G10 central bank governors and heads of supervision endorse the publication of the revised capital framework

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Central bank governors and the heads of bank supervisory authorities in the Group of Ten (G10) countries met today and endorsed the publication of the International Convergence of Capital Measurement and Capital Standards: a Revised Framework, the new capital adequacy framework commonly known as Basel II. The meeting took place at the Bank for International Settlements in Basel, Switzerland, one day after the Basel Committee on Banking Supervision, the author of the text, approved its submission to the governors and supervisors for review.

The Basel II Framework sets out the details for adopting more risk-sensitive minimum capital requirements for banking organisations. The new framework reinforces these risk-sensitive requirements by laying out principles for banks to assess the adequacy of their capital and for supervisors to review such assessments to ensure banks have adequate capital to support their risks. It also seeks to strengthen market discipline by enhancing transparency in banks' financial reporting. The text that has been released today reflects the results of extensive consultations with supervisors and bankers worldwide. It will serve as the basis for national rule-making and approval processes to continue and for banking organisations to complete their preparations for the new Framework's implementation.

"Basel II embraces a comprehensive approach to risk management and bank supervision," explained Mr Jean-Claude Trichet, Chairman of the G10 group of central bank governors and heads of bank supervisory authorities and President of the European Central Bank. "It will enhance banks' safety and soundness, strengthen the stability of the financial system as a whole, and improve the financial sector's ability to serve as a source for sustainable growth for the broader economy. I am pleased to offer this revised framework to the international community."

"The new Framework represents an unparalleled opportunity for banks to improve their risk measurement and management systems," added Mr Jaime Caruana, Chairman of the Basel Committee on Banking Supervision and Governor of the Bank of Spain. "It builds on and consolidates the progress achieved by leading banking organisations and provides incentives for all banks to continue to strengthen their internal processes. By motivating banks to upgrade and improve their risk management systems, business models, capital strategies and disclosure standards, the Basel II Framework should improve their overall efficiency and resilience."

The G10 governors and supervisors supported the Basel Committee's plans to continue discussions on key implementation issues with the industry and other authorities as domestic adoption and approval processes proceed.

The Basel Committee intends for the new framework to be available for implementation in member jurisdictions as of year-end 2006. The most advanced approaches to risk measurement will be available for implementation as of year-end 2007, in order to allow banks and supervisors to benefit from an additional year of impact analysis or parallel capital calculations under the existing and new rules. The G10 governors and supervisors encouraged authorities in other jurisdictions to consider the readiness of their supervisory structures for the Basel II Framework and recommended that they proceed at their own pace, based on their own priorities.

The governors and supervisors also extended their thanks to all those who had contributed to the process to develop and strengthen the quality of the revised framework over the past six years and expressed appreciation for the leadership exercised by William McDonough and Jaime Caruana, the Committee's prior and current chairmen, respectively. They indicated that the Basel Committee's work benefited from the transparency and scale of the public consultations that took place both within the G10 countries and around the world, helping to make the new framework a global product. The governors and supervisors noted that the Basel Committee would continue to work in the spirit of openness and consultation in the future. Regular communication by the Committee of its future plans will enable the Committee and the industry to prioritise their work effectively.

Note to Editors

What is the Basel II Framework?

The *International Convergence of Capital Measurement and Capital Standards: a Revised Framework*, or the "Basel II Framework," offers a new set of standards for establishing minimum capital requirements for banking organisations. It was prepared by the Basel Committee on Banking Supervision, a group of central banks and bank supervisory authorities in the G10 countries, which developed the first standard in 1988.

Why are banks subject to capital requirements?

Nearly all jurisdictions with active banking markets require banking organisations to maintain at least a minimum level of capital. Capital serves as a foundation for a bank's future growth and as a cushion against its unexpected losses. Adequately capitalised banks that are well managed are better able to withstand losses and to provide credit to consumers and businesses alike throughout the business cycle, including during downturns. Adequate levels of capital thereby help to promote public confidence in the banking system.

The technical challenge for both banks and supervisors has been to determine how much capital is necessary to serve as a sufficient buffer against unexpected losses. If capital levels are too low, banks may be unable to absorb high levels of losses. Excessively low levels of capital increase the risk of bank failures which, in turn, may put depositors' funds at risk. If capital levels are too high, banks may not be able to make the most efficient use of their resources, which may constrain their ability to make credit available.

What requirements apply currently to banking organisations?

The 1988 Basel Capital Accord set out the first internationally accepted definition of, and a minimum measure for, bank capital. The Basel Committee designed the 1988 Accord as a simple standard so that it could be applied to many banks in many jurisdictions. It requires banks to divide their exposures up into broad "classes" reflecting similar types of borrowers. Exposures to the same kind of borrower – such as all exposures to corporate borrowers – are subject to the same capital requirement, regardless of potential differences in the creditworthiness and risk that each individual borrower might pose.

While the 1988 Accord was applied initially only to internationally active banks in the G10 countries, it quickly became acknowledged as a benchmark measure of a bank's solvency and is believed to have been adopted in some form by more than 100 countries. The Committee supplemented the 1988 Accord's original focus on credit risk with requirements for exposures to market risk in 1996.

Why is a new capital standard necessary today?

Advances in risk management practices, technology, and banking markets have made the 1988 Accord's simple approach to measuring capital less meaningful for many banking organisations. For example, the 1988 Accord sets capital requirements based on broad classes of exposures and does not distinguish between the relative degrees of creditworthiness among individual borrowers.

Likewise, improvements in internal processes, the adoption of more advanced risk measurement techniques, and the increasing use of sophisticated risk management practices such as securitisation have changed leading organisations' monitoring and management of exposures and activities. Supervisors and sophisticated banking organisations have found that the static rules set out in the 1988 Accord have not kept pace with advances in sound risk management practices. This suggests that the existing capital regulations may not reflect banks' actual business practices.

How does Basel II differ from the 1988 Basel Capital Accord?

The Basel II Framework is more reflective of the underlying risks in banking and provides stronger incentives for improved risk management. It builds on the 1988 Accord's basic structure for setting capital requirements and improves the capital framework's sensitivity to the risks that banks actually face. This will be achieved in part by aligning capital requirements more closely to the risk of credit loss and by introducing a new capital charge for exposures to the risk of loss caused by operational failures.

The Basel Committee, however, intends to maintain broadly the aggregate level of minimum capital requirements, while providing incentives to adopt the more advanced risk-sensitive approaches of the revised Framework. Basel II combines these minimum capital requirements with supervisory review and market discipline to encourage improvements in risk management.

What is the goal for the Basel II Framework and how will it be accomplished?

The overarching goal for the Basel II Framework is to promote the adequate capitalisation of banks and to encourage improvements in risk management, thereby strengthening the stability of the financial system. This goal will be accomplished through the introduction of "three pillars" that reinforce each other and that create incentives for banks to enhance the quality of their control processes. The first pillar represents a significant strengthening of the minimum requirements set out in the 1988 Accord, while the second and third pillars represent innovative additions to capital supervision.

I. **"Pillar 1"** of the new capital framework revises the 1988 Accord's guidelines by aligning the **minimum capital requirements** more closely to each bank's actual risk of economic loss.

- First, Basel II improves the capital framework's sensitivity to the risk of credit losses generally by requiring higher levels of capital for those borrowers thought to present higher levels of credit risk, and vice versa. Three options are available to allow banks and supervisors to choose an approach that seems most appropriate for the sophistication of a bank's activities and internal controls.
    - Under the "standardised approach" to credit risk, banks that engage in less complex forms of lending and credit underwriting and that have simpler control structures may use external measures of credit risk to assess the credit quality of their borrowers for regulatory capital purposes.

  - Banks that engage in more sophisticated risk-taking and that have developed advanced risk measurement systems may, with the approval of their supervisors, select from one of two “internal ratings-based” (“IRB”) approaches to credit risk. Under an IRB approach, banks rely partly on their own measures of a borrowers’ credit risk to determine their capital requirements, subject to strict data, validation, and operational requirements.

- Second, the new Framework establishes an explicit capital charge for a bank’s exposures to the risk of losses caused by failures in systems, processes, or staff or that are caused by external events, such as natural disasters. Similar to the range of options provided for assessing exposures to credit risk, banks will choose one of three approaches for measuring their exposures to operational risk that they and their supervisors agree reflects the quality and sophistication of their internal controls over this particular risk area.

- By aligning capital charges more closely to a bank’s own measures of its exposures to credit and operational risk, the Basel II Framework encourages banks to refine those measures. It also provides explicit incentives in the form of lower capital requirements for banks to adopt more comprehensive and accurate measures of risk as well as more effective processes for controlling their exposures to risk.

II. “Pillar 2” of the new capital framework recognises the necessity of exercising effective **supervisory review** of banks’ internal assessments of their overall risks to ensure that bank management is exercising sound judgement and has set aside adequate capital for these risks.

- Supervisors will evaluate the activities and risk profiles of individual banks to determine whether those organisations should hold higher levels of capital than the minimum requirements in Pillar 1 would specify and to see whether there is any need for remedial actions.

- The Committee expects that, when supervisors engage banks in a dialogue about their internal processes for measuring and managing their risks, they will help to create implicit incentives for organisations to develop sound control structures and to improve those processes.

III. “Pillar 3” leverages the ability of **market discipline** to motivate prudent management by enhancing the degree of transparency in banks’ public reporting. It sets out the public disclosures that banks must make that lend greater insight into the adequacy of their capitalisation.

- The Committee believes that, when marketplace participants have a sufficient understanding of a bank’s activities and the controls it has in place to manage its exposures, they are better able to distinguish between banking organisations so that they can reward those that manage their risks prudently and penalise those that do not.