UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

THE BASEL COMMITTEE'S PROPOSALS FOR REVISED CAPITAL STANDARDS: MARK 2 AND THE STATE OF PLAY

Andrew Cornford

No. 156
September 2001

DISCUSSION PAPERS

THE BASEL COMMITTEE'S PROPOSALS FOR REVISED CAPITAL STANDARDS: MARK 2 AND THE STATE OF PLAY

Andrew Cornford

No. 156

September 2001

The author is grateful for comments by an anonymous referee.

UNCTAD/OSG/DP/156

Comments on this paper are invited and may be addressed to the author, c/o the Editorial Assistant*, Macroeconomic and Development Policies, GDS, United Nations Conference on Trade and Development (UNCTAD), Palais des Nations, CH-1211 Geneva 10, Switzerland. Copies of *Discussion Papers* may also be obtained from this address. New *Discussion Papers* are available on the website at: http://www.unctad.org/en/pub/pubframe.htm

---

* Tel. 022–907.5733; Fax 907.0274; E-mail: nicole.winch@unctad.org

JEL classification: G360,G150, G200, G210, G280 and G320.

CONTENTS

THE BASEL COMMITTEE'S PROPOSALS FOR REVISED CAPITAL STANDARDS: MARK 2 AND THE STATE OF PLAY

Andrew Cornford

United Nations Conference on Trade and Development, Geneva

Abstract

The new 500-page consultative document on capital standards of the Basel Committee on Banking Supervision (BCBS), "The New Basel Capital Accord", gives what is likely to prove a reasonable idea of the eventual shape of the new capital accord. However, many detailed issues remain to be resolved before completion of the drafting process in 2002. The scale and duration of this process reflects both the increasing complexity of banking operations and the role of the BCBS as the institution responsible for globally applicable standards for banking regulation and supervision. The basic structure of the 2001 consultative document follows that of the June 1999 proposals, in particular three Pillars treating the calculation of capital requirements, supervisory review, and the disclosure necessary for effective market discipline. But the 2001 proposals are much more concrete and detailed.

In their present form the proposals of the New Accord raise several concerns likely to apply to all countries but in some respects particularly to developing ones. One set of concerns relates to the New Accord's impact on supervisory divergences among countries, cross-border competition between banks, and cooperation between national supervisors. The New Accord has been crafted to accommodate banks of very different levels of sophistication. Yet this may compromise its basic objective of enhancing competitive equality by actually creating regulatory divergences in some areas of banking practice both within and between different countries. As a result the difficulties of achieving effective cross-border cooperation amongst supervisors may well increase. A second set of concerns involves the relation of the New Accord to ongoing exercises involving codes and standards. Here the key standard is the BCBS's Core Principles for Effective Banking Supervision for which the capital adequacy requirements of the Basle Capital Accord provide the principal benchmark. The New Accord will represent a quantum increase in the complexity of supervisors' responsibilities in most countries, and the resulting administrative burden will be aggravated by its incorporation in assessment exercises regarding compliance with the key standards. Furthermore, the link between the New Accord and key standards for financial systems also implies that implementation will become a subject for IMF Article IV surveillance and part of the conditionality associated with the IMF's new CCL facility. A further set of issues involves possible effects on regulatory arbitrage, since the comprehensiveness and detailed character of the rules of the New Accord will almost inevitably be a source of new opportunities for such arbitrage. Finally, there are concerns as to the effects of the New Accord on economic activity and international capital flows. The proposed risk weights of the IRB approach would lead to substantial rises in interest rates for lending to borrowers with low credit ratings both within countries and internationally – rises likely to affect borrowers from several developing countries. Moreover, owing to their links to the ratings of credit rating agencies and to observed default rates, the risk weights proposed in the New Accord are capable of contributing to the pro-cyclical character of bank lending both within countries and across borders, since they would be likely to translate higher credit risks in more difficult times into increased capital requirements (and thus more restrictive lending policies). Prudential rules which would minimize such dangers can be sketched but would nonetheless be difficult to incorporate in the design of regulatory systems.

I. INTRODUCTION

The new, nine-part, 500-page consultative document on capital standards of the Basel Committee on Banking Supervision (BCBS), issued in January 2001, gives what is likely to prove a reasonable idea of the eventual shape of the new capital accord.[1] However, the paper is still a report of work in progress and many detailed issues remain to be resolved during the last lap of the drafting process, which is to be completed in 2001.[2] The scale and duration of this process reflect partly the increasing complexity of banking operations, but also the role of the BCBS as the institution responsible for globally applicable standards for banking regulation and supervision. At the time of the 1988 Basel Capital Accord no such role was assumed, and the Accord was directed at the internationally active banks of the BCBS's member countries. But during the decade which followed its application was extended much more widely to other jurisdictions and banks. Several factors contributed to this extension, such as the closely parallel regulatory initiatives of the EEC/EU, the BCBS's own proselytizing of other supervisors and supervisory groups, and the internationalization of banking itself since the granting of the market access to foreign banks has become widely conditional on the standards of the regulatory regimes in their home countries – standards for which the rules enunciated by the BCBS are now accepted as a model. Even among developed countries the range of sophistication of banking firms is wide and this point applies *a fortiori* to the international economy as a whole. The number of issues which the BCBS must confront has become correspondingly greater, and the consultation associated with its statements of standards correspondingly more inclusive and lengthy.

---

[1] The full list of consultative documents issued in January 2001 is as follows: the core document, *The New Basel Capital Accord* (133 pages), which is accompanied by a more summary statement, *Overview of The New Basel Capital Accord* (37 pages), as well as a note resembling a press release, *The New Basel Accord: An Explanatory Note* (12 pages), and seven more specialized supporting documents, *The Standardised Approach to Credit Risk* (52 pages), *The Internal Ratings-Based Approach* (102 pages), *Pillar 2 (Supervisory Review Process)* (14 pages), *Pillar 3 (Market Discipline)* (59 pages), *Principles for the Management and Supervision of Interest Rate Risk* (39 pages), *Operational Risk* (26 pages), and *Asset Securitisation* (28 pages). The different documents in this package are referred to by their titles in the sequel and are not included in the References at the end of the paper.

[2] The definitive version of the new Accord was to have been published at the end of 2001, but this deadline has been extended to the end of 2002. The target date for implementation is 2005.

II. THE FLAWS OF THE 1988 BASEL CAPITAL ACCORD[3]

The basic objectives of the 1988 Basel Capital Accord were to strengthen the international banking system and to promote convergence of national capital standards, thus removing competitive inequalities among banks resulting from differences on this front. Its key features were a common measure of qualifying capital, a common framework for the valuation of bank assets in accordance with their associated credit risks[4] (including those classified as off-balance-sheet), and a minimum level of capital determined by a ratio of 8 per cent of qualifying capital to aggregate risk-weighted assets. In the following years a series of amendments and interpretations were issued concerning various parts of the Accord: these extended the definition and purview of qualifying capital, recognized the reductions in risk exposure which could be achieved by bilateral netting[5] meeting certain conditions, interpreted the Accord's application to multilateral netting schemes, allowed for the effects on risk exposure of collateralization with securities issued by selected OECD public-sector entities, and reduced the risk weights for exposures to regulated securities firms. Simultaneously, the BCBS continued its work on other banking risks of which the main practical outcome was the amendment of the 1988 Accord to cover market risk[6] adopted in 1996. But the 1988 Capital Accord lacked explicit provisions for capital to cover banks' interest-rate risks not included under the heading of market risk and their operational risks.

From the moment when it was unveiled the 1988 Basel Capital Accord was the subject of criticism which increased with the passage of time. The importance attributed to different weaknesses of the Accord varied among the different countries and other parties affected. But three points were particularly prominent in the criticisms: firstly, the Accord's failure to make adequate allowance for the degree of reduction in risk exposure achievable through diversification; secondly, the possibility that the Accord would lead banks to restrict their lending (particularly if the new capital requirements were introduced in

---

3 The discussion of the 1988 Basel Capital Accord and of the 1999 proposal for a *New Capital Adequacy Framework* which follows draws heavily on two sources, Cornford (2000) and Matten (2000, Part Three). The latter source goes beyond commentators' usual concentration on legal and accounting issues, placing banks' regulatory capital squarely in the context of the other dimensions of capital management intended to achieve objectives of risk control and economic performance.

4 Credit risk results from the possibility that a bank's counterparty will default on its obligations.

5 Netting refers to the amalgamation of sums due to and from a bank for the purpose of estimating its net risk exposure. Such netting can be bilateral, in which case it applies to the mutual obligations of the counterparties, or multilateral, in which case it applies to the mutual obligations originating within a group of counterparties (net amounts due being settled through a central clearing house). So long as they are supported by appropriate legal rules, such netting arrangements can reduce banks' risk exposure, and the BCBS's role here has consisted in specifying when such a reduction should be reflected in lower capital requirements for banks.

6 Market risk is that of loss due to changes in the market value of a bank's assets before they can be liquidated or offset in some way.

deflationary conditions characterized by downward pressure on their profits); and thirdly, its arbitrary and undiscriminating calibration of credit risks.[7] The last point involved one of a number of features of the Accord which led to regulatory arbitrage resulting from misalignments between regulatory rules and economic incentives. In this case banks were tempted to take advantage of the opportunities afforded by the Accord's calibration of risk to increase their holdings of higher-yielding but also higher-risk assets for a given level of regulatory capital. Other features of the Accord exploited for the purpose of regulatory arbitrage are the possibilities that the Accord offers for reducing regulatory capital through rolling over loans to banks in non-OECD countries to avoid maturities exceeding one year and (after 1996) through shifting exposures from the banking to the trading book.[8]

Another area of concern to both banks and their supervisors was the growing divergence between the framework of the 1988 Basel Capital Accord and innovations affecting the management of credit risk. Some of these innovations were concerned with the modelling of credit risk for the purpose of better measurement and control. Others involved new techniques for the reduction or mitigation of such risk. Of special importance here were credit derivatives, whose use expanded rapidly in the 1990s.

Stripped to their essentials, most credit derivatives are OTC transactions, structured as swaps, options or embedded securities, under which one party (the seller of protection or buyer of risk) receives a premium and in return enters into a commitment to provide the other party (the buyer of protection or seller of risk) with a payment or transfer of value triggered by a specified deterioration in the performance of a third party or parties (the Reference Entity or Entities) under specified debt or securities obligations (Reference Obligations), or by changes in the creditworthiness of the Reference Entity or Entities (see, for example, Henderson, 1999). The opportunities provided by credit derivatives for disaggregating and transferring credit risk are used for various purposes such as the management of credit lines, reduction of the capital required by regulation, the hedging and diversification of portfolios, and pure risk reduction (Reoch, 1997).

Practices regarding regulation of these instruments have yet to become firmly established and are