2003-11-06

TO ALL CHIEF EXECUTIVE OFFICERS OF BANKS, BRANCHES OF FOREIGN BANKS AND MUTUAL BANKS

BANKS ACT CIRCULAR 14/2003

UPDATE ON THE IMPLEMENTATION OF THE NEW BASEL CAPITAL ACCORD AND REQUEST FOR FURTHER INFORMATION

Executive Summary

Some countries, including developed and developing countries have made pronouncements on the scope of application of the proposed new Basel Capital Accord ("Basel II"). For example, the United States of America will require only a small number of banks to be compliant with the new framework by the end of 2006. China, on the other hand, has indicated its intention to delay implementation of the New Accord, but to incorporate elements of the proposed new framework into its regulatory framework. In view of the global debate and some uncertainties, local banks are becoming anxious for the South African Reserve Bank to confirm its position on the implementation of the proposed new Accord. This circular communicates our initial thoughts on the subject. Further details will be published in a position paper, to be made available towards the end of 2003/by 1 February 2004. As an input to the position paper, this Office is requesting information pertaining to the scope of application of Basel II that banks are considering adopting on inception of the new regulatory framework. This input will guide this Office's implementation strategy.

1. INTRODUCTION

The third consultative document ("CP3") on Basel II was released in April 2003, for comment by 31 July 2003. The Basel Committee on Banking Supervision ("the Committee") has by now received some 200 comments from, among others, banks, banking supervisors, consultants, trade bodies and academics from the group-of-ten ("G10") and non-G10 countries. The comments generally support the principles and objectives of the new Accord, but raise concerns about, *inter alia*, the complexities of implementing the new Accord, calibration issues leading to unintended consequences and other concerns related to the technical mechanics of the proposed new Accord. Concerns also point to the excessive costs of implementing the more advanced approaches, and the resource and skills requirement for both banks and regulators. On 10 and 11 October 2003, the members of the Committee met in Madrid to decide on responses to public comments received. In a press release dated 11 October 2003, the Committee stated that all members agreed on the importance of finalising the New Accord expeditiously and in a manner that is technically and prudentially sound. The Committee members committed to work promptly to resolve the outstanding issues by no later than mid-year 2004. Despite the proposed delay in finalising the Accord, the Committee did not communicate any intentions to delay common implementation, which is due to take place on 31 December 2006.

Certain emerging markets, such as China, have indicated their intention to delay implementation, since this would currently be in the best interest of their banking sector. China, however, intends to incorporate elements of the proposed new Accord into its regulatory framework. India, although fully committed to implementing best international practice, argues that some of the issues relevant in the context of emerging markets and developing countries are yet to be addressed fully.

The G10 countries are not without concerns about implementing the proposed new Accord within their banking systems. In testimony to the United States ("US") Senate on 18 June 2003, the vice-chairman of the Board of Governors of the Federal Reserve System again outlined that in the US, Basel II will be imposed only on a small number of banks (the ten largest banks), and another ten banks are expected to follow. According to Mr William Rutledge, Executive Vice President, Federal Reserve Bank of New York, the twenty banks represent around 99 per cent of foreign assets held by the top fifty bank holding companies, and approximately two-thirds of all United States banking assets. A key aspect of this ruling is that most US banks will not adopt Basel II, but will continue to apply the Capital Accord of 1988[1]. The British Bankers' Association and the London Investment Banking Association recently made submissions to the Committee stating, *"The new Accord, as currently proposed, is unduly complex and will be difficult for our members to implement and for national regulators, even in the G10, to supervise"*. They propose that the much simpler existing rules be retained as an option throughout the transition period up until 2010[2].

In view of this global debate and some uncertainty surrounding the implementation of the proposed new Accord, local banks are becoming increasingly anxious for the South African Reserve Bank to confirm its position on the implementation of the proposed new Accord within South Africa.

This circular is intended to inform stakeholders of our overall (initial) position on the implementation of the proposed new Accord.

[1] The Banker. August 2003. Page 22 - 24

[2] Charles Pretzlik in London. The Financial Times. 7 August 2003

2. POSITION OF THE SOUTH AFRICAN RESERVE BANK ON THE IMPLEMENTATION OF THE PROPOSED NEW ACCORD

The mission of the Bank Supervision Department of the South African Reserve Bank is *"To promote the soundness of banks through the effective application of international regulatory and supervisory standards"*. In line with this mission, the current Capital Accord ("Basel I") was accepted as international best practice and was incorporated into the current regulatory framework.

This Office acknowledges that innovation in the business of banking, brought about by, *inter alia*, advancement in technology, may have diluted the effectiveness of Basel I for more complex banking organisations. Accordingly, this Office fully supports the proposed new Accord, and is fully committed to its implementation in accordance with the Committee's timeframe. This Office is of the opinion that application of the principles set forth in the proposed new Accord would be in the best interest of the South African banking system as a whole, and therefore, overall financial stability. This Office confirmed its views on the implementation of the new Accord with its comments on CP3 to the Committee on 31 July 2003. **This Office then stated that it was of the view that the proposed new Accord was suitable for application in both G10 and non-G10 countries, since it provided a menu of approaches suitable for both the most sophisticated and the least sophisticated banks.** The Standardised and Simplified Standardised approaches, the Foundation and Advanced Internal Ratings Based approaches are available for calculating capital requirements for credit risk. Similarly, the menu of approaches available for the calculation of the capital charge for operational risk includes the Basic Indicator approach, the Standardised (and Alternate Standardised) approach and the Advanced Measurement Approach. Comprehensive guidelines for these approaches are set out in the Committee's third consultative paper found on their website – www.bis.org/publ/bcbsca.htm.

This Office further stated that: *"BSD and the banks that it regulates, are endeavouring to implement the New Accord no later than is required by the members of the Committee"*. Furthermore, in his address at the eighty-third ordinary general meeting of shareholders, the Governor of the South African Reserve Bank confirmed that: *"Banks are positive about complying with the new accord and regard it as a strategic challenge. The application of the new framework will require the re-engineering of supervision processes and organisational structures. In collaboration with other supervisors, the Bank is developing an implementation strategy for Basel II."*

The first phase of implementation will involve the determination of the scope of application of the new Accord. This Office would therefore need to establish the range of approaches that banks could reasonably be expected to apply in the appropriate time frame, as well as the selection of banks that would be subject to the new framework. This would be an iterative process, since it would be based on both qualitative and quantitative criteria. This Office has decided on a consultative process and will take the interest of all stakeholders into account. Cognisance will be taken of the results of banks' own evaluation of their readiness; an analysis of supervisory readiness; the overall impact of the chosen approaches on capital levels and competitive equity considerations. Apart from bilateral discussions with banks, the Accord Implementation Forum will continue to serve as the platform for consultation.

This Office is currently determining the strategic alternatives in the implementation of Basel II as well as establishing tactical plans for the implementation of the proposed new Accord. This process will be communicated by means of a detailed position paper, which will be made available to all interested stakeholders before the end of 2003 or by 1 February 2004. This Office will, through the position paper, endeavour to inform the banks of its decision on certain items of national discretion.

This Office's strategy on the implementation of Basel II will largely be guided by, *inter alia*, banks' choices of the various approaches available in Basel II, as well as resource constraints. Limited resources must be optimally utilised, and therefore, implementation must be focused on the approaches that are most widely proposed to be adopted by banks. In an attempt to assess the most likely approaches banks will be intending to adopt, this Office has compiled a survey that is intended to gather the necessary information in the determination of the scope of application and devising the appropriate strategies for implementation. The survey is herewith attached and marked "Annexure A". Please submit the completed survey to Dr Riaan Hattingh, at fax number (012) 313 3758, or to his e-mail address Riaan.Hattingh@resbank.co.za, by no later than Wednesday 19 November 2003. Implementation is expected to be a complex iterative process, and banks may well change their strategic intent in the interim period leading up to common implementation. It is for this reason that this Office merely requires initial thoughts on the likely approaches each bank is in the process of considering. The initial responses will in no way bind individual banks to the proposed approaches decided on.

Please direct any queries to this Office for the attention of Mr Jay Tikam, at telephone number (012) 313 4681, or to his e-mail address Jay.Tikam@resbank.co.za.

3. ACKNOWLEDGEMENT OF RECEIPT

Two additional copies of this circular are enclosed for the use of your institution's independent auditors. The attached acknowledgement of receipt, duly completed and signed by both the chief executive officer of the institution and the said auditors, should be returned to this Office at the earliest convenience of the aforementioned signatories.

E M Kruger
Registrar of Banks

ENCL. 1

The previous circular issued was Banks Act Circular 13/2003 dated 3 November 2003.