

SPEECH

McDonough: Consultative Paper on a New Capital Adequacy Framework

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William J. McDonough, President and Chief Executive Officer

Proposal for a new capital adequacy framework from the Basel Committee on Banking Supervision by William J. McDonough

The Basel Committee on Banking Supervision today issued a proposal for a new capital adequacy framework to replace the previous Capital Accord, issued in 1988. Mr William J. McDonough, Chairman of the Basel Committee and President and Chief Executive Officer of the Federal Reserve Bank of New York, introduced the proposal, noting, "This new capital framework consists of three pillars: **minimum capital requirements**, which seek to develop and expand on the standardised rules set forth in the 1988 Accord; **supervisory review** of an institution's capital adequacy and internal assessment process; and effective use of **market discipline** as a lever to strengthen disclosure and encourage safe and sound banking practices. The Committee believes that, taken together, these three elements are the essential pillars of an effective capital framework." The Committee also believes that the new framework should at least maintain the current overall level of capital in the banking system.

Within the same timeframe as its review of the existing standard capital requirements for credit risk, the Committee is also seeking to develop an alternative approach for establishing minimum capital requirements at some banks, based on the banks' internal credit ratings. Looking further ahead, Mr McDonough noted that the Committee will continue to analyse the potential use of credit risk models for regulatory capital requirements, as highlighted in its report, *Credit Risk Modelling: Current Practices and Applications*, released in April 1999.

"The 1988 Accord has been a cornerstone of the current international financial architecture. It has helped to strengthen the soundness and stability of the international banking system and enhanced competitive equality among internationally-active banks," said Claes Norgren, Director General at Finansinspektionen, Sweden, and Chairman of the Task Force on the Future of Capital Regulation, the group leading the review of the Accord. Mr Norgren added, however, that the financial marketplace has developed dramatically during the past ten years, to the point where the Accord's capital ratio is sometimes not a good indicator of a bank's financial condition. The world financial system has also recently witnessed considerable economic turbulence. "The new framework is designed to better align regulatory capital requirements to underlying risks, and to recognise the improvements in risk measurement and control," he said.

Minimum Regulatory Capital Requirements

With respect to the first pillar of the framework, the objective is to have a more comprehensive and risk-sensitive treatment of credit risk. The Committee has considered the following approaches for setting minimum capital requirements: a modified version of the existing approach, the use of banks' internal ratings, and portfolio credit risk models.

In the consultative document released today, the Committee is proposing revisions to the existing approach aimed at better aligning capital charges to underlying risk. With regard to sovereign risks, the Committee proposes replacing the existing approach by a system that would use external credit assessments for determining risk weights. It is intended that such an approach will also apply, either directly or indirectly and to varying degrees, to the risk weighting of exposures to banks, securities firms and corporates. The result will be to reduce risk weights for high quality corporate credits, and to introduce a higher-than-100% risk weight for certain low quality exposures. A new risk weighting scheme to address asset securitisation also is proposed, as is the application of a 20% credit conversion factor for certain types of short-term commitments.

The Committee has decided that mortgages on commercial real estate do not, in principle, justify other than a 100% weighting of the loans secured. The appropriate capital treatment of various types of assets, including those secured by commercial real estate, will continue to be reviewed by the Committee during the consultative period and after the Committee has received comments.

The Committee also recognises that, for some types of transactions, the 1988 Accord does not provide the proper incentives for **credit risk mitigation techniques**. For example, there is only minimal capital relief for collateral, and in some cases, the Accord's structure may not have favoured the development of specific forms of credit risk mitigation by placing restrictions on both the type of hedges acceptable for achieving capital reduction and the amount of capital relief. As such, the Committee is seeking to devise a more sound and consistent approach for capital treatment of credit risk mitigation techniques. This includes proposals for expanding the scope for eligible collateral, guarantees, and on-balance-sheet netting.

The proposals outlined above are intended to form the basis for a standardised approach for setting capital charges at the majority of banks. However, the Committee recognises that, for some banks, **internal credit ratings** could become a viable basis for regulatory capital requirements, subject to supervisory approval, and adherence to quantitative and qualitative standards. The Committee therefore is also seeking to develop an approach to regulatory capital based on banks' internal ratings within the same timeframe as its review of the standard capital requirement for credit risk. The Committee will present a more detailed analysis of its proposals in this respect in a forthcoming consultative document.

The Committee also has considered the possible use of **portfolio credit risk models** in setting regulatory capital requirements. "The Committee commends the use and continued development of such models," said Danièle Nouy, Secretary General of the Basel Committee Secretariat, and Chairwoman of the Models Task Force, which was responsible for the report on credit risk modelling. The report notes that a number of hurdles, including data availability and model validation, must be overcome before such models can be used for regulatory purposes. "The Committee will verify how, after further development and testing, credit risk models could play an explicit part in setting regulatory capital requirements, and we intend to monitor progress on these issues closely," Ms Nouy added.

The Committee also is seeking to expand coverage of the Accord to incorporate **other major categories of risk**. While the current Accord focused mainly on credit risk, it has since been amended to also address market risk. Interest rate risk in the banking book and other risks, such as operational risk, have not been explicitly addressed. However, the growing significance of these other risks has led the Committee to conclude that they are too important not to be treated separately within the capital framework. The Committee therefore proposes to develop a capital charge for interest rate risk in the banking book for banks where interest rate risk is significantly above average. The Committee also proposes to develop an explicit capital charge for other risks, principally operational risk, and is exploring practical ways in which this could be done.

Finally, it is proposed that the scope of application of the new Accord be extended to include, on a fully consolidated basis, holding companies that are parents of banking groups.

Supervisory Review Process

The second pillar of the framework, the supervisory review of capital adequacy, will seek to ensure that a bank's capital position and strategy is consistent with its overall risk profile and strategy and, as such, will encourage early supervisory intervention if the capital does not provide a sufficient buffer against risk. The report notes that supervisors should have the ability to require banks to hold capital in excess of minimum regulatory capital ratios – a point underscored in the course of the Committee's discussions with supervisors from emerging markets. Furthermore, the new framework stresses the importance of bank management developing an internal capital assessment process and setting targets for capital that are commensurate with the bank's specific risk profile and control environment. This internal process would then be subject to supervisory review and intervention where appropriate.

Market Discipline

The Committee also believes that supervisors have a strong interest in facilitating effective market discipline, the third pillar, as a lever to strengthen the safety and soundness of the banking system. Effective market discipline requires reliable and timely information that enables market participants to make well-founded risk assessments. The Committee plans to issue more detailed guidance on the disclosure of capital structure, risk exposures, and capital adequacy later this year.

Next Steps

The Committee believes that the Accord must keep pace with financial innovation and improvements in risk management practices. The Committee seeks comments on its proposals from all interested parties by 31 March 2000. The exact date for the implementation of the new Accord after this time will depend on the comments received and thus work that needs to be undertaken in the meantime. The Committee expects that the consultation process will include extensive interaction with banks and industry groups.

Notes to editors

Objectives of the New Framework

- The Accord should continue to promote safety and soundness in the financial system;
- The Accord should continue to enhance competitive equality;
- The Accord should constitute a more comprehensive approach for addressing risks; and
- The Accord should focus on internationally active banks, although its underlying principles should be suitable for application to banks of varying levels of complexity and sophistication.

Coverage of the New Framework

The 1988 Accord was designed for internationally active banks in the G-10 countries. The Accord has been widely adopted and applied throughout the world, not only to internationally active banks but also, in many countries, to domestic banks. While the focus of the new Accord will again be on internationally active banks, the guiding principles, as embodied in the three pillars, are generally suitable for any bank in any jurisdiction. Full account must be taken of individual circumstances; for example, some non-G-10 countries show greater volatility at the macro-economic level. Moreover, supervisors will need to consider carefully whether the essential pre-conditions laid down in the Accord are met - for example, whether there are sound accounting principles and practices - and to take appropriate action where needed. Circumstances of individual banks (such as scale, diversification, risk management systems, and riskiness), and of supervisors (including resources available for review), are all relevant to how and when individual countries can apply the Accord

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, Sweden, Switzerland, the United Kingdom and the United States. Its current chairman is 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 Task Force on the Future of Capital Regulation

This Task Force on the Future of Capital Regulation, chaired by Mr Norgren, was set up by the Basel Committee in December 1998, with a mission to discuss issues related to the new Capital Accord.

The Models Task Force

The Models Task Force, chaired by Ms Nouy, was set up by the Basel Committee in 1994. The Task Force consists of supervisory experts from member institutions of the Basel Committee.

Where can I obtain the full report?

The text of the report, "Consultative Paper on a New Capital Adequacy Framework" can be obtained from the BIS website (www.bis.org) as of 12:30 (CET) on 3 June 1999. The report is also available from the Basel Committee's Secretariat at the Bank for International Settlements and from member bank supervisory authorities and central banks.
