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BASEL II: THE REVISED FRAMEWORK OF JUNE 2004

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***JEL classification**: F36, G15, G18, G21, G28*

Contents

Abbreviations

ALM	asset and liability management
AMA	Advanced Measurement Approach
BCBS	Basel Committee on Banking Supervision of the BIS
BIS	Bank for International Settlements, Basel, Switzerland
CF	commodities finance
CP1	A New Capital Adequacy Framework, BCBS 1999
CP2	The New Basel Capital Accord, BCBS, January 2001
CP3	The New Basel Capital Accord, BCBS, April 2003
EAD	exposure at default
ECAIs	external credit assessment institutions
ECAs	export credit agencies
EL	expected losses
FSI	Financial Stability Institute of the BIS
HVCRE	high-volatility commercial real estate
IAA	internal assessments approach
IASB	International Accounting Standards Board
IASCF	International Accounting Standards Committee Foundation
ICBA	Independent Community Bankers of America
IOSCO	International Organisation of Securities Commissions
IPRE	income-producing real estate
IRB	internal ratings-based approach of the BCBS
LGD	loss given default
M	maturity
OF	object finance
OTC	over the counter derivatives
PD	probability of default
PF	project finance
QIS3	Quantitative Impact Study 3
QRREs	qualifying revolving retail exposures
RBA	ratings-based approach
RF	International Convergence of Capital Measurement and Capital Standards: a Revised Framework
SF	Supervisory Formula
SMEs	small and medium-sized enterprises
SPE	special purpose entity
UL	unexpected losses

BASEL II: THE REVISED FRAMEWORK OF JUNE 2004

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Abstract

The June 2004 document of the Basel Committee on Banking Supervision (BCBS), International Convergence of Capital Measurement and Capital Standards: a Revised Framework (RF), is designed to be the culmination of the process beginning in 1999 to replace the 1988 Basel Capital Accord of 1988 with a New Basel Capital Accord (Basel II). The basic components of Basel II were first fleshed out in the consultative paper of 2001. These consist of three Pillars and a number of alternative approaches to the setting of numerical capital requirements. Under the first Pillar these components include two basic approaches to the numerical capital requirements for credit risk, the Standardised and the Internal Ratings-Based (IRB) approaches, and alternative options for the capital requirements for operational risk. Under the Standardised approach the calibration of risk is based on the assessments of external credit assessment institutions (ECAIs), an important role for this purpose being attributed to credit rating agencies. Under the IRB approach there are two basic versions of different degrees of sophistication, "foundation" and "advanced", reliance on banks' own internal ratings for the inputs used to estimate risk weights and exposures being greater under the latter than under the former. Conditions for eligibility for the two versions of the IRB approach and the three alternative options for operational risk are also spelled out. The second and third Pillars are supervisory review of capital adequacy and market discipline through standards for disclosure.

A major aim of Basel II has been to revise the rules of the 1988 Basel Capital Accord in such a way as to align banks' regulatory capital more closely with their risks, taking account of progress in the measurement and management of risk and of the opportunities which these provide for strengthened supervision. Achievement of this aim has involved the incorporation in Basel II of methods for quantifying banking risks introduced since the late 1980s. The task of the designers of Basel II has been complicated by the way in which the BCBS's rules for banks' capital, originally intended for the internationally active banks of its member countries, have become a global standard widely applied in developing as well as developed countries. Acceptance of this role by the BCBS has entailed a global consultation process, whose results have been reflected in three consultative papers and the RF, and the different approaches and options for setting numerical capital requirements which are intended to accommodate banks and supervisors of different levels of sophistication.

As well as providing a commentary on the main features of the RF this paper documents the response of the BCBS to some of the more important points which were raised during this consultation process, including the outcome of decisions taken at a meeting in Madrid in October 2003 following comments on the consultative paper of April 2003, and summarises the results of the most recent of the BCBS's initiatives to estimate the quantitative impact of the Basel II rules on banks' capital. This discussion includes a review of papers issued by the BCBS as part of the last stage of its work preceding the RF.

Implementation of Basel II will be a large-scale exercise, making major demands on bank supervisors and requiring extensive technical assistance, especially for developing countries. The paper summarises the published results of a questionnaire of the Financial Stability Institute sent to more than 100 non-BCBS countries with the intention of providing an idea of the extent and envisaged timeframe for implementation of Basel II as well as of other issues such as choices of different approaches and options for the setting of capital requirements.

A. THE DEVELOPMENT OF BASEL II

The June 2004 document of the Basel Committee on Banking Supervision (BCBS), *International Convergence of Capital Measurement and Capital Standards: a Revised Framework* (henceforth RF), follows a series of three consultative papers on a New Basel Capital Accord (Basel II) stretching back to 1999.

The first of these papers, *A New Capital Adequacy Framework* (CP1)**,** contained a sketch of basic components of the subsequent, progressively more elaborated versions of Basel II.[1] Under the first so-called Pillar these components included two basic approaches to the numerical standards for banks' capital adequacy, the Standardised and the Internal Ratings-Based (IRB) approaches. Under the standardised approach the calibration of risk was finer than in the 1988 Basel Capital Accord and was to rely on the assessments of external credit assessment institutions (ECAIs), an important role for this purpose being attributed to credit rating agencies. The second and third Pillars were supervisory review of capital adequacy and market discipline through standards for disclosure. More explicit recognition than in the 1988 Basel Capital Accord – if feasible through quantitative capital charges – was proposed for interest-rate risk in the banking book and for operational risk. The paper also included new approaches to the treatment of securitised assets and of credit risk mitigation.

The nine-part, 500-page *The New Basel Capital Accord* of January 2001 (CP2), provided a more fleshed-out picture of the likely eventual shape of Basel II.[2] However, many of the detailed proposals were acknowledged to be still provisional or lacking important elements. Under the IRB approach there were two basic versions of different degrees of sophistication, "foundation" and "advanced", reliance on banks' own internal ratings for the inputs used to estimate risk weights and exposures being greater under the latter than under the former. Moreover there was a classification of exposures by six broad categories: corporate, sovereign, bank, retail, project finance, and equity. Conditions for eligibility for the two versions of the IRB approach were spelled out. And three options also of progressively greater sophistication were proposed for quantifying the capital required for operational risk.

The third in the series, also entitled *The New Basel Capital Accord* (CP3), was issued in April 2003 and was a step forward in comparison with CP2 in both coherence and completeness.[3] But greater coherence was not accompanied by a reduction in complexity. Much of this complexity has been due to the attempt to set global standards for the regulatory capital of banks at different levels of sophistication. It has also reflected the BCBS's response to continuing rapid financial innovation and