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BASEL II: THE NEW CAPITAL ACCORD

THE CURRENT STATE OF THE CONSULTATION PROCESS IN FEBRUARY 2004

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The Current State of the Consultation Process in February 2004

Klaus Peter Follak

On the basis of comments received on the Basel II proposals the European Commission has published its consultation paper 3. Nevertheless there are further changes to be expected, and the timetable had to be revisited. This paper gives an overview on the substantive update that has taken place, and deals with open problems and questions to be answered. These problems range from operational complexity, discrepancies between regulatory and corporate reporting over the scope of implementation and consistency needed for implementation to cross border issues. The author concludes with a plea for flexibility for new developments and needs of financial services as a volatile industry. It is pointed out that the Basel II process has clearly demonstrated the limits of detailed descriptiveness for risk-sensitive capital requirements.

Keywords: accounting standards, banking supervision, Basel Concordat, capital accord, capital requirements, consolidated supervision, covered bonds, cyclicality, empirical basis of capital requirements, EU directives on capital adequacy, EU harmonization, expected losses, financial services groups, implementation / EU and USA, insurance companies, internal risk based approach, international convergence of banking regulation, investment firms, level playing field, models of capital requirements, partial use, risk models, scope of implementation, standard approach, verification and validation, unexpected losses.
JEL-Classification: G 21, K 23, K 33.

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1. Timetable Revised

On the basis of the comments received on the 1999 proposal for a new Capital Accord, a revised and extended version was released as a consultation paper in January 2001. Initially, the official consultation process on these papers was to extend through 31 May 2001. Yet, as several aspects seemed to require further assessment by working groups of the Basel Committee, additional supporting papers were circulated in January 2002. During its July 2002 meeting, the Committee reached agreement on a number of important issues. A revised proposal (the so-called third consultative paper "CP 3") [1] has been issued for consultation in April 2003 after completion of a third Quantitative Impact Study (so-called QIS 3, Oct.–Dec. 2002) [2]. Following a short consultation period which ended on 31st July 2003, the proposals should have been finalized in the 4th quarter of 2003 to come into force pursuant to national implementation legislation at year-end 2006. However, the Committee recognizes that certain countries may need more time beyond 2006 [3]. Following recent criticism by the US Supervisory Agencies on certain basic elements, the Committee has reconsidered the anticipated time schedule on 10th/11th October, 2003 [4]. The Committee has invited interested parties to comment on a proposal to adopt an approach based on unexpected rather than on both expected and unexpected losses [5] by year-end 2003. At the Committee's January 14th/15th 2004 meeting, it has evaluated the outcome of related consultations and reviewed the progress made in resolving several further new issues [5a]. The Committee has the intention to resolve the outstanding issues by no later than mid-year 2004. In this case, final implementation during the course of 2007 might still be a realistic aim.

2. Substantive Update

The basic structure of the proposal has been maintained: three pillars comprising quantitative capital requirements (Pillar 1), a supervisory review process (Pillar 2) and market discipline (disclosure requirements, Pillar 3). Regarding quantitative requirements – *the first regulatory pillar* –, the menu approach of risk weightings based on either external credit ratings (Standard Approach) or internal models (Basic and Advanced Internal Risk Based Approaches) has not been changed. For the determination of capital requirements for credit risks, three alternative methods may be chosen:

1. The *Standard Approach*, which is a modified version of the existing Accord using standard risk weights based on external ratings; requirements regarding external ratings are specified by CP 3, Annex 2.
2. The *Foundation Internal Risk Based* (IRB) *Approach*, where banks may use their own default experience, but the resulting loss ratios and a capital matrix will be set by the supervisors. The concept of default experience is based on the "Probability of Default" (PD), i.e. the probability that a customer defaults within one year.
3. The *Advanced Internal Risk Based Approach*, where banks may use not only their own default experience, but also their estimates on resulting losses (after enforcement of collateral, defined as "Loss Given Default", LGD). The ratio of capital charges for estimated losses will be determined by supervisors. "The advanced IRB risk-weight function for an unhedged exposure depends on an obligor's PD, an LGD, and an asset-cor-

[1] www.bis.org/press/po30429.htm, and www.bis.org/bcbs/bcbscp3.htm, quoted as CP 3 in this publication.
[2] www.bis.org/bcbs/qis/qis3.htm.
[3] CP 3, Overview, p. 11.
[4] BIS press release, 11th Oct. 2003, www.bis.org/press/po31011.htm.
[5] BIS press release (FN 4), attachment.
[5a] Press release (www.bis.org/press/po40115.htm) and Modifications to the capital treatment for expected and unexpected credit losses in the New Basel Accord 30th January 2004 (www.bis.org/publ/bcbs104.htm).