Basel II and Financial Stability

- Contribution to Financial stability: Reinforcing tools/objectives
- Encouraging enhancements in risk management
- Being receptive and responsive: SMEs
- Where are we now?
- Implementation: Enhancing consistency
- Related matters: Accounting

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Why does the New Capital Accord represent a critical review ?

- The 1988 Accord was a blunt instrument that quickly fell behind the times.
- Merely updating the rules would be unsatisfactory.
- The New Capital Accord is about more than just capital.
- The New Accord is much more comprehensive:
  - Four objectives/complementary tools.
  - Three pillars.
  - New features and building blocks.

Key message. Overall objective: Financial stability.

- When individual banks are adequately capitalised and well managed, they are more stable and better able to withstand periods of financial distress.

- When all banks have the proper incentives to manage their risks appropriately and hold adequate levels of capital, the entire financial sector becomes more resilient, less sensitive to the business cycle, and better able to act as a source for the sustainable growth of the broader economy.

The New Accord is much more comprehensive

Three reinforcing pillars

- Minimum capital requirements more sensitive to underlying risks.
- More consistent supervisory review.
- Transparency through enhanced disclosure of risk profile

New features and building blocks

- Menu driven approach. Not one-size-fits-all. Recognizing diversity.
- Internal ratings.
- Operational risk.
- Credit risk mitigation.
- Securitization framework.

Basel II uses a set of complementary tools/objectives

- Common rules => Maintaining a level playing field.
- Setting minimum capital requirements =>Adequate risk sensitive capital.
- Incentive based =>Encouraging enhancements in internal controls and risk management
- Promoting greater cooperation and coordination among supervisors =>consistency

Encouraging enhancements in internal controls and risk management

- Economic incentives to adopt more accurate risk measures
- Clear, comprehensive, and consolidated view of risks
- Common language to compare exposures to different risks
- Based on a strong foundation of corporate governance
- Improvements to internal reporting
- Greater transparency to harness market incentives

Being receptive and responsive.

SMEs:Major changes to the proposals since 1999 and 2001:

- Reduced capital charges for loans to smaller businesses
- Retail treatment permitted for aggregate exposures to a single business borrower of up to €1 million
- National supervisors to determine whether such portfolios qualify for retail treatment
- Recognition of a wider range of collateral and guarantees than the current Accord.

Recent changes to the proposals:

- Treatment of credit losses in the IRB approach
- Securitisation
- Credit risk mitigation
- AMA home/host

Where are we now?

- Significant progress in a number of important areas.
- We are well on-track to resolve outstanding issues by the middle of this year, in line with the time schedule set in October 2003.
- Implementing the New Accord is a domestic responsibility
- Prior to implementation, there will be a further review of the calibration of the New Accord.
- The banking industry needs some certainty about the rules.
- Basel II will be evolutionary.

Implementation: Enhancing consistency.

- Banks and supervisors should continue their efforts to prepare for implementation of the New Accord
- The Committee has intensified its efforts in this field
- Key issues: cross-border application, pillar 2.
  - High-level principles for cross-border implementation.
  - Principles for the home-host recognition of AMA operational risk capital.
  - Clarification of pillar 2. January press release.

High-level principles for cross-border implementation

- **Principle 1:** The New Accord will not change the legal responsibilities of national supervisors …….
- **Principle 2:** The home country supervisor is responsible for the oversight …. on a consolidated basis.
- **Principle 3:** Host country supervisors … have requirements that need to be understood and recognised
- **Principle 4:** There will need to be enhanced and pragmatic cooperation among supervisors with legitimate interests. The home country supervisor should lead this coordination effort
- **Principle 5:** Wherever possible, supervisors should avoid performing redundant and uncoordinated approval and validation work … in order to reduce the implementation burden…
- **Principle 6:** In implementing the New Accord, supervisors should communicate …to banking groups …The home country supervisor would lead this coordination effort …

Related matters : Accounting

- Accounting is extremely important for banking stability.
- We support the international convergence of standards.
- Central banks and supervisors have a legitimate interest to call for accounting standards that are consistent with sound risk management and that enhance transparency.
- The Basel Committee is committed to promote a sound and constructive dialogue with IASB and the industry.
- Reconciling approaches from different points of view - accounting, prudential, sound risk management - will continue to be high in our agenda.