to comply with a minimum risk asset ratio (RAR) requirement of 8%. This is derived - see **Exhibit 2** - by expressing the "adjusted capital base", comprising allowable "Tier 1" and "Tier 2" capital (subject to limits and restrictions - see **Exhibit 1**) as a percentage of the "total of weighted risk assets (TOWRA)". The denominator is, in turn, derived by adding the sum of the risk-weighted balance sheet items (see **Exhibit 3** for the risk weights applied) to the sum of risk-weighted off-balance-sheet "credit risk equivalents", the latter being derived by multiplying the national principal exposures by the relevant "conversion factors" (see **Exhibits 4 and 5**).
- Since 1 January 1998, in an attempt to accommodate banks' market risk as well as credit risk exposures, the RAR methodology has been modified - see **Exhibit 6** - although the 8% floor remains. At national discretion, an additional source of capital, known as "Tier 3""capital, however, may be used to meet market risk capital charges, but it is subject to the limits and restrictions set out in **Exhibit 7**.

  For those banks allowed by their national supervisory authorities to use internal models (i.e. VaRs) to calculate their market risk capital charges, the "market risk capital charge" alluded to in **Exhibit 6** can be calculated in accordance with the methodology set out in **Exhibit 8** as an alternative to the so-called prescriptive "standardised approach".

DEFICIENCIES IN THE CURRENT ASSESSMENT REGIME

- Although a number of important benefits have resulted from the widespread adoption of the Accord since its inception - notably, the contribution to financial stability resulting from banks being forced to hold more (and higher quality) capital than would otherwise have been the case, and to link this, albeit in a fairly arbitrary fashion, to some of the major risks to which they are exposed - a number of potentially serious flaws/deficiencies remain.
- The main deficiencies are set out in **Exhibit 9**.

THE JUNE 1999 PROPOSALS FROM BASLE

Aims

- To improve the way regulatory capital requirements reflect underlying risks
- To better address the financial innovation that has occurred in recent years
- To recognise the improvements in risk management and control that have occurred. Longer-term, the committee wishes to introduce a framework that is flexible, more accurately reflects the risks to which banks are exposed, and is responsive to financial innovation and developments in risk management practices

Main Objectives

- To continue to promote safety and soundness in the financial system.
- To continue to enhance competitive equality (i.e. to further level the playing field for internationally-active banks).

Components of the New Framework

Three mutually-reinforcing supervisory “pillars” comprising:

- Minimum regulatory capital requirements;
- Supervisory review of an institution’s capital adequacy and internal assessment process; and
- Greater market discipline (to be achieved through enhanced information disclosure).

[For full details see **Exhibit 10**]

Main Changes Proposed Under the First Pillar:

- An amended "standardised" approach to continue to be used by the vast majority of banks (see **Exhibit 10** for full details of the proposed amendments, including the use of external credit assessments in the determination of risk weights).
- More sophisticated banks being allowed to use internal rating (and, possibly, portfolio credit risk models at some future date) to set capital charges, subject to supervisory approval and adherence to quantitative and qualitative guidelines.

Implications of the Proposals

Had the proposals of June 1999 been implemented in their entirety a number of significant developments would have resulted. These are duly summarised in **Exhibit 11**.

AN ASSESSMENT OF THE JUNE 1999 PROPOSALS

Positive Features

1. Would increase *stability* of the international banking system because of, *inter alia*:

   - the removal of some of the "perverse" incentives currently facing the banks;
   - the focus on additional bank risks;
   - the promotion of the further development of risk mitigation techniques;
   - the reduction of the bias in favour of short-term interbank lending;
   - the introduction of a higher (i.e. 150%) risk weight for lowly-rated (i.e. below "B-") borrowers;
   - the abolition of the 50% cap on the risk-weighting of derivative exposures;
   - the incentives provided to most borrowers to seek higher credit ratings;
   - the demand for greater information disclosure; and
   - the new obligations placed on bank supervisors (e.g. to engage in "prompt corrective action", to impose bank-specific capital charges that closely reflect the risk exposures actually assumed, and to take explicit account of an individual bank's relative importance in national and international markets and its potential to trigger systemic instability).

2. Would increase *economic efficiency* because of, *inter alia*:

- the use of external credit ratings, which take account of, among other things, the characteristics of the obligor, to determine risk weights;
- the possibility of banks obtaining supervisory recognition of internal credit ratings (and, perhaps, at some future date, portfolio credit risk models), which would align regulatory capital requirements more closely with the internal allocation of economic capital;
- the removal of the bias in favour of loans to OECD countries and OECD banks;
- the reduction in the bias in favour of short-term (i.e. for less than 365 days) interbank lending;
- the introduction of a 150% risk weight for lowly-rated borrowers;
- the incentives created for most borrowers to seek improved ratings;
- the attempts to block the use of securitisation as a means of circumventing capital requirements through the risk-weighting of securitisation trenches; and
- the enhanced information disclosure requirements, which will lead to improved market transparency and greater market discipline

3. On balance, is likely to contribute to a further *levelling of the regulatory playing field* because of:

- ♦ the enforced geographical spread of “prompt corrective action” and the application of bank-specific capital charges;
- ♦ the induced convergence in information disclosure standards and supervisory practices; and
- ♦ the removal of the bias resulting from OECD membership/incorporation.

Concerns

Despite the positive advances inherent in the Basle Committee's proposals of June 1999, a number of concerns have been raised. The most significant are summarised immediately below (for full details see **Exhibit 12,** Section B).

1. Too much power would be vested in the hands of far from infallible *credit rating agencies*. The main anxieties relate to:
   - their previous track record, especially in relation to the recent Asian crisis;
   - the degree of concentration in the industry;
   - the absence of an agreed industry standard for ratings procedures, and hence the opportunities for regulatory arbitrage;
   - their potential to act in a destabilising fashion and to intensify the procyclicality of bank lending;
   - fears about how they will react to the commercial and political pressures they will face in the new environment [their goal of profit-maximisation may not sit easily alongside the desire to maximise social welfare].

2. *Perverse incentives* are also apparent in the proposed new framework e.g.:-
   - Those banks, sovereigns and corporates currently without a rating and fearful of being awarded a rating of below "B-" would have a positive disincentive to seek a rating as they would end up being worse off if their fears were realised (because unrated borrowers typically incur a 100% risk weight whereas those rated below "B-" incur a 150% risk weight);
   - Given the failure to differentiate adequately between corporate borrowers (those with a rating of between "A+" and "B-" all incur the same risk weighting of

100%), as under the current accord banks would have an incentive to court the higher-risk corporate borrowers if they believed that they could extract sufficiently high loan charges to more than offset the costs associated with the increased risk of default.

3. Similarly, inexplicable *anomalies* also feature in the proposed new framework e.g.:-

- Why are sovereign borrowers generally favoured by the new risk framework proposed?
- Why is such little differentiation made in respect of corporates and, to a lesser degree, between banks, a factor which reduces incentives to seek higher ratings?

4. The imposition of additional flat rate capital charges to cover 'other' risks, such as *operational risk*, is widely believed to be ill-conceived.

5. As the Committee acknowledges, insufficient attention has been paid to the *maturity of claims* in the promulgation of risk weights, militating against accurate assessment of underlying risks.

6. The scope for *national discretion* is still to great, militating against a levelling of the playing field.

7. The proposals imply a significant, and possibly untenable, increase in the *burden placed on* most *supervisory authorities*.

8. In terms of the overall impact on compliance costs the proposals are *inequitable*. A small group of highly-sophisticated global players would probably enjoy significantly-reduced costs whilst the vast majority of banks would probably incur significantly-increased costs.

9. In respect of the treatment of *bank claims*, both "options" are flawed.

10. Although the introduction of *"prompt corrective action"* has been enshrined in statute in the USA and Japan, where it is seen as an important device for limiting supervisory "forbearance", poor design and injudicious use of the policy instrument could, potentially, be destabilising.

11. In so far as the *standardised approach*, which the vast majority of banks would still adopt, would still treat credit risks as being addictive, the basic flaw in the risk assessment methodology would remain, notwithstanding the greater supervisory recognition of risk mitigation techniques.

12. Finally, the Committee's *desire to at least maintain the current overall level of capital* within the international banking system does not sit easily alongside the primary objective of the reform exercise namely, to refine the credit risk assessment process, linking capital requirements more closely to the "true" (in an actuarial sense) levels of risk run by individual banks.

THE JANAURY 2001 PROPOSALS FROM BASLE

- In the light of the comments received during the consultation period which followed the publication of its June 1999 proposals, a revised set of proposals was released by the Basle Committee in January 2001. These are summarised in **Exhibit 13**.

- As expected, the Committee confirmed that its new approach would be based around the previously-identified mutually-reinforcing "pillars" of minimum regulatory capital requirements, supervisory review and market discipline.
  The approaches to be adopted under each of these pillars, however, have been substantially revised and extended. The main changes made (also identified in Exhibit 13) are summarised below.

- In general, the changes reflected the Committee's greater emphasis than hitherto on providing banks and their supervisors with a range of options for the assessment of capital adequacy, in an attempt to move further away from prescription and a "one size fits all" approach; and a greater willingness to allow banks to deploy their own assessments of the risk to which they are exposed in the calculation of regulatory capital charges is also evident [e.g. in their proposals for the use of internal ratings-based (IRB) approaches].

Main Changes Made Under Pillar 1

1. A *more risk-sensitive standardised approach* is proposed, embracing a revised set of risk weights deriving from the use of the credit assessments of eligible external credit assessment institutions or, for the first time, the risk scores of export credit agencies (*see* **Exhibit 14** for full details).

2. *Operational requirements* to be applied under the standardised approach.

- ♦ National supervisors to ensure that banks do not assign risk weights based on external credit assessments in a mechanical fashion.

- ♦ To gain supervisory recognition of their credit assessments, external credit assessment institutions (ECAIs) must satisfy six criteria, covering issues of "objectivity", "independence", "international access"/ "transparency", "disclosure", "resources", and "credibility".

- ♦ Supervisors are responsible for mapping the ECAIs' assessments with the risk weights, for ensuring the risk weight assignment is consistent with the level of credit risk involved, and for preventing banks from "cherry-picking" from the available assessments.

- ♦ Banks are expected to apply the assessments consistently for both risk weighting and risk management purposes.

3. *Credit risk mitigation* in the standardised approach.

- ♦ The use of collateral, credit derivatives, guarantees and netting arrangements are all now recognised.
- ♦ Recognition, however, is subject to minimum operational standards being adhered to and to the fulfilment of certain disclosure requirements set out under Pillar 3.
- ♦ Credit Risk mitigation is also available under a foundation IRB approach and an advanced IRB approach.

4. The standardised approach to *asset securitisation*

- ♦ The Committee published for consultation standardised and IRB approaches for treating the explicit risks that securitisation creates for banks, be they issuing banks, investing banks or sponsoring banks.
- ♦ Within each approach, operational requirements, disclosure requirements and minimum capital requirements are laid down.

5. *IRB approaches*

- As foreshadowed in the June 1999 consultation paper, banks with more advanced risk management capabilities are to be able, at national discretion, to use internal assessments of credit risk - now set out as IRB approaches - provided they satisfy rigorous supervisory standards.
- To be eligible to use the so-called *"foundation"* approach, banks must satisfy the following *minimum* requirements, both at the outset and on an on-going basis, relating to:

  i) a meaningful differentiation of risk

  ii) completeness and integrity of rating assignments;

  iii) oversight of the rating system and processes;

  iv) criteria and orientation of the rating system;

  v) estimation of the probability of default (PD);

  vi) data collection and IT systems;

  vii) use of internal ratings;

  viii) internal validation; and

  ix) disclosure requirements (as set out in Pillar 3).
- A bank using its own estimates of any components of the *"advanced"* IRB approach - i.e. in respect of "loss given default" (LGD), "exposure at default" (EAD) and the treatment of guarantees and credit derivatives - must satisfy all of the above as well as the additional minimum requirements for the relevant risk component it is estimating.

6. The treatment of *operational risk*

- The Committee confirmed its intention to require banks to establish an explicit capital charge to cover operational risk, which it defines as "the risk of direct or indirect loss resulting from inadequate or failed internal processes, people and systems or from external events".
- All internationally - active banks and banks with significant operational risk exposure are expected to use one of the last two-mentioned approaches.
- Based on industry experience, the Committee proposed that a figure of 20% (later reduced to 12%) of regulatory capital be used as a first approximation in developing the minimum capital charge. As additional loss data becomes available, the minimum capital requirements will be adjusted accordingly.

Main Changes Made Under Pillar 2

- ♦ The Committee has now identified four *"key principles"* of supervisory review which are designed to complement the extensive supervisory guidance already established.

- ♦ The *first key principle* is that:

  "Banks should have a process for assessing their overall capital adequacy in relation to their risk profile and a strategy for maintaining their capital levels."

  - The main features of such a process should comprise:

  (i) a sound risk management process subject to effective board and senior management oversight;

  (ii) sound capital assessment;

  (iii) a comprehensive assessment of risks;

  (iv) an adequate system for monitoring and reporting risk; and

  (v) adequate internal control review.

  - Guidance given under this principle is designed to ensure that banks are able to demonstrate that chosen internal capital targets are well founded and that these targets are consistent with their overall risk profiles and current operating environments.

- The *second key principle*, associated with internal control review, is that:

  > "**Supervisors should review and evaluate banks' internal capital adequacy assessments and strategies, as well as their ability to monitor and ensure their compliance with regulatory capital ratios. Supervisors should take appropriate supervisory action if they are not satisfied with the result of this process.**"

  - Under this principle, the Committee is seeking to ensure that supervisors regularly review, on the basis of published criteria, banks' capital adequacy assessment processes, banks' risk positions, and the resultant amounts and quality of capital held by the banks.
  - Supervisors are also expected to evaluate the soundness of the banks' internal capital adequacy assessment processes.
  - The Committee believes that the emphasis of the review should be on the quality of the banks' risk management and controls, and should comprise some or all of the following:

    (i) on-site examinations or inspections;

    (ii) off-site review;

    (iii) discussions with bank management;

    (iv) review of relevant work done by external auditors; and

    (v) periodic reporting.

- The *third key principle*, which is designed to ensure *all* banks operate above the minimum regulatory capital requirements, states that:

  > **"Supervisors should expect banks to operate above the minimum regulatory capital levels and should have the ability to require banks to hold capital in excess of the minimum."**

  - This may involve, as in the UK, setting bank-specific "target" and "trigger" capital ratios or, as in the USA, defining categories above minimum regulatory capital ratios (e.g. "well-capitalised" and "adequately-capitalised") when identifying the capitalisation level of a bank.
  - Alternatively, countries may choose to set higher ratios for the banking system as a whole.
  - Maintenance of an operational buffer, over and above the Pillar 1 standard, is deemed necessary to take account of:

    (i) the banks' own preferences for greater credit-worthiness;

    (ii) fluctuations in the type and volume of business activities undertaken;

    (iii) potential future difficulties faced when raising additional capital;

    (iv) the severity of the impact of sanctions/remedial action triggered by breaches of the relevant laws; and

    (v) the risks not captured by Pillar 1 requirements.

  - At the individual bank level, supervisors should clearly explain their reasons for setting capital requirements above the minimum requirement.

- Finally, the *fourth key principle*, designed to ensure that prompt supervisory intervention and remedial action are taken, states that:

  > **"Supervisors should seek to intervene at an early stage to prevent capital from falling below the minimum levels required to support the risk characteristics of a particular bank, and should require rapid remedial action if capital is not maintained or restored."**

  - Under this principle, supervisors are expected to consider a range of options if they feel banks are not meeting the requirements embodied in the principles outlined above. These actions may include:

    (i) intensifying the monitoring of the bank;

    (ii) restricting the payment of dividends;

    (iii) requiring the bank to prepare and implement a satisfactory capital adequacy restoration plan; and

    (iv) requiring the bank to raise additional capital immediately.

Main Changes Made Under Pillar 3

- Building on the six broad recommendations set out in its January 2000 paper, the Committee has developed a set of more specific qualitative and quantitative disclosures in four key areas:
  - (i) scope of application;
  - (ii) composition of capital;
  - (iii) risk exposure assessment and management processes; and
  - (iv) capital adequacy.
- It also now distinguishes between disclosure *requirements*, which serve as pre-conditions for the use of a particular methodology or instrument, and *strong recommendations*.
- A distinction is also now drawn between *"core"* and *"supplementary"* disclosure requirements, in recognition of the disclosure burden placed on some institutions.
- Core disclosures are defined as those which convey vital information for all institutions and are important to the basic operation of market discipline. All institutions are expected to disclose such information, subject to "materiality".
- Supplementary disclosures, in contrast, are important for some, but not all, institutions depending on the nature of their risk exposure, capital adequacy and methods adopted to calculate the capital requirements. Sophisticated, internationally-active banks are expected to make the full range of core and supplementary information publicly available, again on the basis of materiality.
- In respect of the *strong recommendations* made in relation to the disclosure on **capital structure**, *core* disclosure recommendations are both quantitative and qualitative in nature. The former cover disclosure of:
  - (i) The amount of Tier 1 capital held, with separate disclosure of:
    - paid-up share capital/common stock;

- disclosed reserves;
- minority interests in the equity of subsidiaries;
- innovative Tier 1 capital instruments grandfathered;
- innovative Tier 1 capital instrument not grandfathered; and
- goodwill and other amounts deducted from Tier 1.

(ii) the total amount of Tier 2 and Tier 3 capital held;

(iii) deductions made from Tier 1 and Tier 2 capital; and

(iv) overall eligible capital held.

The latter cover, in turn:

(i) accounting policies used for the valuation of assets and liabilities, provisioning and income recognition;

(ii) information on consistency of accounting principles used between years;

(iii) whether unrealised gains are included in Tier 1 capital;

(iv) whether unrealised losses have been deducted from Tier 1 capital;

(v) what influence deferred taxes have on Tier 1 capital; and

(vi) the nature and functions of innovative Tier 1 capital instruments.

♦ *Supplementary* disclosures, meanwhile, are expected to cover: the amount of Tier 2 capital (split between “Upper” and “Lower” Tier 2), with separate disclosure of material components; and the amount of Tier 3 capital.

- Summary disclosure of information about the terms and conditions of the main features of all capital instruments, especially in the case of innovative, complex or hybrid capital instruments, is also expected under both core and supplementary disclosures. And this information should provide a clear picture of the loss-absorbing capacity of each instrument, and highlight any conditions (.e.g. "trigger" events) that may affect the analysis of banks' capital adequacy.

- Similarly, with respect to **capital adequacy** disclosures, *core* disclosure recommendations (to be made on a consolidated basis by each internationally-active bank within a banking group, and by holding companies of banking groups) embrace:

  (i) capital requirements for credit risk for balance sheet assets;

  (ii) capital requirements for credit risk for off-balance-sheet instruments;

  (iii) capital requirements for market risk, including disclosure of capital charges for component risk elements;

  (iv) capital requirements for operational risk;

  (v) total capital requirements;

  (vi) total eligible capital; and

  (vii) percentage of total eligible capital to total capital requirements.

  Banks using the internal models approach should also disclose their individual capital requirements for component elements of market risk.

- Under the *supplementary* disclosure recommendations, banks are also expected to provide an analysis of factors impacting on their capital adequacy position and economic capital allocations. This would include:

(i) changes in capital structure and the impact on key ratios and the overall capital position;

(ii) information about contingency planning;

(iii) its capital management strategy including, where appropriate, future capital plans; and

(iv) the amount of economic capital allocated to different transactions, products, customers, business lines, or organisational units.

- Banks are also invited to consider disclosing a summary comparison/analysis of internal estimates of *aggregate* economic capital requirements *versus* reported capital amounts *versus* regulatory requirements.

- Finally, in connection with the *frequency of disclosure* (and banks are encouraged to use electronic media as the medium for more frequent disclosures), the Committee believes that it is desirable for the disclosures covered on its paper to be made on no worse than a semi-annual basis, subject to proper verification on no worse than an annual basis. For certain categories of disclosure which are subject to rapid time delay (e.g. risk exposure) and, in particular, for internationally-active banks, quarterly disclosures are expected.

AN ASSESSMENT OF THE JANUARY 2001 PROPOSALS

Positive Features

The January 2001 package of proposals represented a major advance on the June 1999 package because of the increased cost-effectiveness likely to result from, *inter alia*:

- the increased choice (subject to national supervisory approval) now offered to a wider range of banks as a result of the Committee's more concerted attempt to move away from the current "one size fits all" policy;
- the promulgation of a more risk-sensitive standardised approach which addresses the concerns raised about the lack of granularity in the treatment of corporates, the operation of a sovereign floor for bank/corporate exposure risk weights, and the assignment of a 100 per cent risk weight to unrated borrowers;
- the reduction, from six to three months, in the original maturity of interbank claims before they qualify for preferential treatment under 'Option 2';
- the additional safeguards built into the use of external credit assessments and internal assessments (under the IRB approaches);
- the new IRB framework for credit risk explicitly recognising more elements of credit risk (i.e. the credit-worthiness of the obligor, the structure and maturity of the transaction, and the concentration of loans to a particular borrower or borrower group) in the regulatory capital calculation;
- the increased financial stability induced by the extension of the supervisory review process;
- the enhanced market discipline deriving from the adoption of a much broader range of disclosure requirements and recommendations, the former now extending to the provision

of prerequisites for the supervisory recognition of internal methodologies for credit risk assessment, credit risk mitigation techniques and asset securitisation; and

- the attempts made to lighten the overall burden place on banks and supervisors alike by the decisions taken to, respectively, distinguish between core and supplementary disclosure requirements/recommendations under Pillar 3, and to phase in the new requirements (under the Committee's transitional arrangements).

Continuing Concerns

This does not mean, however, that all the previously-expressed fears and concerns had dissipated. As far as the Committee's *stability objective* is concerned, concerns persisted because of the following:

- notwithstanding the greater supervisory recognition to be given to credit risk mitigation techniques, credit risks would still be treated in an additive fashion under the standardised approach, with no account being taken of the degree of portfolio diversification secured;

- the fear that the more risk-sensitive framework might amplify business cycles;

- the danger that some banks would be allowed to operate the IRB approaches prematurely;

- the very real fear that, because of limited skills, expertise and experience and a lack of professional standing, supervisors in a number of jurisdictions might not match up to the Committee's expectations. [Indeed, the Committee has acknowledged this, promising that it, together with the BIS's "Financial Stability Institute", will stand ready to provide assistance and will serve as a forum for information dissemination and exchange among supervisors.];

- the feeling that the ‘safeguards’ introduced to assuage the fears of the dissenters concerning the use of external credit assessments still did not do enough to ensure that the public interest prevailed;
- some perverse incentives remained in the new framework;
- the Committee’s failure to provide sufficient incentives, *via* the credit risk calibration process, to encourage take-up of the IRB approaches;
- the Committee’s failure to take account of a bank’s liquidity and access to future funding when assessing the value of its loan portfolio (a “fair value” approach may overstate true worth as the latter may depend on its liquidation value);
- a belief that both external ratings and IRB approaches are too blunt an instrument to reflect the day-to-day riskiness of credit portfolios;
- the Committee’s failure to resist more forcefully the “special pleading” from certain governments and other interested parties;
- the Committee’s decision to treat operational risk under Pillar 1 rather than Pillar 2; and
- continuing fears about the overall burden - reporting and otherwise – to be placed on the banks.

Similarly, in connection with the Committee’s *level playing field objective*, a number of fears persisted. The main one relates to the wide range of opportunities available to national supervisors to exercise their discretion under the latest set of proposals and the fear that, despite the Committee’s promise to monitor the use of discretion, serious competitive distortions will materialise. In a similar vein, bankers are anxious about the possible further loss of market share to non-bank financial service providers active in certain markets yet not subject to comparable regulation (e.g. insurance companies involved in credit derivatives).

CONTINUING DEVELOPMENTS IN BASLE

- In January 2001 the Committee stated that its work would continue in the following areas:

  - the treatment of asset securitisations;
  - the treatment of operational risk;
  - assessing the potential impact of provisioning practices on capital adequacy;
  - the development of the IRB approach;
  - the mapping of external credit assessments to the standardised risk buckets; and
  - the development of the information disclosure requirements and recommendations.

  [For further details see **Exhibit 13**]

- Such work subsequently led to the following changes to its January 2001 package of proposals:

  - a revised credit calibration was issued to encourage the take-up of the IRB approaches;
  - a new Working Paper on operational risk was issued in September 2001, refining the definition of operational risk and foreshadowing a future recalibration of the associated capital charge (the proximate "target" for the minimum capital charge was cut from the initially proposed 20 per cent of total regulatory capital to 12 per cent);
  - in respect of *disclosure requirements,* a new Working Paper on market discipline was also released in September 2001 proposing a number of changes to required disclosures with the intention of reducing the overall burden placed on banks

(although the Committee also suggested that the proposed streamlined disclosures become “requirements” rather than recommendations);

- as regards the treatment of *credit risk mitigation*, the Committee announced in September 2001 that it would drop the idea of applying a “w factor” to account for residual risks, although these will now have to be addressed under Pillar 2;

- in respect of the treatment of *specialised lending* a modified IRB approach was set out in a Working Paper on the subject issued in October 2001;

- a new Working Paper on *asset securitisations* was also issued in October 2001 setting out the eligibility conditions for the treatment of securitised assets under the IRB approach;

- following pressure from the German government and other interested parties, the Committee reduced the required capital charges associated with loans to SMEs (confirmed in July 2002); and

- finally, in July 2002, the Committee produced a revised package of proposals, which will be the subject of a final “impact study” in October 2002. The third and final consultation round will commence in May 2003 with a view to having the definitive set of proposals agreed by end-2003 for adoption by end-2006 at the latest.

SUMMARY AND CONCLUSIONS

- The Basle Committee is to be congratulated for, finally, moving to address the long-standing flaws inherent in the original Basle Capital Accord, for seeking to move forward with the times, and for responding in such a positive fashion to the comments received following the publication of its original reform proposals in June 1999.

- The January 2001 package of proposals represented a marked improvement, in terms of the overall increase in cost-effectiveness likely to result, on the initial set of proposals, although serious concerns persisted on a number of fronts.

- Similarly, the July 2002 package provided, on balance, yet further improvements. However, not all of the concerns raised earlier have been adequately dealt with and, as the Committee still has time to further refine its blueprint for reform before implementation is called for (end- 2006), it is to be hoped that some at least of these outstanding concerns will be addressed.

- Whatever the shape and form of the definitive reform package to emerge, at the end of the day the "proof of the pudding will be in the eating"; so a final judgement should perhaps await the outcome of its eventual implementation.

- Finally, by demonstrating its willingness to "work with the grain" of the market, the Committee has paved the way for the eventual adoption of a fully market-based approach to capital adequacy assessment, should a consensus for such an approach ever emerge.

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