

Chapter 13

The Wider Application of Basel

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13.1 Introduction

The 1988 Basel Accord became – in a relatively short space of time – a global standard. Simple and robust, it has been adopted by over 100 countries, and has acquired a currency that it was never intended to have when it was first devised. Compliance with Basel’s Core Principles and with the Accord is formally assessed in the Financial Services Assessment Programme. The Basel Accord has become a fundamental element of the framework for enhancing international financial stability.

The wider application of the revised Basel Accord – its suitability for, and its impact on, countries not represented on the Basel Committee – has therefore unsurprisingly proved to be the subject of great debate. Even within the Basel Committee, there are differing views on the appropriate scope of application. The USA proposes to adopt an approach whereby only the largest and most internationally active US banks will be required to adopt a Basel II type approach to regulatory capital, and only the advanced approaches to credit and operational risk are available. The European Union (“EU”), by contrast, has determined that a Basel II type approach will be applied not only to all banks (or credit institutions in the jargon), but also to all investment firms that have their authorisation under the Investment Services Directive (“ISD”)¹ This wider scope has meant that the

¹ Directive 93/22/EEC will be replaced by the Markets in Financial Instruments Directive of 21 April 2004 (Directive 2004/39/EC).

European Commission has proposed some amendments to the Basel approach in order to make it fit the EU context.

Beyond the EU, approaches taken by non-G10 countries differ. The authorities of leading financial centres will adopt Basel II, often with a local “finish”. Emerging market countries will be allowed to adapt to the new standards at their own pace. The Basel Committee has encouraged non-G10 countries to proceed cautiously. Nick Le Pan, Vice Chairman of the Committee and the Canadian Superintendent of Financial Institutions, was quoted in the press release announcing agreement on the Accord “non-member countries must proceed at their own pace based on their own priorities”.² The Basel Committee has reinforced this message in its recent paper on the practical considerations of implementing Basel II.³ The International Monetary Fund (“IMF”) has not placed Basel II compliance at the heart of the Financial Services Assessment Programme for emerging market countries. Instead it is encouraging these countries to focus on reinforcing their financial services infrastructure and to select the elements in Basel II that are best suited to their circumstances.

That said, it does not appear that the pronouncements of the Basel Committee are losing their currency as global standards. A survey conducted for the Financial Stability Institute suggests that, including the G10 countries, over 100 countries will – or plan to implement Basel II based capital adequacy standards by 2012.

13.2 Application across the EU in the Risk based Capital Directive

The EU will – through the Capital Requirements Directive (“CRD”)⁴ often dubbed “CAD3” – apply capital adequacy standards based on

² BIS Press release “Consensus achieved on Basel II proposals”, 11 May 2004.

³ “Implementation of Basel II: Practical Considerations”, Basel Committee on Banking Supervision, July 2004.

⁴ Proposal for Directives of the European Parliament and of the Council recasting Directive 2000/12/EC of the European Parliament and of the Council of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions and Council Directive 93/6/EEC of 15 March 1993 on the capital adequacy of investment firms and credit institutions, Markt/1050/04, 14 July 2004.

Basel II to all institutions that meet the EU definitions of credit institutions and investment firms, even though G10 countries no longer constitute a majority of the Member States of the EU. The actual geographical scope of application of the EU Directive will embrace the European Economic Area. The EEA comprises the 25 countries of the EU together with Norway, Iceland and Liechtenstein. Credit institutions include building societies as well as banks of all sorts. Investment firms are firms that have received authorisation under the Investment Services Directive. This includes a very diverse population spanning broker/dealers, asset managers and arrangers and transmitters of orders. Following the passage of the Markets in Financial Instruments Directive⁵ (the successor to the ISD), dealers in commodity derivatives and investment advisers may also come within the definition.

The EU adopted the standards of the first Basel Accord as part of the capital adequacy framework underpinning the single market in banking services. The definition of regulatory capital was adopted through the Own Funds Directive,⁶ and the risk weightings and the solvency calculation itself were set out in the Solvency Ratio Directive.⁷ Together these provided the necessary assurance of appropriate home country supervision that allowed EU countries to agree to allow banks to use the EU passport to branch and provide cross-border services on the strength of their home state authorisation that was at the centre of the Second Banking Directive.⁸

The same rationale was applied to investment firms. In return for a passport based on a single authorisation from the home state in the ISD, they were made subject to harmonised capital requirements in the 1993 Capital Adequacy Directive (“CAD”).⁹ In order that investment firms and banks competing in the same European market should compete on the basis of the same rules, it was decided that banks and

⁵ Directive 2004/39/EC, Official Journal L145 30 April 2004. The status of dealers in commodity derivatives and the capital regime to which they will be subject will be determined following a further report to the Commission.

⁶ Directive 89/299/EEC.

⁷ Directive 89/647/EEC.

⁸ Directive 92/30/EEC. The Own Funds and Solvency Ratio Directives have together with the Second Banking Directive, Large Exposures Directive and Consolidated Supervision Directive now been consolidated into a single legal text, the Banking Consolidation Directive 2000/12/EC.

⁹ Directive 93/6/EEC.

investment firms should be subject to the same requirements when doing the same business. Thus, the credit risk requirements were aligned with the 1988 Basel Accord, and the market risk requirements were aligned with the 1995 Amendment to the Basel Accord that extended the scope of the Accord to market risk

It is perhaps insufficiently appreciated that EU directives – even those that are apparently regulatory in nature – are intended to be market-opening, trade liberalising measures. Their rationale is less to apply constraints on firms as to provide the minimum safeguards necessary to oblige Member States to open their markets. It is this that also underlies the universal application of rules – that some have argued are overly complex – to all banks and to all financial institutions, whether or not they take advantage of the EU passport. All firms are part of the single market, and have the opportunity to use the cross-border freedoms should they choose to do so. All firms in the same market should therefore be subject to the same standards. The European Commission is, however, sensitive to the charge that Basel II is unnecessarily complex for smaller and less complicated institutions. Therefore, in addition to some specific EU touches that are examined below, the EU – unlike the US – has chosen to offer all the approaches to credit and operational risk to its institutions, leaving the choice of approach to the firm in consultation with its home supervisor.

13.3 Principal differences between the EU approach and Basel II

13.3.1 Differences between the Basel and Brussels processes

An obvious – but key – difference between the Basel Committee for Banking Supervision and the EU is that of underpinning. Basel is an international standard developed by supervisors and central bankers in an autonomous forum that operates under the aegis of the Bank for International Settlements. Although there has been some attempt to describe Basel as “soft law” and an international Treaty, notably by the US Congress, it is and remains an agreement that is not binding in law and whose enforcement depends primarily on moral suasion – and some degree of market discipline.

The EU is a very different animal. It is a Union founded on international treaties (and possibly in the not too distant future on a Constitution), bound together by a common legal framework and subject to the ultimate jurisdiction of the European Court of Justice. The legislative acts of the EU are legally binding on those to whom they are addressed. While the standards applied may be – and frequently are – subject to quite different interpretations, implementation itself is not a matter of choice. Nor can the interpretations depart wildly from the agreed text without attracting legal action.

The processes of the EU are also very different from those of the Basel Committee. Basel II has seen a remarkable degree of openness from the Basel Committee, both in its willingness to conduct formal consultations and in its preparedness to engage in informal dialogue with interested parties. Ultimately, however, decision taking is behind closed doors and is largely technocratic. The EU processes are rather more political, and in the case of the European Parliament, explicitly so. Some of the negotiation, especially in the European Parliament (the Council of Ministers continues to conduct most of its business in secret), takes place in the public eye.

13.3.2 The form of the EU Directive

It is not surprising, therefore, that the products of the Basel and the Brussels processes are very different. The Basel Accord is written as a supervisory manual, complete with explanation. The Directive text is very different, even if it encompasses the same ends. It is written as law, and as an instruction to Member States to regulate to fulfil certain objectives that are set out in the Directive. There is little – apart from the word on the page – to educate the reader as to the legislator's intentions, although some explanatory rationale can be found in the recitals (the “whereas clauses”) that are intended to assist readers interpret the Directive.

13.3.3 A Lamfalussy compatible approach

The EU Directive is presented in a format that is designed to make it easier to cope with the evolutionary nature of Basel II, which is expected to change rather more frequently than its predecessor Accord. Traditionally, EU directives have contained all the detail that is relevant

to the matter in question. This means that a full directive that can take many years to negotiate is needed to amend the text. There is a technique, called comitology, for making technical amendments to directives, but it has traditionally had very limited scope and use.

It is clearly important that in future the EU should be able to adapt its capital adequacy framework in a timely manner to respond to changes in market practice and to the evolution of the Basel Accord. The so-called Lamfalussy approach to legislation should permit a more flexible approach in future. This envisages that the EU will operate at a number of levels:

- Level I – directives establishing the broad principles for EU action adopted by co-decision by the European Parliament and the Council of Ministers;
- Level II – technical detail and technical amendments adopted by the Banking Committee composed of representatives of finance ministries using the comitology process;
- Level III – the development of common standards by supervisors in the Committee of European Banking Supervisors;
- Level IV – enforcement action initiated by the Commission.

As the extension of Lamfalussy-type procedures to banking had not been formally agreed when the Directive was proposed, CRD will be debated in the traditional manner, with the European Parliament debating the full technical detail in the first instance. The Directive is, however, drafted in such a way as to be compatible with Lamfalussy-type procedures when it comes to future amendments. The articles contain the general principles and main provisions that both act as the principal constraints on firms and their supervisors and are unlikely to change radically over time. Much of the technical detail will be contained in annexes. It is envisaged that these will be rather more subject to change and will, be subject to change by the Banking Committee acting at level II.

13.3.4 The “EU Finish” and key EU issues

The fundamental principle that the EU has adopted is that of parallelism with Basel. The Commission proposes a capital adequacy framework that is very similar to that suggested by the Basel

Committee. The same three-pillar structure is proposed, with the same menu of options offered under the First Pillar for the calculation of minimum capital requirements. There are, however, a number of amendments and differences of emphasis to take account of the peculiar circumstances of the EU, and the fact that the EU will be applying its capital adequacy framework to all credit institutions and to all investment firms.

13.3.4.1 IRB approach to credit risk

The EU will essentially follow Basel in the approach to credit risk. However, given the wider scope of application of the CRD, the EU plans to allow a less rigorous approach to rolling out IRB systems for smaller institutions, in order to encourage such institutions to make use of the more advanced approaches and to facilitate their use of them. Basel will require internationally active banks to apply IRB approaches to all material portfolios across the entire banking group according to an “exacting, yet realistic” plan agreed with the supervisor.¹⁰ The EU, however, envisages that smaller institutions will be able to make permanent partial use of the IRB approach for – say – their corporate and retail portfolios, while maintaining the Standardised approach for their other portfolios, notably the inter-bank and sovereign portfolios.

13.3.4.2 Small and medium-sized enterprises (“SMEs”)

The treatment of SMEs was an explosive political issue in the EU in the wake of the publication of Basel’s CP2 in January 2001. The German Chancellor, Helmut Schroeder intervened publicly, and his concerns were echoed in Italy and Austria among other countries. The amendments made to Basel’s CP3 which established a discount for SMEs treated as corporate exposures based on the size of the firm in addition to the favourable treatment for retail exposures that cover exposures to the smaller SMEs, did much to defuse the problem. Nevertheless, the EU institutions remained concerned about the impact of the Basel proposals on the wider economy and on SMEs in particular. The Commission was asked to study these issues and in turn delegated this task to PricewaterhouseCoopers. PricewaterhouseCoopers’ report found that, for the most part, the

¹⁰ Basel Committee on Banking Supervision, “International Convergence of Capital Measurement and Capital Standards, A Revised Framework”, 26 June 2004, paragraph 258.

effects of the new capital framework on SME lending should be positive – although there might be transitional issues in some countries, especially where the SME community suffered from a shortage of equity.¹¹

The EU is therefore largely content to adopt Basel's approach to SMEs. The Commission is, however, examining the use test for SMEs that are treated as retail exposures. This requires such exposures to be treated like other retail exposures. This could have the unintended effect of requiring institutions to change their risk management practices and portfolio definitions. The EU will also allow competent authorities to apply a lower standard LGD of 35 per cent for leasing and factoring in the Foundation IRB. This is partly because these are seen as lower risk activities, and partly because leasing and factoring are important avenues for SME finance.

13.3.4.3 Credit risk mitigation

Here too the EU largely follows Basel, especially in its reluctance to allow non-financial collateral to be recognised as an eligible risk mitigant in the Standardised approach. The requirements for guarantees may be eased to allow the recognition of principal-only guarantees and to extend the eligibility of counter-guarantors to include Public Sector Entities and 0 per cent risk weighted multilateral development banks. This is based on the argument that it is prudentially sound to recognise such guarantees, and on the more political grounds that such guarantees are often important for SME finance. Supervisors will also have the freedom to admit provisional payment guarantees in mutual guarantee schemes that have been recognised by the supervisor.

13.3.4.4 Large exposures

Basel does not establish a large exposures regime to take account of risk concentration. The EU, through the Large Exposures Directive, does. The definition of an exposure for Large Exposures purposes is closely connected to the definition of an exposure for capital

¹¹ Markt/2003/02/F Study on the financial and macroeconomic consequences of the draft proposed new capital requirements for bank and investment firms in the EU. Final Report 8 April 2004.

adequacy purposes. CRD will substantively amend the definition of what is an exposure, especially through the new approach to credit risk mitigation and the greatly expanded definition of eligible collateral. The EU Directive clarifies that the definition of an exposure for Large Exposures purposes will take account of financial collateral where a firm uses the comprehensive approach to credit risk mitigation. Nevertheless, even though the definition of exposure is amended, firms will still have to report gross and net positions, and firms will be required to stress test realisable collateral values.

13.3.4.5 Mortgages and covered bonds

The EU approach to mortgages will follow Basel. However, while Basel is silent on the treatment of covered bonds, such as Pfandbriefe, this market is so important in Europe that there is a specific treatment of such instruments in the present capital framework and specific provision for them needs to be made in CRD. In the Standardised approach, an exposure to a covered bond will attract a risk weighting one notch below that of the issuer (so a covered bond issued by an institution that would attract a 20 per cent risk weight is weighted at 10 per cent and a bond issued by an institution weighted at 50 per cent is weighted at 20 per cent and so on). The Commission also proposes a 12.5 per cent LGD for covered bonds in the Foundation IRB.

13.3.4.6 Trading book

The EU will await the outcome of the joint Basel/IOSCO working party on the treatment of market risk in the Basel Accord before amending its current treatment of settling and unsettled transactions. For the rest, it will follow the Basel Committee.

13.3.4.7 Operational risk

The EU had at earlier stages of the consultative process considered making considerable amendments to the Basel provisions on operational risk. In particular, it considered allowing insurance as an eligible risk mitigant for operational risk. Over time, however, the EU has come into line with the Basel view, and credit institutions in the EU will essentially be subject to the same regime outlined in the Basel document. The operational risk regime is considerably amended for investment firms (*see below*).

13.3.4.8 Investment firms

The Basel Accord applies to internationally active banks. The extension of the Accord to cover investment firms raises issues for the EU that the Basel Committee did not have to face. In particular, the Basel proposals can be seen as a rebalancing of the capital charge. Under Basel I, the credit risk charge covered more than simply credit risk. It contained an unspecified element to cover "other risks". Basel II separates out the element of capital for other risks from the credit risk charge. It institutes an operational risk charge to cover other risks and reduces the credit risk charge to compensate. However, most investment firms carry little credit risk, and for them impact analyses showed that the operational risk charge was purely additional.

The Commission therefore proposes to segment the investment firm population into firms that run significant quantities of credit risk and those that do not. Low risk firms are those that act as intermediaries without taking positions in their own right and that do not hold client money. These firms will not be subject to the operational risk charge; instead they will continue to calculate a capital requirement based on three months' expenses. This is the so-called expenditure based requirement.

In addition, following the PricewaterhouseCoopers study, the Commission has distinguished another category of low risk entity. These firms may sometimes take positions in their own name, but only as a result of a failed trade. These are also considered low risk firms, and will be subject to a capital charge that is based on the credit risk and market risk charges for the risks that they are running, plus the expenditure based requirement referred to above.

There will be some firms for whom the expenditure based requirement will exceed the operational risk charge, and that may – as a result – seek to opt in to the operational risk regime, especially as it is to be expected that firms will still have to comply with the qualitative standards for the control of operational risks set out in the Basel Committee's Sound Practices paper.

Finally, the EU has recognised that for firms whose business is dominated by trading and sales, it seems perverse to apply a higher

capital charge under the more sophisticated Standardised approach than under the very simple Basic Indicator. The Basic Indicator applies a charge of 15 per cent of gross income, while Basel suggests a beta of 18 per cent of income for trading and sales activity. This scarcely encourages firms to seek to move to more risk-sensitive and more sophisticated approaches. In the Standardised approach to operational risk, the EU therefore proposes a transitional beta of 15 per cent of income from trading and sales for firms (banks included) where the trading and sales business line accounts for more than 50 per cent of business. This transitional arrangement will last until 2012.

13.3.5 The Second Pillar

If the details on the Second Pillar are sketchy in Basel, they almost disappear in the CRD. They are confined to two brief articles and one brief annex. The first article requires firms to have sound, effective and complete strategies and processes to assess and maintain the amount, type and distribution of capital needed to cover the risk profile of the firm. The second requires supervisory authorities to review the firm's assessment and to determine whether the firm's own assessment is sound at least annually. The CRD does not specify what supervisors are to do if the assessment falls short of expectations, although "measures shall be required" if an institution is especially exposed to interest rate risk in the banking book.¹² The Annex specifies the risks that supervisors must explicitly take into account in their supervisory review.¹³

With so little specified in the CRD, it is clear that much of the detail will have to be left to the Committee of European Banking Supervisors ("CEBS"). This Committee is already operational and developing pan-European supervisory coordination and common principles that will underlie the actions of European supervisors in the future. One of its first acts has been to issue for consultation a set

¹² This occurs if a firm's capital base declines by more than 20 per cent if there were a sudden interest rate shock.

¹³ These include the results of stress testing, the exposure to and management of liquidity and concentration risks, the exposure to and management of residual risks arising from the use of credit risk mitigation techniques, and the exposure to and management of risks arising from the securitisation of assets.

of principles that will govern the operation of the Second Pillar in the EU.¹⁴ This document suggests that EU supervisors will expect to see economic capital models in place at more sophisticated institutions, although many of these will not have been constructed with the requirements of the Second Pillar or the interests of supervisors in mind. Smaller institutions will be expected to have some method for relating the capital they hold to the risk that they run, but it is not clear what supervisors will expect to see.

13.3.6 The Third Pillar

The EU will apply the Third Pillar disclosure requirements on a consolidated basis at the parent credit institution level, or at the financial holding company level. Significant subsidiaries will also be required to disclose their Tier 1 and total capital ratios on an individual or sub-consolidated basis. The EU will require disclosures to be made at least annually. This is to avoid imposing undue burdens on the EU's many small banks and investment firms. However, firms will be required to assess whether they should make more frequent disclosures in line with the Basel Committee's recommendation of semi-annual disclosure, and quarterly disclosure of Tier 1 and total capital ratios, together with the quarterly disclosure of elements subject to rapid time decay. Firms that are likely to be subject to more onerous disclosure requirements will include those larger firms that are internationally active, that are linked to payments and clearing and settlement systems and that are active in a wide range of financial markets and sectors.

13.3.7 The implications for non-banking subsidiaries and consolidated supervision

The EU is a single market, and – at least as far as prudential supervision is concerned – the emphasis is very much on the role of the home supervisor. There are potential tensions between the supervisors of the parent bank and the supervisors of subsidiaries in other Member

¹⁴ The Application of the Supervisory Review Process under Pillar 2, The Committee of European Banking Supervisors, CP03, May 2004.

States, although the Basel Committee through the Accord Implementation Group is seeking to foster efficient cross-border collaboration. As EU legislation is coordinated and as EU supervisors should be working closely together to develop common standards in the Committee of European Banking Supervisors, there should be more scope for dealing efficiently with these problems in the EU context. The CRD will take up the Basel model of collaboration between home and host supervisors and go further by specifying the role of the consolidating supervisor, by requiring supervisors to have cooperation agreements in place with one another and by imposing on them a duty to cooperate.¹⁵

One key output of this for firms is that the Commission proposes that there should be only one application process for the use of the more sophisticated risk management and capital adequacy approaches. The application to use one of these approaches will be made to the consolidating supervisor that will co-ordinate the approval process in “full consultation” with the other interested supervisors. This follows the train of thought made explicit by the Commission in its feedback on responses to the third consultation exercise. It made clear that it wanted to build on the coordinating supervisor model established in the Financial Groups Directive, especially in relation to adjudicating on applications to use the advanced approaches. The Commission said that it wanted to see “a documented determination by all relevant supervisors on the approval application by all entities within the group”. It was not intended that this should mean a heavy involvement by all potential supervisors, but “it does mean that there should not be several separate approval processes in relation to the same EU group”. It remains to be seen whether home supervisors will be prepared to relinquish some of their authority in this area. This is likely – along with the Second Pillar – to be an area of focus for the Committee of European Banking Supervisors.

A further key issue is the level of application of the Accord and the CRD. Much attention is focused on the group consolidated level, and some of the requirements of the CRD – for example, the full disclosures under the Third Pillar – apply at group level. Many firms would

¹⁵ Commission Proposal Article 132.

also like to see more of the Accord and CRD applied only at group level, for example, in relation to the internal capital assessment and allocation plans under the Second Pillar and the design of the Advanced Management Approach for operational risk under the First Pillar.

However, supervisors remain concerned about the capitalisation of individual entities and about the distribution of capital within a financial services group. The Basel Accord applies to each internationally active bank and banking sub-group within an overall internationally active banking group. CRD also applies in principle at group, sub-group and solo entity level. Firms will therefore have to apply Pillar 2 requirements and ensure the model fit of any AMA approaches at solo level – at least for their most significant operating subsidiaries.

However, there is a broad level of agreement that, applied mechanistically, full group solo and sub-group supervision of every regulated entity in a banking group would be too much of a good thing, and thus there have always been a number of waivers and exemptions in the interests of pragmatism and efficiency. There is also a recognition that full consolidated supervision may not always be appropriate for investment firm groups. The CRD maintains a number of waivers that can be found in existing directives – although some of these are in modified form, and may no longer be as widely applicable – or as useful as they previously were.

Key waivers include:

- A waiver of solo supervision where parent and subsidiary are authorised in the same Member State, and where the subsidiary is included in the consolidated supervision of the parent. This is subject to a number of additional criteria, notably that there should be no impediment to the free transfer of capital between subsidiary and parent. This should allow the preservation – subject to some restrictions – of solo consolidation and similar techniques.
- A waiver exempting groups of homogeneous investment firms, financial institutions or asset managers from consolidated supervision, provided that they are based in the EU, do not take positions,

meet the capital requirements of the CRD on a solo basis and provided that the parent holds sufficient capital to cover the full book value of the firm that would otherwise be consolidated. Banks and other credit institutions cannot be exempted from consolidated supervision.

- In addition, supervisors of subsidiaries may delegate their supervisory responsibility to the authorities that authorise and supervise the parent institution.

Institutions will need to look closely at the wording of waivers, together with the use that they currently make of them. The scope of consolidation is likely to be subtly modified for many. In making these assessments, institutions will also need to be mindful of the changes to consolidated supervision brought about by the Financial Groups Directive.

13.4 Outside the EU

Leading non-G10 financial centres will apply Basel II, sometimes with local adaptations. For example, it is clear that Australia will implement Basel standards,¹⁶ as will Hong Kong¹⁷ and Singapore.¹⁸ In the run up to agreement in May 2004, there had been speculation that countries like China and India would not implement Basel II, but would remain on Basel I. In the event, this speculation has proved unfounded, with both countries reaffirming their support for the Basel process and declaring their intention to work towards Basel II standards over time.

More generally, as noted in the introduction, the Basel Committee and the Bretton Woods institutions have urged countries to adapt to Basel II at their own pace, and not to make implementation some form of financial virility symbol. Instead, they have urged developing countries to focus on compliance with some of the fundamental Core

¹⁶ See APRA APS 110 Capital Adequacy and APS 111 Capital Adequacy: Measurement of Capital.

¹⁷ See "Proposals for the Implementation of the New Basel Capital Adequacy Standards ('Basel II') in Hong Kong" August 2004

¹⁸ See for example the consultation by the Monetary Authority of Singapore on "IRB Approach – Definition of default", July 2004.

Principles of Banking Supervision, where the Financial Sector Assessment Programmes conducted by the IMF and World Bank have highlighted deficiencies. Indeed, Agustin Carstens, Deputy Managing Director of the IMF has stressed that “the premature adoption of Basel II in emerging countries could risk distracting their attention from important – even basic – supervisory deficiencies that are still widespread”.¹⁹

When – as the IMF has noted – some 45 per cent of emerging market economies are materially non-compliant with the principle of supervisory operational independence, and when some 70 per cent are not fully compliant with the principle of consolidated supervision, and when the loan evaluation practices of a large proportion of these countries are insufficient, there are other priorities than Basel II implementation.²⁰ Addressing these issues, and ensuring full compliance with Basel's Core Principles, will do much more than for financial stability.

13.4.1 Practical considerations in implementing Basel II

That moving to the adoption of Basel II may not be the first priority for all supervisors is a key message of the Basel Committee's paper on practical considerations in implementation. This paper was drawn up by a working group that brought together some G10 members but also representatives from non-G10 countries.²¹ It argues that supervisors outside the G10 should not be driven blindly by the Basel text and timeline, but should consider carefully the benefits of the new capital adequacy framework in the context of the domestic banking system of the country concerned. Where the Core Principles have not yet been implemented to provide a sound baseline supervisory

¹⁹ “Opportunities for Emerging and Developing Countries in International Standard Setting: An IMF Perspective”, Luncheon remarks at the fourth annual IMF/World Bank/Federal Reserve Seminar Basel II – The International Banking System at the Crossroads, Washington DC 2 June 2004.

²⁰ Ibid.

²¹ The countries represented were Australia, Brazil, France, Hong Kong, Japan, Mexico, Russia, Saudi Arabia, Singapore, South Africa and the United Kingdom together with representatives of the International Monetary Fund, the World Bank and the Bank for International Settlements.

system, this should receive priority.²² In particular, supervisors should consider implementing Pillars 2 and 3 (supervisory review and market discipline) even if Basel II Pillar 1 standards are not yet fully in place on the basis that it is these elements of Basel II that will be most conducive to the development of risk management and of an adequately capitalised and sound banking system.²³

Even where supervisors choose to move towards minimum capital standards that are consistent with Basel's Pillar 1 proposals, there is a recognition that implementation will need to suit local circumstances and that effective implementation of the Accord does not necessarily mean that all banks should be subject to the new standards, and that a simplified approach may be appropriate for less sophisticated institutions or those with a purely domestic focus. Supervisors adopting Basel II may also limit the choice of approach to capital adequacy that is available to their banks. That said, supervisors are encouraged – over time if need be – to extend the more complex capital adequacy approaches to complex, significant and internationally active banks.²⁴

Nor should the Basel minima, especially in the Standardised and Foundation IRB Approaches be applied blindly. The paper stresses that the risk weightings are calibrated to the experience of G10 countries, and that local supervisors should assess whether they are consistent with the experience in their jurisdiction. Similarly, the extension of credit risk mitigation envisaged by the proposals should depend on an assessment of whether the legal basis for the enforcement of collateral is effective and whether there is a liquid market in which to value and realise collateral.²⁵

More generally, national supervisors will need to think carefully about the choices that they make using the national discretions that are available under the Accord. An annex to the paper lists no fewer than some 61 areas of discretion.²⁶

²² Op. cit., p. 2

²³ Op. cit. pp. 1 and 4.

²⁴ Op. cit. pp. 7–9

²⁵ Op. cit. pp. 9–10

²⁶ Op. cit. pp. 28–36

There is a recognition that Basel II will require a substantial resource commitment on the part of both banks and supervisors. The availability of such resource should be a factor in considering whether and how to implement the new proposals. Even where appropriate staff are available, their skills will probably need to be significantly upgraded, and more specialist staff will be required. Non-personnel resources such as the regulatory reporting and information systems of supervisors are likely also to require attention. Even so, supervisors may need to consider making use of other parties such as external and internal audit and consultants.²⁷

13.4.2 Take up of Basel II

There are many ways to skin a cat, and – if the Practical Considerations Paper is any guide – there will be many approaches to Basel II. That said, it is clear from a study conducted by the Financial Stability Institute in Basel that compliance with Basel II remains a medium to long-term objective of most countries.²⁸ The FSI sent a questionnaire to 115 countries in Africa, Asia, the Caribbean, Latin America and the Middle East and non-G10 Europe exploring their intentions with regard to Basel and received a reply from 107. Of these no fewer than 88 non-G10 countries intended to adopt Basel II standards.

Some 31 jurisdictions indicated that they would implement Basel by the end of 2006. This cohort includes 15 EU countries that will be adopting Basel standards through the Capital Requirements Directive. A further 42 jurisdictions indicated an intention to implement between January 2007 and 2009. Nine countries indicated that they would implement Basel II sometime between 2010 and 2015.

Between 2007 and 2009, just over 5,000 banks controlling almost 75 per cent of banking assets in 73 non-Basel Committee jurisdictions are expected to be subject to Basel II. The FSI notes that a major driver for this appears to be the implementation of this framework locally by foreign controlled banks or local branches of foreign banks, with the

²⁷ Op. cit. pp. 25–27

²⁸ Financial Stability Institute, Occasional Paper No. 4 “Implementation of the New Capital Adequacy Framework in non-Basel Committee Member Countries”, July 2004.

Foundation Internal Ratings-Based (“IRB”) approach likely to be the most used methodology for calculating capital requirements for credit risk. The (simplified) Standardised approach, however, ranks closely behind the Foundation IRB.

The Basic Indicator approach seems to be the most widely employed method for calculating capital requirements for operational risk.

Little take-up of the most advanced methodologies is anticipated outside the major jurisdictions.

Taking these 88 and the countries represented on the Basel Committee, this means that over 100 countries are likely to implement Basel II standards in some form. This is not far short of the currency that the original Basel Accord has achieved and suggests that Basel will remain a global standard for some time to come. It is also a formidable challenge for financial institutions and regulators everywhere.

