PILLAR 1 – RISK-BASED CAPITAL

I. Credit Risk

Standardized Approach

- Regulatory capital thresholds based largely on asset category, although weightings can be supplemented if external ratings exist
- Past-due assets get a 150% weighting
- Significant expansion in recognition of credit risk mitigation, including wide range of highly-rated counterparties through guarantees, insurance and derivatives
- Overall drop of weighting for residential mortgages (generally to 35% for low-risk mortgages) and other retail credit (below unrated corporate assets)
- Small- and medium-sized enterprises (SMEs) generally get retail treatment

Internal Ratings-Based (IRB) Approaches

- Both foundation IRB (F-IRB) and advanced one (A-IRB) rely on internal models for key risk factors: probability of default (PD), loss given default (LGD) exposure at default (E) and maturity (M)
- IRBs differ in degree to which bank can rely on regulatory vs. own estimates of each of these factors
- Wider recognition of credit risk mitigation
- Weightings set for retail exposure based on category (mortgages, revolving exposures and other retail ones). Qualifying SMEs are considered other retail exposures.

Specialized Lending

- Approaches vary by type of loan and/or internal model
- Higher capital for “high volatility” commercial real estate

Equities

- Option One: use of PD and LGD, with a 90% LGD assumption with minimum 100% weighting in most circumstances
- Option Two: model market value over quarterly period

Securitization

- Standardized Option: use of regulatory weights, which generally impose higher capital for securitizations than whole loan. Unrated securitization positions must be deducted from capital.
- IRB: more reliance on internal models, but still more stringent than whole loans. First-loss positions must be deducted from capital.
- Explicit treatment of liquidity facilities.
- New capital for securitizations with early-amortization features

Qualifications for IRB

- Minimum supervisory standards to use F-IRB and A-IRB, focusing on risk management, board involvement, disclosure, etc.

II. Operational Risk

Basic Indicator

- Operational risk-based capital (ORBC) equal to 15% of gross income averaged over three years
- No entry criteria, but banks "encouraged" to comply with operational risk (OR) sound practices

Standardized

- Based on gross income, but different weightings based on eight regulator-determined business lines
- Must comply with minimal OR management standards

Advanced Measurement Approach (AMA)

- Permits recognition of internal models
- Allows limited recognition of insurance
- Includes numerous qualifications for use

PILLAR 2 – SUPERVISORY REVIEW

- Banks using IRB must also "stress test" risk-based capital to ensure sufficient capital buffer over economic cycle
- Mandatory review of concentration risk
- Mandatory review of risks related to providers of credit risk mitigation
- Specific standards for securitization, with specific penalties for cases of "implicit recourse"

PILLAR 3 – MARKET DISCIPLINE

- New public disclosure standards on capital and risk management

TIMING

- Final rule: year-end, 2003
- Effective date: year-end, 2006
- Outside G-10: implementation may be slower and more banks omitted from framework
- In U.S.: Advanced notice of proposed rulemaking due shortly with plan to make rules final in early 2004. Only biggest banks will be subject to Basel II and then only allowed to use the A-IRB and AMA.

TRANSITION

- Rules may change after going final, but won't be "moving target"
- Banks using IRB and AMA must run in parallel with current rules for one year prior to implementation of Basel II. Floors for value from IRB/AMA in place thereafter.
- Principles underway to coordinate home/host country supervisory review, with guiding reliance on "mutual recognition"