

# Global Risk Regulator

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## Dissent and wrangling in the US

Op risk opponents activate the political process. House hearings scheduled for February. Regulators divided.

*By Melvyn Westlake*

US opponents of proposals to regulate large banks' operational risks have been boosted by the decision of a key Congressional committee to hold hearings on the new rules early this year. The move fulfils the opponents' threat to "activate the political process" in their bid to get the proposed regulations changed.

It is far from definite that the hearings by the House of Representatives Financial Services Committee, expected in late February, will result in any firm recommendation that the proposed regulations be reconsidered. But the hearings will create new uncertainty over the ability of US regulators to approve the

Basel II capital accord, in the form that it is now emerging after five years of painstaking discussion between the 13 countries represented on the Basel Committee for Banking Supervision.

The regulatory treatment of operational risks - risks arising from events such as fraud, systems failures or processing errors - is the most vexed and controversial aspect of the accord for many of the US banks that will be subject to the new regime when it is introduced in late 2006 (on the present timetable). There are sharp differences over the treatment of operational risk even among the four US regulatory agencies represented on the Basel Committee. While Jerry Hawke, Comptroller of the Currency is to page 4

## Date set for Singapore insurance rules

Latest proposals for general insurers are aimed at harmonised risk-based supervision of the financial sector

*By David Keefe*

Singapore regulators are targeting January 1, 2004 as the date for bringing new risk-based rules into force to safeguard the solvency of both general and life insurance companies in the city-state.

Whether that target will be met depends to a large extent on whether any major revisions are needed, in the light of industry comment, to new rules just proposed for general insurance companies, says a spokesman for the Monetary Authority of Singapore (MAS), the city state's central bank and chief financial services watchdog.

Singapore regulators are still refining their plans for the risk-based supervision of life assurance companies that they had originally hoped to bring into effect from January 1 this year.

The plans were delayed because of modifications made in the light of comment from the life assurance industry. Now

the intention is to bring the two complementary sets of rules into force together.

Insurance industry analysts say the need for two different, but related, approaches to the regulation of general and life insurance companies lies in their different risk profiles. Life insurers have greater certainty about what future claims will be made against their life policies; general insurers have less certainty about the claims likely to be made against, for example, their fire and accident policies.

This tends to mean that general insurers need to hold more buffer capital than life insurers do to help absorb unexpected claims, analysts note.

The new proposals for general insurers are all part of a strategy by MAS to bring banks, insurance companies and investment firms under harmonised, risk-based supervision, both as a matter of prudence and to help ensure Singapore remains a leading financial centre.

The proposals for general insurers to page 6

## Time pressure builds for analysing QIS 3 results

Working Group will study responses at three-week session. Basel Committee expects to review findings at March meeting

By David Keefe

Global banking regulators acknowledge the schedule is tight for analysing responses to the key QIS 3 survey of banks and incorporating any lessons from them in the final consultative paper on the Basel II bank capital accord that the regulators hope to issue in May.

But supervisors with the Basel Committee on Banking Supervision, the architect of the controversial and twice-delayed accord that is intended to make

the world's banking system safer, are generally confident they can keep to the timetable.

QIS 3, or the third Basel II quantitative impact study, polled more than 200 banks in nearly 50 countries seeking information on how the complex and risk-based accord would affect them. Responses to QIS 3 had to be with national banking supervisors by December 20.

As *Global Risk Regulator* went to press,

national regulators generally said they were still collating the vast amount of information involved.

Bankers declined to comment on the information they had given in QIS 3. Having completed the survey as requested, many banks were themselves analysing the significance of the data they had supplied.

But several banking sources said the QIS 3 exercise provided a useful *to page 8*

## Taylor plan to scrap Basel II and start again

An idea for an alternative capital adequacy regime for banks is being closely examined by several key regulators in the US and UK

By Melvyn Westlake

Bank regulators, returning from the Christmas break, have discovered a paper in their in-trays that threatens to provide a powerful new rallying point for opponents of the controversial Basel II capital regime for the world's major banks. The paper, which advocates the scrapping of the proposed Basel II accord, and its replacement by a simpler and cogent alternative, is written by Charles Taylor, director of operational risk at the Risk Management Association in Philadelphia, and former executive director of the Group of 30, a Washington-based thinktank for bankers and central bankers.

Not only is the risk management framework adopted by Basel II already behind the industry's best practice, and excessively complex, but most importantly, it "may have the unintended consequence of undermining bank governance," Taylor argues. "It is very dangerous for regulators to micro-manage banks on a continuing basis. This undermines the responsibilities and erodes the accountability of bank management," he says. Amplifying his case in an interview with *Global Risk Regulator*: he says: "Micro-management in a uniform way is not only bad news for the governance of individual institutions, but also for the bio-diversity of the glob-

al banking system. Would you really want every bank to be run the same way, so that when we experience a shock, they all do the same thing?" he asks rhetorically.

His alternative – a New Generalised Approach or NGA\* – would not only avoid these dangers, he claims, it would get around several other problems identified with Basel II. It encourages "best practice;" increases fairness between banks and non-banks; makes it easier for the European Union to extend the capital standards to non-banks; eliminates the tendency of risk-based capital adequacy regimes to worsen economic downturns; and would avoid encouraging *to page 9*

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Subscriptions: See Page 24

# Global Risk Regulator

## A new publication for a new regulatory era

Welcome to the first issue of *Global Risk Regulator*. This newsletter, and related e-mail news service, are intended to meet the ever-growing demand for information about regulation in the world's financial services industry. Almost everywhere, financial firms are facing a regulatory revolution.

The Basel II capital accord, scheduled to take effect at the end of 2006, will have profound consequences for many banks. The European Union's new capital adequacy directive will extend the proposed Basel II regime to all banks and investment firms in what, by 2006, is expected to be a 25-nation union.

New regulations will also require insurance companies in many countries to measure and manage the risks they actually face rather than simply obey one-size-fits-all solvency rules.

Meanwhile, corporate governance scandals have set in train a wave of new regulations in the US. And, the fragility of many Japanese financial institutions will eventually lead to regulatory changes there, too. For sure, in Japan's case, the biggest problem is that the existing rules, stipulated under the first Basel accord, are simply being ignored. This is, however, an unsustainable situation.

Yet, so complex and extensive are the new rules that no one individual, even the most dedicated expert, can hope to follow all developments and maintain a grasp on all aspects of the overlapping risk management regimes. For many chief executive officers and chief operating officers, it is simply a nightmare.

Outside the sophisticated inner circle of banks, there are hundreds more that have barely begun to grapple with even the most basic of the risk-based forms of regulation stipulated under Basel II.

We think *Global Risk Regulator* can help. With a monthly newsletter (in hard copy or electronic form), providing

comprehensive reporting and informed analysis, and an internet service offering rapid up-dates and breaking news, *GRR* can contribute to a better understanding of events and what they mean for the risk management industry.

An independent publishing team, with no axe to grind, we subscribe to the traditional journalistic values of concise and objective reporting - no shibboleths, no jargon. We would, however, like to believe that we can be an important information resource for our subscribers.

Among other things *Global Risk Regulator* will:

- \* follow and analyse the trend to risk-based regulation of banks, insurance companies and securities firms around the world: a trend that regulators believe will make the financial system safer, but which some critics think will bring hazardous complexity at great financial expense;

- \* provide detailed coverage of the progress of the Basel II international bank capital adequacy accord, as well as the parallel risk-focused European capital adequacy rules. And we'll be looking at the impact of both Basel II and the EU proposals on local banks;

- \* follow insurance sector developments, such as the European Commission's Solvency II plans, the UK's Tiner review of regulations and Singapore's risk-based capital proposals that aim to apply risk-sensitive rules to the supervision of insurance companies;

We'll keep a constant eye on such countries as the US, Canada and Australia where risk-based insurance regulation is well advanced;

- \* look at the key accounting questions and the development of the information technology needed to support sophisticated risk management and measurement;

- \* keep subscribers up to date on the latest thinking among regulators, as well as

the issues that divide them, and the political background to their decisions

- \* monitor the debate among private sector practitioners, lobby groups and professional bodies;

- \* follow developments in many of the smaller countries, outside the major industrial group, who are struggling not to be left behind in an industry where it is becoming hugely costly even for the world's biggest banks to pursue best practice

In addition, the newsletter's pages will be open to professional and academic contributors who wish to argue the merits of the theories and mathematical models that underpin the higher level of risk-sensitive regulation.

We look forward to providing you with a high-quality and comprehensive service of news, comment and analysis on this important and controversial subject. **GRR**

### Our Editorial Team:

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## US Controversy Reaches Congress

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sympathetic to the opponents of the proposed op risk rules, William Rutledge, head of banking supervision at the New York Federal Reserve Bank, and his boss, William McDonough, the NY Fed president, and chairman of the Basel Committee, broadly back the draft accord.

The House Financial Services Committee hearings are a response to heavy lobbying by major US banks, particularly the specialist firms, such as State Street, Mellon Bank, Northern Trust and the Bank of New York, whose businesses are heavily dominated by a single activity, such as asset management, or custodian services, or cheque clearing. Some of these banks, which believe they will be put at a severe competitive disadvantage by the proposed op risk rules, have formed the Financial Guardian Group, to lobby Congress on their behalf.

They are campaigning to have op risk excluded from Pillar 1, under the Basel II capital accord. Pillar 1 involves the measurement of risks, and the calculation of the capital that banks must set aside to meet them. Many banks are seeking, instead, to have op risk primarily treated under the second of the accord's three Pillars, which involves supervisory assessment of a bank's risk control framework, but no capital charge (Pillar 3 is concerned with information disclosure and market discipline).

### A forceful letter

Responding to this lobbying, Ohio Republican Michael Oxley, chairman of the House Financial Services Committee, and its ranking Democrat, Barney Frank from Massachusetts, wrote in the autumn to Federal Reserve Board chairman Alan Greenspan, informing him of their intention to hold hearings on the subject of operational risk regulation. In a forceful letter, the Congressmen note Comptroller Jerry Hawke's preference that op risk be treated under Pillar 2, as well as industry concerns that many US

banks will, otherwise, be at a competitive disadvantage vis-à-vis their European financial rivals. The Congressmen want to know whether the preference of some US regulators for Pillar 1 over Pillar 2 "reflects to some extent the need to reach agreement with European regulators who are insisting on a Pillar 1 approach." And they want to "explore further the extent to which foreign insistence is at the root of the Pillar 1 choice." Worries about US bank competitiveness under the proposed capital accord are not restricted to foreign rivals. They

**"Why should it be predetermined that even institutions that have done an excellent job of securing against operational risk should have to pay a capital charge?"**

extend also to non-bank domestic financial institutions, such as asset managers and payments processors, who will not be subject to the new regulatory regime. "Why should it be predetermined that even institutions that have done an excellent job of securing against operational risk in many ways should have to pay a [capital] charge?" the Congressmen ask. "And this leads to a question as to whether or not there will be a competitive disadvantage between even the best financial institutions that come under bank regulation and competitors that do not come under the bank regulatory scheme," the letter says. It adds: the committee should explore how pricing distinctions might be avoided "between two equally well-run institutions, and whether or not we are providing some incentives for people to change the nature of their charters to avoid regulation."

The Basel Committee has already made some Pillar 1 concessions, softening its impact by introducing a concept known as the "Advanced Measurement Approaches," which allows greater flexibility in the way each bank constructs systems to assess and manage its own individual op risk exposure. But this has not placated the opposition.

"We are appreciative [of these concessions], but we are not going away," says

Karen Shaw Petrou, executive director of the Financial Guardian Group, the most aggressive of the anti-Pillar 1 lobbyists. Some of the problems faced by American banks arise from the specific legal risks unique to the US, such as compliance with laws against employment and loan discrimination, she explains. Under the proposed rules, which Petrou describes as "completely arbitrary," US banks would have to measure and hold capital against such risks. "Securities laws already oblige firms to disclose major legal risks and hold reserves against them. We do not understand why there should be a regulatory charge on top of that," Petrou says. And, as the specialist US banks do not have large loan portfolios, they will not be able to offset the op risk capital charge by achieving a more risk-sensitive charge on their credit risk.

But regulators at the New York Fed argue that many of these concerns have already been addressed, particularly with the development of the Advanced Measurement Approaches (AMA), under Pillar 1, and the elimination of a floor for the op risk capital charge. They leave little doubt that they expect the larger US banks to adopt the AMA framework. "Operational risk is a major driver of risk within banking organisations, and there are a lot of good reasons to embed [the management of them] within Pillar 1," says the New York Fed's Rutledge,

### Fed to be flexible

However, as op risk measurement is less developed than either credit risk or market risk measurement, the Fed is prepared to be flexible, making its determination of risk exposure under the AMA "much more individual, institutionally driven," he says. "In effect, this will capture the spirit of Pillar 2."

And, the specialised banks will not be at a marked disadvantage in relation to non-bank financial firms undertaking similar business activities, argues Rutledge, if the amount of regulatory capital that banks must hold is broadly in line with the level of economic capital that they need to keep, anyway. All financial firms – whether banks, or not – need a certain level of economic capital in order to run sound

businesses, and meet unforeseen risks, whereas regulatory capital represents a minimum requirement.

Banks will be allowed to assess their own op risks under Pillar I Advanced Measurement Approaches. As long as regulators approve such assessments, the capital that banks hold for regulatory purposes should be no higher than economic capital.

If the markets, too, accept the validity of these assessments, and oblige non-bank financial firms to apply comparably sound practices, the playing field should become more level over time for all participants, according to Rutledge.

Regulators over at the Office of the Comptroller of the Currency (OCC) in Washington also think that changes introduced into Pillar I last year (2002), including the flexibility embodied in the AMA, represent a significant improve-

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**“Most banks are not betting on Pillar 2 being the regulatory bulwark for op risk, and are working towards Pillar 1”**

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ment. And a further softening seems likely during the process of implementing the Basel II accord in the US.

Employing a distinctly more conciliatory tone towards the banks than adopted by other regulatory agencies, Kevin Bailey, OCC deputy comptroller, of bank supervision policy, says operational risk is “still an evolving discipline, and we need to make sure that we get the final regulations right, in consultation with the industry.” He adds: “We want to put our own implementing regulation in place using much more tangible language than in the present Basel document.” The intention is to issue, possibly next July, a Notice of Proposed Rule Making (the procedure used in the US to develop regulation), based on that more tangible language. Comments on this notice will then be sought from banks, including the specialised variety. “We will have to figure out where to go after assessing those comments,” Bailey says.

Although the notice will be “consistent with the spirit and purpose of the proposed accord, there are “areas of nation-

al discretion that have to be taken into account,” as well as “different regulatory regimes and different supervisory structures that have to be rationalised,” he adds. These differences, between the American regulatory system, and those of the European Union and Japan, mean that “the literal implementing language in the US will not be identical with that of the accord.” And, while the Notice of Proposed Rule Making will put operational risk under Pillar I, this “will be amenable to comments under the notice and comments process,” Bailey says.

The US banks, themselves, are far from agreed on their view of the present Basel accord proposals. Senior JP Morgan executives insist that their bank will have fully compliant operational risk models in place by the time the Accord goes into effect. There are others that are similarly confident. But one strong opponent of the current op risk proposals insists that most of the top ten US banks are against the new rules. “It is not even possible to define op risk, let alone measure it,” he says.

However, many of the big banks seem resigned to putting the necessary op risk requirements in place. “Most banks are not betting on Pillar 2 being the regulatory bulwark for op risk, and are working towards Pillar 1,” says a risk management consultant. Only the specialised banks seem likely to resist until the bitter end. “For them, it could be the beginning of the end of competing as regulated banks,” says the consultant, implying that the specialised banks will surrender their bank charters and register as non-bank financial institutions.

### Which US banks affected?

But, it remains unclear how many of the 8,400 US banks will eventually be fully subject to the Basel II capital accord. The final decision may not be taken until after the accord is finalised at the end of 2003. Illustrating some current supervisory thinking, Rutledge divides the US banks into three categories. In the top tier are 10 to 20 large, “internationally active” banks, that have complex operations and sophisticated risk management systems that “clearly will be subject to the accord, and expected to adopt the advanced approach-

es [for assessing capital charges]” he says. In the second tier, are large, regionally focussed banks within the US that typically do not have international operations, but “do have a size and complexity of

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**One strong opponent of the current op risk proposals insists that most of the top ten US banks are against the new rules. “It is not even possible to define op risk, let alone measure it,”**

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activities that makes elements of the accord rather relevant to their businesses.” These banks will not necessarily be subject to the accord, but they may voluntarily seek to adopt it as their businesses evolve.

Supervisors in the US still have to “think through what kind of capital regime makes sense” for the vast bulk of mostly community banks that make up the third tier, he says.

A possibility, according to one bank regulator in Washington, would be for the community banks to simply remain subject to the 1988 Basel accord, which sets an 8% minimum capital adequacy ratio. All US banks were subject to the first accord. A variant of this approach, he says, would be to also adopt some elements of the proposed Pillars 2 and 3 (supervision and market discipline) into the supervisory policy for smaller banks, although this would be some years away.

Meanwhile, US banks in the top tier are certainly being left in no doubt that they will be expected to adopt the advanced Internal Ratings Based (IRB) approach to measuring credit risk. In recent months, the chief executive officers and other senior executives of the largest banks are reported to have been called into the Federal Reserve Board, by its vice president, Roger Ferguson, and told that this is what they are required to do.

“Let me phrase it this way,” says one regulator: “It is our strong expectation [that the large banks will adopt the IRB approach]. We have a bias in that direction.” **GRR**

## Singapore sets insurance date

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were made in a discussion paper on a new risk-based capital framework issued in late December by a workgroup chaired by MAS (see box). February 14 is the deadline for comment from the more than 100 insurance and reinsurance companies, foreign and local, that will be affected by the new rules.

The paper says a change to a risk-based approach, which aims to bring prudential policies more into line with the risks actually faced by general insurers and improve the valuation of assets, is necessary because of the mounting complexity of the insurance business. In particular, regulators are concerned about the increased volatility of asset risks and diversity of liability risks in insurance companies.

### A risk-based supervisory approach for insurance companies would rely heavily on the strength of company leadership and management.

The workgroup says it drew on the approaches to risk-based regulation of insurance companies in the UK, the US, Canada and Australia.

In order that the new rules are transparent, not unduly complex and comparable across companies, the paper says the so-called standardised approach should be used. This means the factors for the risk charges and the calculation of capital requirements will be prescribed for insurance firms; firms will not calculate the charges on the basis of their own models of the risks they face, for example.

The paper says the current solvency margin requirements for general insurers don't accurately reflect the relative volatility of different lines and classes of general insurance and don't take into account the market and credit risks of the firm's assets.

Furthermore, the current asset valuation method used - the lower of book or market value - could distort the true value of assets and, in turn, the true solvency position of an insurance fund. The paper says

asset valuation should be on a fair value basis similar to that proposed for life insurers.

Singapore-based companies polled by *Global Risk Regulator* for early reactions to the paper said they were still digesting the proposals and would not comment until later.

But the workgroup wants feedback from insurers and says it intends to work closely with the industry in the testing and further fine-tuning of the proposals. And the workgroup included experts from three industry bodies - the Singapore Actuarial Society, the General Insurance Association of Singapore and the Singapore Reinsurers Association - as well as the Institute of Certified Public Accountants of Singapore.

The workgroup proposes a framework consisting of a fund solvency requirement, applicable to each insurance fund and a capital adequacy requirement, applicable at the company level.

The fund solvency requirement would ensure the available assets are greater than its required fund solvency, namely the total of charges that would be made against liability risks, market and credit risks and the risk posed by the concentration of investments in a particular asset class.

Under the capital adequacy requirement, insurers would have to maintain a ratio of available capital, including the available assets of insurance funds and shareholders' funds, to required capital. Required capital is the sum of the required fund solvency of all the insurance funds of a company and the asset risk charges of shareholders' funds.

### Best Practice by 2005

MAS chairman and Singapore deputy prime minister Lee Hsien Loong said last year that a risk-based supervisory approach for insurance companies would rely heavily on the strength of company leadership and management. Lee said then that MAS aims to have all insurance companies meeting international best practice standards by 2005.

Within the risk-based rules, MAS would expect company directors to provide clear strategic leadership and set consistent corporate values.

Meanwhile, MAS created a new prudential

policy department on September 1 last year to integrate the risk-based regulation of banks, insurance companies and investment firms. The risk-based Basel II bank capital accord, which global banking regulators want to bring into effect for major banks by the beginning of 2007, will apply to banks in Singapore.

### The proposals in detail

Proposed new risk-based capital rules for general insurance companies in Singapore will much better reflect the underlying risks faced by insurers than does current regulation, the Risk-Based Capital Workgroup says in its paper.\*

The new rules will promote a higher and more stringent level of asset and liability risk management among general insurers, both in terms of underwriting new risks and of continuous monitoring of insurers' existing business, the 80-page paper says.

The new rules will help counter the increased volatility of their asset risks and diversity of the risks to their liabilities.

General insurance companies are facing mounting complexities and many of the new risks are not explicitly tackled in Singapore's current solvency margin requirement.

The current solvency margin is a percentage, which varies by type of insurer and type of fund, of net written premiums or outstanding claims reserves. It imposes an asset concentration risk charge - to guard against the hazards of a high concentration of investment in certain asset classes and sectors - via asset admissibility rules.

The paper acknowledges the virtues of the simplicity of the existing solvency rule, but says it does not adequately reflect the relative volatility of different lines and classes of general insurance business and doesn't take into account the market and credit risks of the assets.

The current asset valuation method of using the lower of book or market value has the advantage of producing relatively stable results over time. But the method promotes the accumulation of hidden margins that could distort the true or fair values of the assets and in turn the

true solvency position of an insurance fund.

The new rules will centre on a fund solvency requirement applicable to each insurance fund and a capital adequacy requirement that will apply at the company level.

The new risk-based rules - which are intended to reflect all the relevant risks faced by general insurers - will address asset risks that aren't reflected in current rules and also refine the allowance for liability and concentration risks.

They will also help to align Singapore insurance regulation with the global trend to risk-adjusted capital requirements and transparent valuation, the paper says.

## Early Warning Indicator

The new rules should also serve as an early warning indicator of trouble in a company and aid intervention by both companies and regulators.

The Risk-Based Capital Workgroup comprises officials from the Monetary Authority of Singapore (MAS), the city-state's central bank and chief financial services watchdog, and Singapore's insurance industry and accounting trade bodies. The deadline for industry responses to the paper is February 14.

The new rules would complement risk-based capital standards being developed for life assurance companies in Singapore.

The new rules are based on several principles in addition to the aim that they reflect all relevant risks faced by general insurers. The capital adequacy requirements should be consistent with the asset and liability valuation basis for capital to serve as an effective buffer to absorb fluctuations in asset and liability values. The rules should as far as possible be consistent with that of other financial institutions, such as life insurers and banks, so that there's a level playing field and the opportunities for capital arbitrage in an increasingly integrated financial services industry is minimised.

The framework should also be transparent, not unduly complex, and be comparable across companies. The paper therefore proposes the adoption of the so-called standardised approach using prescribed risk charges, rather than subjectively

determined ones.

The impact of the new risk-based rules on general insurance funds and companies is not directly obvious yet, the paper says.

**It's likely that companies with more volatile policy liabilities and higher asset risk exposures "will be more negatively affected".**

But it's likely that companies with more volatile policy liabilities and higher asset risk exposures "will be more negatively affected".

Under the fund solvency requirement in the new rules, each insurance fund must have 'available asset', or AA, greater than its required fund solvency (RFS). The available asset of an insurance fund is defined as the difference between total assets and total liabilities, namely shareholders' equity, less ineligible assets such as goodwill and other intangibles. RFS takes into account liability, asset and concentration risks. It is grouped into three components: liability risk, market and credit risks, and concentration risk. No explicit charges are envisaged for operational risk on the view that op risk is better dealt with by a company's internal risk management systems and by supervisory review.

The liability risk component of RFS takes into account risk factors affecting policy liabilities of each line of business to reflect the volatility of outstanding claims and unexpired risks. Risk charges are based on a combination of statistical analysis of historical claims experience and the study of the characteristics and risk profiles of major lines of business. The total charge for liability risks is the sum of a percentage of claims liabilities and a percentage of premium liabilities. The charge would range from 20% for low volatility business, such as personal accident and residential fire insurance, to 30% for high-risk business such as marine and aviation hull and liability. The paper acknowledges that the risk charges may not be entirely relevant to offshore risks and risks underwritten by reinsurers as the characteristics of such risks were not taken into account in the workgroup's analysis.

The market and credit risks component

of the RFS incorporates the risks arising from changes in the value of assets and liabilities due to changes in economic factors, as well as the credit risk of assets. These are captured by specific and general risk charges for equity, property, interest rate and foreign currency exposures. The equity risk charge, for instance, is proposed as the sum of a specific risk requirement of 8% of gross equity positions (the sum of all long and short equity positions) and a general risk requirement of 8% of the overall net equity position (the difference between the long and short positions).

## Concentration risk

The concentration risk component reflects the additional risk of higher concentration of investments in a particular class of asset or with a particular counterparty. Due regard will also be given to concentration risks arising from natural catastrophes or economic recessions.

Insurers must maintain a minimum ratio of available capital to required capital, the CAR ratio. The required capital is the sum of the RFS for all the insurance funds of a company and asset risk charges of shareholders' funds. Available capital includes the available assets of insurance funds and shareholders' funds. It will comprise two tiers - tier 1 core capital and tier 2 supplementary capital - depending on the quality of support provided by the various capital instruments. The workgroup also proposes the adoption of realistic asset valuation, aligned with Singapore Accounting Standards, for insurance funds to improve the transparency of financial reporting. In brief the new standard will use a 'fair value' approach instead of the lower of book or market value. The current asset inadmissibility rules will be removed for the purpose of asset valuation under the risk-based capital regime. **GRR**

\* Risk Based Capital Framework for General Insurers in Singapore (RBC General Insurance Workgroup) is available on the Monetary Authority of Singapore's website: [www.mas.gov.sg](http://www.mas.gov.sg)

## Basel II QIS Study

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insight into how Basel II will work. "A valuable chance to test the calibration of the accord as it applied to us," said one banker.

However, the British Bankers' Association (BBA), the trade body that represents both British and foreign banks based in the UK, said the process of completing QIS 3 had made it clear to BBA members how difficult it would be to achieve a level playing field for all banks under Basel II.

The BBA said it was concerned at the high number of national discretions introduced into the accord at each stage of its development.

The BBA, in a joint response to QIS 3 with the London Investment Banking Association, said the Basel Committee should set itself short term and medium term objectives. The short term aim should be to remove national discretion in respect of those items that will have a material impact on the competitiveness of banks.

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**The BBA said it was concerned at the high number of national discretions introduced into the accord at each stage of its development.**

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The medium term aim of the committee should be to further reduce the amount of discretion allowed as a consensus emerges and practice converges.

The International Swaps and Derivatives Association (Isda), the trade organisation for the financial risk management industry, said it wanted to draw attention to the "urgent need" to review the credit risk mitigation proposals in the accord. Isda also urged the committee to ensure the accord is implemented consistently across firms and jurisdictions.

Isda said the accord's complexity, and the availability of many options at the discretion of both supervised firms and regulators, could cause competitive problems for international active banks. It said it was essential that the Basel

Committee's accord implementation group aids not just the exchange of information between supervisors, but also the adoption of common approaches and solutions to implementation issues.

The regulators' work schedule should culminate in the Basel Committee, the body of senior banking supervisors that in effect regulates international banking, giving its conclusions on QIS 3 after its next meeting in early March. The committee would then give the go-ahead to the preparation of the third consultative paper on Basel II, or CP 3, with the aim of issuing it in May for banking industry comment.

The committee wants to publish its final version of the Basel II pact by the end of this year. That would allow banks and their national regulators up to three years to ready themselves for the accord's coming into force in late 2006 for the large international banks of the world's leading economies.

Technical experts with the Basel Committee's QIS 3 working group will spend three weeks in London from January 27, under the aegis of the Bank of England, analysing the QIS 3 responses.

The working group's findings and conclusions will be reviewed by the Capital Task Force, the Basel Committee's senior subgroup, later in February prior to the committee's March meeting.

"The technical people will have their work cut out simply normalising all the data they've received before going on to make sense of it," said one banker responsible for Basel II implementation at an international bank.

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**Three weeks now needed to sift mass of data**

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The QIS 3 working group's session was originally planned as a two-week affair. The additional week reflects the scale of the task confronting the working group, bankers say. The group consists of experts from non-Group of Ten (G 10) countries as well as from the G 10 countries from which the Basel Committee supervisors are largely drawn.

In the course of the three weeks, experts from G 10 and non-G 10 countries will meet for separate two-day sessions at

which they will study the results as they apply to their different situations.

Basel II is intended in the first instance for the large internationally active banks of the G10 and other leading economies, but it is designed also for banks of any size and in any country.

The current, and simpler, Basel I accord that dates from 1988 has been adopted as the standard for bank regulation by over 100 countries.

QIS 3 provided banks with the factors and calibrations needed to calculate the minimum protective capital requirements under pillar 1 of the three-pillar accord.

Pillar 1 determines the minimum capital a bank needs to act as a buffer to absorb unexpected losses from credit, market

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**"The technical people will have their work cut out simply normalising all the data they've received before going on to make sense of it," said one banker responsible for Basel II implementation at an international bank.**

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and operational risks. Banks using their own internal data and models to measure their risks should enjoy lower pillar 1 capital charges than banks using simpler approaches. (Pillar 2 of the accord provides for review of a bank's risk management by supervisors; pillar 3 promotes market discipline by requiring banks to disclose more information about their risk management systems and practices).

QIS 3 is in effect the way the Basel regulators envisage the final shape of the accord, at least in terms of pillar 1. In that sense the survey is a preview of CP 3. The data assembled from the QIS 3 responses would have to throw up big surprises for the regulators to cause any major revisions to the Basel II proposals in CP 3.

The Basel Committee originally hoped that the accord would come into effect early in 2004. But the complexity of the proposals, and the disputes arising from it, caused first a delay to 2005 and then a further postponement to the current target date of late 2006. **GRR**

## Taylor Plan to torpedo

### Basel II *from page 2*

herd behaviour because NGA would accommodate diversity in risk tolerances, measurement and management practices, the author claims. "The new idea [in NGA] is that regulation should be outcome orientated, not input orientated," he tells GRR. The paper, published simultaneously in London and New York, in December, looks set to attract a lot of attention from Basel II critics who have attacked the proposed capital accord on the grounds of its complexity and unfairness. Some US regulators who are critical of the new accord, notably at the Office of the Comptroller of the Currency, are also analysing the Taylor paper. The Federal Reserve bank of NY and the Bank of England are looking at it closely, as well, according to Taylor.

His paper is likely to be received rather more sceptically at the Basel Committee secretariat, after more than four years of painstaking work to craft the new capital accord. Scheduled to take effect from the end of 2006, the proposed accord is already running two years late. Its abandonment now would be a huge setback. Although the Taylor paper has landed on desk of secretary general Danielle Nouy, it was still awaiting attention at the start of the New Year. "I would be rather sceptical of some completely different and alternative proposal," she says. "We keep abreast of the best practices at the best banks. If there was a better way [of managing bank risks], we would have heard about it," she adds.

### How the NGA would work

Under the Taylor proposal, a qualifying bank (the more sophisticated firms with internal risk models) would propose two thresholds for all its business lines combined: a capital threshold and a loss threshold. If the regulators accepted these thresholds, the bank would commit to keeping its capital above the agreed levels, and its losses below the agreed level, (over an agreed reporting period). Regulators would not simply review and approve the thresholds. They would also

set a loss parameter in advance. This parameter would fix the loss threshold as a percentage of the capital threshold. "So the way this capital adequacy regime applied to a particular bank would be a function of the choices of both the bank management and its regulators," says the paper.

Regulators would set the loss parameter empirically, based on the length of the reporting period used, the level of confidence with which regulators wanted to avoid insolvencies, the systemic importance of the bank, the degree to which its business took advantage of any explicit or implicit government guarantees, and the stage of the business cycle.

The loss parameter could be set globally for all of the banking systems in the Group of 10 leading countries, or regulators could

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**Would you really want every bank to be run the same way, so that when we experience a shock, they all do the same thing?"**

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be allowed a degree of discretion in determining this parameter, based on local market conditions and practices – such as the scope for diversification in the local economy or local accounting practices.

Then any qualifying bank with losses in excess of its agreed threshold, or capital that fell below the agreed threshold, would be subject to regulatory and supervisory actions.

Under this proposal, the banks have an incentive to set realistic capital thresholds. "Gaming" the system will not work, Taylor argues. Banks may get their calculations wrong – at least without the regulatory review that is part of the NGA – but they will not get them wrong intentionally. Most importantly, the NGA gives bankers "sufficient leeway to do their job, because it focuses on the end that is of public policy importance – bank insolvency – rather than the means – the risk management calculations that the banks need to make to decide on their capital," says Taylor.

In addition, the loss parameter can be modified to make the banking regime anti-cyclical (whereas the Basel II proposal is criticised for being pro-cyclical). It can be

raised during recessions and lowered when the economy is performing strongly.

The NGA is not a wholly new idea. It is a lineal descendant of a concept first advanced by two researchers at the Federal Reserve Board in Washington, Paul Kupiec and James O'Brien. They proposed a concept known as "pre-commitment" during the debate that preceded the Market Risk Amendment to the Basel I accord, in 1996.

Their idea was, however, shot down. This was partly because it was introduced very late in the amendment process, but, more significantly, because it involved imposing a penalty payment on a bank when it had just suffered a major loss. Supervisors thought this would only worsen things for a bank and the system as a whole.

The pre-commitment idea is modified very substantially by Taylor. Apart from expanding its scope to cover all risks, the NGA requires separate thresholds for capital and losses (Kupiec and O'Brien did not discriminate between these variables) and inserts the loss parameter between them. This results in a much less mechanical application of the basic concepts.

Additionally, the NGA moves away entirely from financial penalties. Instead, Taylor prefers direct regulatory action, which might range from more frequent monitoring or compulsion on a bank to develop an acceptable capital restoration plan, to the sale of stock, a merger or restrictions on transactions, deposits and interest rates. This idea draws on the kind of powers given by the US Congress to the Federal Deposit Insurance Corporation.

Although Taylor accepts that, coming at this late stage in the Basel II process, there is a 60% chance that his idea will be ignored by regulators, observers note that the Market Risk Amendment of the mid-1990s was radically altered at a late stage. **GRR**

\* A New General Approach to capital adequacy: a simple and comprehensive alternative to Basel 2 - Charles Taylor.

Published by the Centre for Financial Innovation

## Newsroom

### Regulators grope for disclosure policy

WASHINGTON -- US regulators are struggling to get an agreed approach with the private sector over increased disclosure of financial information amid signs of growing opposition from sections of the banking industry. Enhanced disclosure by banks, as a means of exposing them to more rigorous market discipline, is the third pillar of the proposed Basel II capital accord. This is leading to a growing debate in Britain and the US about precisely what additional information banks might provide.

Some sceptical risk managers believe that the disclosure of technical data will do more to confuse the situation, than clarify it. "In principle, we agree that enhanced disclosure is a good thing. But more is not necessarily better," says a senior risk manager at one leading US bank. "It is not really clear to us what kinds of information the market is demanding that are not already disclosed. We do not want to be loaded down with disclosure requirements on aspects of credit risk models that no one is going to understand. We would have to spend more time trying to explain them to the world than would do anybody any good," he says. Regulators say that it is still too early to say what might emerge from the current discussions. "It might lead to an enhancement of existing [disclosure] regulations, or it might just lead to an articulation of best practices," says a senior regulator at the Office of the Comptroller of the Currency (OCC).

Last July, Donald Powell, chairman of the Federal Deposit Insurance Corporation (FDIC), announced the setting up of a working group composed of practitioners in the financial services industry and regulators to consider the issues. The group would recommend a disclosure policy based on four principles, he said.

First, it should provide the markets with access to important and timely information, so investors can make sound decisions and impose market dis-

cipline. Second, this policy should enhance the safety, soundness and stability of the financial system. Third, the policy should ensure a level playing field on disclosure between US banks and their overseas competitors. Lastly, the new disclosure regime should ensure the proper and timely implementation of the Basel II capital accord.

At a New York symposium sponsored by the FDIC, Powell said the "marketplace might be the regulator's best friend. If we set the capital requirements too low, the markets will require more – but only if they have good information to rely on." But, he acknowledged, "there is a balance to be achieved ... and we should work together with the industry to find it."

The disclosure working group subsequently met for a two-day session in December. The results of that meeting are still being considered, says the FDIC. Although the corporation is the regulatory agency taking the lead on disclosure, its discussions and ultimate recommendations will be undertaken in concert with the OCC and the Federal Reserve. The biggest US banks are the main concern of regulators in formulating a disclosure policy. The FDIC chiefly supervises the country's smaller banks, but has taken the lead on disclosure because of its role as deposit insurer for all banks. Since 1989, it has also had authority to impose further disclosure requirements, which it has never invoked.

The FDIC working group is only one of several recent initiatives on disclosure. The Sarbanes-Oxley Act, passed by the US Congress last year in the wake of corporate governance scandals, such as those at the energy company Enron, also require further information, notably on off-balance sheet activities. Meanwhile, a private sector group, chaired by Walter Shipley, former Citibank head, has also been considering the ways that finance groups might voluntarily improve their disclosure.

Regulators are anxious that these initiatives should lead to a consistent and coherent overall policy on disclosure, they say, and not a patchwork of rules that burden financial firms without adding to the market's understanding

### Japanese banks have negative capital

TOKYO -- Japan's biggest banks now have negative capital ratios, on average, according to the latest calculations of a leading credit rating agency. The adequacy and quality of Japanese bank capital has been deteriorating for some time. Most of the country's major institutions have only been meeting the international, minimum capital-asset ratio of 8%, stipulated under the Basel capital accord, by using various unconventional book-keeping practices.

On more rigorous measures, the capital ratios of some banks were revealed to be already negative by the end of the 2001-2002 financial year, on March 31. Since then the situation has worsened. The average Tier 1 capital ratio of the largest seven banks is estimated by Tokyo bank analysts at Fitch Ratings, to be minus 0.38% by the end of September.

Tier 1 capital is a bank's first line of defence in a crisis, and is supposed to comprise the highest quality capital, chiefly equity and retained earnings. Tier 1 and Tier 2 (subordinated debt) capital, taken together, should be not less than 8% of a bank's risk weighted assets, under the 1988 bank safety accord agreed between regulators of the leading countries. (In addition, Tier 2 cannot be greater than Tier 1).

Measured in the most rigorous way, Mitsubishi Tokyo Financial Group and Sumitomo Trust Bank were the only two of the seven largest Japanese banks to have Tier 1 capital ratios that were still positive at end-September, reckons senior bank analyst Reiko Toritani. To arrive at her unpublished calculations, Toritani strips out certain dubious items such as "deferred tax receivables" and state-held preferred shares. Deferred tax is an intangible item that arises from certain past loan loss provisions, which were not tax deductible at the time they were made. The deferred tax – accounting for over 50% of average bank Tier 1 capital – can, theoretically, be received as relief against future profits, once the losses are realised.

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However, Fitch commented in a research note last year: "As almost every Japanese bank has very poor profit performance, the expectation that these deferred tax 'assets' can be fully realised is unrealistic."

Much of the balance of the banks' Tier I capital takes the form of preferred shares held by the state-owned Deposit Insurance Corporation (DIC). To properly qualify as Tier I capital, these preferred shares must be "perpetual" and "loss absorbing." If dividends are not paid on these preference shares, the DIC accrues voting rights, which amounts to creeping nationalisation. The banks are so anxious to avoid this fate that they will go to any lengths to pay dividends, and have pledged themselves to redeem these preferred shares. So, they are neither "perpetual" or "loss absorbing" and are thus, technically, not eligible as Tier I capital.

Once deferred tax and preferred shares are excluded from the equation, the Tier I average capital ratio of Japan's seven largest banks - some of the biggest in the world, such as Mizuho Holdings and UFJ Holdings - drops from an ostensible 5.35%, to minus 0.38%. Even if 10% of deferred tax is included in Tier I, as permitted by US regulators, the ratio of capital to risk weighted assets is barely positive, at 0.82%.

Heizo Takenaka, the recently appointed minister for the economy and financial services, Japan's bank regulator, has proposed the adoption of a US-style, 10% limitation on deferred tax within Tier I. This suggestion was met by howls of opposition from bank executives.

Whether the banks' capital situation continues to worsen this year will largely be determined by events on the Japanese stock market. The banks' huge equity portfolios amount to around 22 trillion yen (\$183 billion), or 120% of their ostensible Tier I capital (down from 150% in March). When the prices of these equity investments fall, the portfolios have to be "marked to market," and the consequent losses offset against regulatory capital. So a continuing slide in

domestic shares prices in coming month will leave bank capital ratios even further in negative territory.

### Survey seeks data on credit-ratings validation

NEW YORK - Three financial sector trade bodies launched a survey in December with the aim of giving guidance to banks and their national regulators on the validation of internal credit ratings under the proposed Basel II bank safety accord.

Internal credit ratings are a key element in the internal ratings-based (IRB) approach to measuring credit risk under the risk-based accord, which the global banking regulators of the Basel Committee on Banking Supervision want to bring into effect for large international banks from late 2006.

Banks wanting to use the IRB approach, as distinct from the simpler standardised approach, must show they can validate their estimates of default probabilities and the techniques they use to assign internal ratings. But the Basel regulators left specific standards for validation to the discretion of national banking supervisors.

The survey, which is supported by major financial institutions and leading financial regulators, will not recommend the adoption of specific methodologies or standards.

Instead, the information gained will provide banks and regulators with a better understanding of the range of validation techniques in use and how to implement them.

Participants will complete the survey during January, the International Swaps and Derivatives Association (Isda), the Risk Management Association (RMA) and the British Bankers' Association (BBA) said in a joint statement.

The results will be published in April.

Isda is the trade body for the international financial risk-management industry; the RMA is an association for financial risk management professionals; the BBA is the trade body for British and foreign banks in the UK.

### Project financiers proving their case

LONDON- Bankers who arrange complex structured financial deals for multi-billion dollar projects around the world are increasingly confident of persuading regulators that this specialised business is no riskier than conventional lending to the corporate sector. Indeed, far from suffering a higher capital charge than regular corporate lending, as proposed under the Basel II draft accord, the accumulating data suggests that project finance ought to incur lower charges, according to Chris Beale, global head of project and structured trade finance, at Citigroup, in New York.

Four leading project finance banks - Deutsche Bank, ABN Amro, Societe Generale and Citigroup -- have already helped win concessions from the Basel Committee on Banking Supervision following delivery of last year's key study on debt default probabilities and loss recovery in their business.

Now the study is being widened to include up to another ten banks, with the aim of increasing the quantity of the data, its geographical spread and industry coverage - energy, mining, infrastructure and so on -- to support the project financiers' case. The aim now is to get this wider study completed by February.

Deal makers in the project finance business were stunned when the Basel Committee originally suggested that this activity should require between 1.5 and 3.5 times more regulatory capital - depending on the credit-worthiness of the project - than unsecured bank loans to companies. Although such projects are often complex, and frequently in risky locations, they also have many built-in safeguards, say dealmakers.

They typically have security in the assets of the project and the project frequently has hard currency revenues. Moreover, major partners in such projects are often governments or multinational companies who will support these ventures even when problems arise, because of their strategic importance.

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On top of this, the degree of analysis required before such projects are undertaken, makes this form of lending far more transparent than unsecured corporate credit, says Beale. "Our intuition has been confirmed by the study, which shows that project finance is less risky than corporate lending, across the credit spectrum [non-investment grade as well as investment grade projects]," he says. Beale estimates that roughly 60% of the \$100 billion annual syndicated project loan market (this figure was halved in the difficult circumstances of 2002), involves investment grade ventures

There are deep concerns that if the Basel Committee continues to insist on the originally-proposed capital charges, many of the banks that regularly participate in the lending syndications, particularly the smaller ones, will be driven out of the business.

The four-bank study, published in the later part of last year, and based on several years data from each of them, was collated and analysed by Standard & Poor's Risk Solutions, the customised services arm of the rating agency. The data was then compared with S & P's extensive credit database.

The results show that the "loss given default" in the combined project loan portfolios of the four banks is around 25%. The majority of the defaulted project finance loans resulted in a restructuring with 100% of loan value retained. Each of the four banks had an individual average recovery rate significantly over 50%. This was at, or above all other classes in the S & P loss/recovery database (including leveraged loans, unsecured bank loans and bonds).

Although the four banks represent about 24% of the project finance market, this is not viewed as a sufficiently adequate sample to completely convince Basel regulators. The wider study, also being undertaken by S & P Risk Solutions, is likely to include banks representing 40% of the market – a sample generally regarded by statisticians as meaningful.

Initial signals from Basel suggest that regulators are prepared to allow investment

grade projects to bear the same capital charge as corporate lending, but that non-investment grade projects should still incur a higher rate.

Dealmakers are hoping that the wider study will not only prove that non-investment grade projects should not bear this penalty, but that all projects across the credit spectrum should incur a lower capital charge than comparable unsecured corporate loans.

One indication that the project finance banks are starting to win their case came in the instructions attaching to the third quantitative impact study, which the Basel Committee sent to more than 200 banks last October, to test the risk weighting calibrations in the proposed capital accord. These instructions said that if specialised lenders could satisfy their regulators about the accuracy of their estimates for default probabilities and "loss given default," these exposures need not be identified separately from other lending. They could be treated under the internal risk-based approaches, for assessing capital charges, as part of the corporate loan portfolio.

### Enron lessons: Banks must know their customers' business

WASHINGTON – US banking regulators stressed at US Senate hearings in December the importance of banks properly understanding their customers' business in the wake of the collapse of the energy trading group Enron.

Senior deputy comptroller Douglas Roeder of the Office of the Comptroller of the Currency (OCC) said the agency, in a shift of policy, would now seek to determine whether bank managements understood customer disclosure and accounting intent.

In the past the OCC, which uses a risk-based approach in supervising the largest of the 2,000 banks under its jurisdiction, focused on how well a bank assessed the sophistication of the customer and that customer's ability to perform under the terms of the contract.

But banks must now also carefully consider the appropriateness of complex struc-

ture credit products from the standpoint of the customer, Roeder told the hearings on the lessons to be learned from the fall of Enron, overwhelmed by extensive and complex borrowings hidden from view by false accounting.

Roeder said this was one of three points on which the OCC sought to enhance its approach to supervising banks. He said the OCC's risk-based approach took into account the various sources of risk to a bank.

"Because credit risk has traditionally posed the greatest threat to the safety and soundness of banks, much of our supervisory attention traditionally focused on credit issues. However, the Enron situation demonstrates just how significant other types of risk can be."

Roeder said the OCC would also focus more intently on banks' procedures for authorising new products. The agency's examiners will evaluate a bank's system to ensure there's a comprehensive process for senior managers to review and approve new products.

The agency also plans to review banks' relationships with their large customers – even if credit risk is low – and "flag" structured products during its credit work for potential further review.

Roeder said it is encouraging that banks are studying and learning from the Enron scandal, whether or not their experience was first hand. Banks offering complex structured credit products now realise they can suffer great harm if they are implicated in questionable activities conducted by their customers.

A senior US Federal Reserve Board official told the hearings that "not surprisingly, the lessons hark back to risk management fundamentals.

"In particular, banks should recognise that a fundamental time-tested element of analysing credit risk – evaluating a borrower's character – can heavily influence the magnitude of losses, even when significant credit risk is not evident from other factors," the Fed's banking supervision director Richard Spillenkothen said.

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### Everyone a winner?

LONDON - A high proportion of financial firms think that the Basel II capital accord will result in a reduction of the regulatory capital that they are required to hold. This hugely optimistic view of the proposed new capital adequacy regime for banks is revealed in a survey conducted across 18 countries by KPMG, the accountants and consultancy firm. However, as the average levels of capital within the banking system will need to stay broadly at existing levels, this widespread belief cannot be justified, and many organisations are likely to be disappointed, says the survey's author.

British organisations are particularly optimistic, with over 90% of those surveyed believing their capital requirement will fall when the new Accord comes into effect in four years time. "Not everyone can expect to gain through the Basel Accord," says Jane Leach, a London-based partner in KPMG Financial Services, who led the survey. Capital requirements could fall for some firms, but they could rise for others, particularly those in investment banking or making loans to borrowers with a higher default risk.

"Some institutions could be in for an unpleasant surprise," particularly if they adopt the most basic (of the three) approaches to calculating risk allowed under the proposed regime.

However, it is just possible that the Basel Committee on Banking Supervision, which is crafting the new regime, has got its sums wrong, and that a large number of firms are, indeed, likely to save capital. The committee has just been conducting its third quantitative impact study into the effects of the proposed accord, and the results could show that the BCBS needs to do some re-calibrations, says Leach.

It is notable that the changes to the proposed new rules that have been agreed over the last year between the committee and the banking industry will, in general, tend to lower the capital requirement, not increase it. "And, it could be that things have gone too far, and that

some risk weights need to be re-calibrated back up again," Leach adds.

The KPMG survey, which was conducted in the autumn, involved 190 organisations, chiefly banks in Europe, the US, Australia, Hong Kong South Africa and other developing countries. It found that, overall, financial institutions have now begun to work in earnest in preparing for the new accord, and that, compared with 2001, more of them are intending to adopt the more advanced approaches to measuring risk. Some 89% of firms have started preparing for the new regime, compared with 75% a year ago, when KPMG conducted its first such survey, while 34% now intend to adopt the most advanced approach to credit risk measurement (compared with 25% last year).

The survey shows that United Kingdom firms are catching up with the rest of the world in preparing for Basel II. But over 20% of UK respondents have still not started any work on it, compared with 6% of firms in Europe as whole, and 11% globally. A year ago, 37% of UK respondents had not started any preparations.

In their approach to calculating operational risk, UK banks are intending to take more basic approaches than their international counterparts: 75% intend to adopt a basic or standardised approach, compared with 58% in Europe as a whole, and 53% globally. On credit risk, UK banks are broadly in line with their global peers in their choice of approach to the calculation of risk. Some 55% intend to adopt a basic or standardised approach, compared with 59% globally.

### Hopes rise over securitisation meeting

LONDON – Specialists in the securitisation business are hoping to persuade regulators, when they meet in London on January 17, that their activities are being unfairly penalised under the proposed Basel II capital regime. The meeting, which will be attended by the members of the Basel Committee's working group on securitisation, and private sector groups, including the European Securitisation Forum (ESF) and the American

Securitisation Forum, is scheduled to take place at the British Bankers Association.

It is the latest in a series of informal gatherings aimed at finding an appropriate way for setting risk-based capital charges in one of the most complex areas of structured finance. January's meeting will be the first since the results of the third quantitative impact study started to become available. This study is intended to discover the likely impact of the Basel II accord on all the aspects of banking that will be subject to it. Among other things, the results should help demonstrate whether there is any justice in the claims that securitisation is being treated unfairly.

"We are asking those in the industry that wish to dispute or challenge our proposals to come up with evidence – which means numbers – to show whether our proposals make sense or not. And, if not, to what extent they are off the mark," says Jean-Phillip Svoronos, the Basel Committee Secretariat member on the securitisation working group.

Although regulators do not view meetings with private sector firms as, in any sense, negotiations, they are very willing to listen to what the industry specialists have to say. In the end, the capital adequacy regime will be determined by discussions between regulators, "but we need the input" from the firms involved in the securitisation business, says Svoronos.

Some forms of securitisation, such as residential mortgage-backed securities, have been around for over 20 years. But collateralised debt obligations (CDOs) really only date from the later 1990s. CDOs involve taking a pool of debts, with a particular overall degree of risk, and then slicing them into tranches with different levels of risk attaching to each. The tranches are effectively derivatives through which risk is be diversified or concentrated. The most senior tranche may have a triple-A credit rate, while the riskiest tranche has a double-B or single-B rating.

One of the main areas of dispute between regulators and the designers

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and traders of CDOs is that the proposed capital charges for the various tranches differ from the capital charges assigned to conventional bonds with a comparable credit rating.

"This cuts both ways," says Svoronos. The triple-A tranche, which benefits from the diversification of, say, 50 underlying loans, will have a lower risk weight than a conventional triple-A bond. But, at the other extreme, the double-B tranche, embodying the concentrated risk of 50 underlying loans, will face a higher capital charge than a straight double-B bond, he explains.

CDO traders claim there is no evidence to show that the default rates for a double-B tranche is any greater than a straight double-B bond. They fear that the higher proposed capital charge will make the riskier tranches harder to sell to investors - who will incur the charge - or that these tranches will have to be sold more cheaply in future.

Because some types of securitisation are relatively new, they have not been subject to the vicissitudes of a complete credit cycle. So, there is not much of a track record. This is making it harder to convince regulators that the proposed charges are excessive. However, the last meeting between regulators and private sector specialists, at the New York Federal Reserve Board in November, is said to have been very fruitful. And there is optimism among bankers that some concessions can be won from regulators.

### BIS head warns on shift of authority from central banks

FRANKFURT, GERMANY – The consequences of the transfer of authority in recent years from central banks to independent financial supervisors may not yet have been fully thought through, Bank for International Settlements (BIS) retiring general manager Andrew Crockett said in December.

"Central banks, with their authority and liquidity-creating powers, have historically been the bulwark between strain and panic in the financial system.

"As constituted at present, regulatory authorities could not easily play this role," Crockett told a monetary stability conference in Frankfurt organised by the German central bank and finance ministry.

This doesn't necessarily mean the transfer process should be reversed, but more thought needs to be given to what role central banks should continue to play in financial stability, broadly conceived, Crockett said.

"It's hard to believe that the system as a whole will be stronger if this role is allowed to atrophy," added Crockett who is due to leave the BIS, the so-called central bankers' central bank, in March.

He said close co-operation between central banks and regulatory authorities, and a free flow of information between the two, is part of what is needed. It will also be important to develop a common perspective on the causes of, and remedies for, financial instability.

In the past several years, the tide has flowed in the direction of removing supervisory functions from central banks, noted Crockett who also chairs the Financial Stability Forum. The forum groups the central banks, finance ministries and financial regulators of the Group of 7 leading economies in an effort to monitor risk in the financial system.

He cited several factors in the trend away from central banks as supervisors. These included the exchange by central banks of their bank supervisory roles for wider responsibility for monetary policy and the increasing integration of financial activity. The supervision of banks, insurance companies and securities firms must be internally consistent, given the blurring of the boundaries between them, Crockett said.

But he said there are still a number of reasons why central banks are closely interested in the health of the banking sector. In particular, important channels through which monetary policy operates go through the banking system.

"The health of banks' balance sheets shapes how they respond to monetary stimuli.

"More generally, cutting the supervisory link between central banks and the banking

system obscures the question of who is responsible for overall systemic stability," Crockett said.

### ABA creates new op risk data programme

WASHINGTON - The American Bankers Association (ABA) has set up an "Operating Risk Committee," to both help bankers reduce losses and comply with the proposed Basel II capital accord. Top priority for the committee, created at the end of December, is the development of a peer group reporting programme, designed to collect, analyse and compare participating banks' risk events, such as internal fraud, workplace safety and IT security. As an independent third party, the ABA can collect this information while keeping the sources confidential.

Bankers have been asking the association to help create a database and to help standardise methods of measuring operational risk, so that they do not all have to start from scratch, explains an ABA spokesman. If they can share information anonymously, it helps everyone, he says. The association's members include a high proportion of the 8,000 banks in the US, but it is not necessary to be a member in order to participate in the data sharing group. Participation costs \$10,000 a year, but may decline as the number of banks involved increases.

Most of the interest so far has been generated by the larger banks, many of which are still only beginning to work out how to define and measure their operational risks. And, the number of banks participating in the ABA programme seems likely to be far more than the roughly 20 "internationally active" firms that will initially be subject to the Basel II capital regime when it comes into effect at the end of 2006. Many others see the measurement and control of op risk as a competitive necessity. US bank regulators are also indicating that they will eventually want all the larger banks to adopt op risk controls whether they are subject to the new international capital accord or not.

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"Good benchmarking data will lead to best practices and good performance strategies that can benefit the entire banking industry," says Robert Jones, director of operating risk management for FleetBoston Financial, who chairs the ABA Operating Risk Committee.

"The ABA has a proven record of confidential data collection and analysis in areas such as cheque fraud. It is the perfect trusted-third-party to facilitate such a highly sensitive programme," says Jones. "Better data will help banks develop better strategies to reduce losses and will help banks develop more efficient methods for determining their capital reserves."

The new committee will be able to share those successful strategies with the industry, he says. It will also aid the association in its efforts to develop and advocate legislative and regulatory policy related to operational risk.

Members of committee will include senior managers from Bank of America, BB&T, Comerica, First Tennessee, FleetBoston, Hibernia, Key Bank, National City, Wachovia and Zions.

**That's the conclusion of a study\* published by the Bank of England in December, which says the evidence is that financial innovations reduce volatility in financial markets but are blamed for the opposite effect.**

**Philippe Jorion, finance professor at the University of California at Irvine and the study's author, concludes that major financial markets have been no more volatile in recent years, which have witnessed many financial changes, than previously.**

**Jorion notes quantitative techniques such as option pricing, portfolio insurance and VaR have become essential tools of investment portfolio management.**

**Since 1998 commercial banks have been allowed to use their internal VaR models to calculate their market-risk capital charges under the current Basel accord.**

**A VaR model provides a bank with a single number measure of the maximum probable loss it could suffer on its financial market positions over a target period.**

**The Basel accord determines the minimum amount of buffer capital banks must hold to absorb any unexpected losses from the risks of the banking business.**

**Under the Basel accord an increase in VaR should lead to a bank either raising more capital as protection against the increased risk or cutting its market positions to reduce VaR.**

**Critics have argued that since raising capital isn't feasible in a hurry, commercial banks presumably sell their market investments and thus further increase market volatility.**

**In particular banks, along with market traders, were accused of creating a 'vicious cycle' of position cutting that added to the downward pressure on prices in 1998.**

**But Jorion says the Basel charges apply only to the highest level of commercial banks. Other financial institutions, such as investment banks or hedge funds, do not have such regulatory requirements.**

**Even for commercial banks, actual capital ratios in 1998 were far in excess of the minimum required by the Basel accord, so that minimum market risk charges weren't binding.**

**Furthermore, capital adequacy requirements move so slowly they could not possibly have caused panic selling, Jorion says. The Basel market-risk rules have two smoothing mechanisms.**

**The first is that a VaR model must be based on at least a year of historical data; the second that VaR is averaged over 60 days.**

**"The fact that VaR-based market risk charges were introduced in 1998 and that markets experienced a crisis in 1998 is pure coincidence," says Jorion.**

**But he says that an insight of his analysis is that risk-sensitive systems should incorporate smoothing mechanisms.**

**The quest for accuracy in VaR measures should take second place to stability in the market risk charge, he says.**

**And VaR systems should not be viewed as a panacea – they provide no guarantee that large losses will not occur.**

**Jorion notes that the "vicious cycle" criticism of VaR models is reflected in the fears about the possible "procyclicality" of the credit risk charges under the Basel II accord proposed by the Basel Committee on Banking Supervision for late 2006.**

**Critics worry that Basel II will induce banks to tighten credit as credit risk increases, precisely at the wrong time in a recession.**

*\*Fallacies about the Effects of Market Risk Management Systems is published in the Bank of England's Financial Stability Review of December 2002 and is available on the UK central bank's website: [www.bankofengland.co.uk](http://www.bankofengland.co.uk)*

### Basel market-risk rules not to blame for volatility

**LONDON – The very slow response of Value at Risk (VaR)-based capital charges to financial market movements means the market risk charges required by the Basel bank safety accord can't be blamed for increased market volatility.**

**In particular, the risk-based charges weren't to blame for the 1998 financial crisis that began with Russia's debt default and culminated in the near bankruptcy of the Long-Term Capital Management hedge fund.**

## Insurance

### Interview: Knut Hohlfeld, Secretary-General of the IAIS

# Ten-year march to new insurance regime

IAIS role seen as encouraging common approaches among national insurance regulators

International acceptance of risk-based regulation of insurance companies is likely to become a reality over the next 10 years.

"Regulations in different countries won't be identical in all respects, but they will be similar," says Knut Hohlfeld, secretary general of the International Association of Insurance Supervisors (IAIS).

Only a failure to agree international insurance accounting standards would block progress toward a broadly accepted common approach to safeguarding the solvency of insurers through rules aimed at measuring and combating the risks actually faced by individual companies, Hohlfeld told Global Risk Regulator.

And there's no reason to suppose, for

**"IAIS members have different views but more and more the risk-based approach is seen as the way ahead," Hohlfeld says.**

instance, that the current work of the International Accounting Standards Board, the London-based independent accounting standard setter, in developing common insurance accounting standards won't ultimately be successful, Hohlfeld believes.

Under traditional insurance regulation, supervisors impose one-size-fits-all solvency rules that, while having the merit of simplicity, don't capture all the risks faced by the industry in an increasingly complex global market.

The IAIS solvency subcommittee started out as a supporter of the traditional approach, says Hohlfeld, but is now much more favourable to risk-based supervision.

Hohlfeld, who retires at the end of May, set up the IAIS secretariat in 1998, four years after the organisation was established to promote co-operation among

insurance regulators and set international standards for insurance supervision. He will be succeeded by Yoshihiro Kawai, currently deputy secretary general.

The IAIS, whose executive committee chairman is Mexican finance commission president Manuel Aguilera-Verduzco, now represents the insurance regulators of some 100 countries and jurisdictions.

Hohlfeld sees the role of the IAIS, which does not have anything like the power that the Basel Committee on Banking Supervision exercises in the banking world, as encouraging common approaches among national insurance regulators. (The IAIS secretariat, like the Basel Committee's, is located at the Bank for International Settlements' headquarters in Basel, Switzerland.)

The IAIS plans a series of standards and discussion papers related to risk-based approaches to regulation for adoption by members. Issues covered include the quantifying and assessing of liabilities and the use of actuaries this year, stress testing and the form of capital adequacy requirements in 2004 and guidance on asset acceptability and valuation in 2005.

IAIS recommendations on regulation, which are agreed by members at the organisation's annual meetings, are not binding on member countries.

But the recommendations are usually backed as desirable best practice by influential agencies such as the International Monetary Fund and World Bank.

"IAIS members have different views but more and more the risk-based approach is seen as the way ahead," Hohlfeld says.

International supervision of insurance has lagged behind that of banking, where the Basel Committee in effect regulates international banking and is the architect of the planned risk-based Basel II bank capital accord.

That's mainly because the insolvency of an insurance company has generally not posed such an obvious risk to the international

financial system as has the collapse of a large, internationally active bank.

But several factors are now spurring a more international approach based on

**Only a failure to agree international insurance accounting standards would block progress**

risk-focused rules. These include the emergence of large, global financial services conglomerates that bring banking and insurance, and their risks, under one roof. The growth of risk transfer where, for example, bank credit risk is transferred to insurance firms via credit derivatives, is also an influence.

New "super regulators", such as the UK's Financial Services Authority (FSA), want to introduce harmonised risk-based regulation of all financial sectors.

Several countries, among them the US, Australia, Canada, Japan, Singapore (see front page), have introduced, or are introducing, risk-based approaches to insurance regulation.

The Basel II accord, which the Basel Committee wants to bring into effect for major banks by the beginning of 2007, has also influenced insurance regulators. The UK's FSA, for instance, wants to apply a three-pillar Basel II-type regime of capital charges, supervisory review and market discipline for insurers, ultimately within the framework of the European Commission's Solvency II rules now under development.

Hohlfeld says it would clearly be best if the solutions of national regulators didn't diverge too much. The IAIS will continue to provide a forum for supervisors to develop common approaches so that the chances of regulatory arbitrage, in which insurers might choose to be regulated by the regime most favourable to them, are restricted. **GRR**

## Insurance

# Insurance failures pose systemic risk

Regulators must watch companies with large market shares

**A**ustralian experience shows, contrary to academic opinion, that insurance failures could pose a threat to a community's financial position, a senior Australian regulator said in December.

Insurance supervisors need to watch for companies with large market shares in key sectors, said Charles Littrell, executive general manager of the Australian Prudential Regulation Authority (APRA). APRA is Australia's integrated financial services industry watchdog, which this year re-licensed the entire insurance industry under tighter provisioning and capital rules and a new risk-sensitive regime for management, auditors and actuaries.

In Australia's case it was the collapse in early 2001 of HIH Group, which provided half the builder's home warranty insurance in Australia, and the near failure of United Medical Protection, the country's largest provider of medical indemnity insurance, that illustrated the point, Littrell said.

**"In our experience, trouble comes more quickly to insurance companies than it does to banks"**

HIH's collapse with a \$A5 billion shortfall (\$2.8 billion) was the largest failure in Australia's corporate history. Remaining insurers were unable to take up the slack, leading to a sharp slowdown in construction, a significant sector of the Australian economy, Littrell told the Institute of International Affairs in London.

The prospective failure of United Medical led the Australian government to provide guarantees while a new funding and liability mechanism was worked out. Without this arrangement, Australia's healthcare

industry would have been unable to operate on anything like a normal basis, Littrell said.

Littrell summarised the lessons learned by APRA in supervising general insurance:

First, try to make the industry "less special". Look through any obsolete or unclear accounting for the economic reality, particularly in the provisioning and reinsurance areas. Make sure that adequate capital is held.

Second, it's extremely helpful to have experienced industry hands to back up the supervisors – APRA now has five such people in an insurance risk consulting group. They contribute about 100 years of insurance industry experience.

Third, don't rely to heavily on external auditors and actuaries – their analyses are useful but not necessarily conclusive.

Fourth, collect adequate and timely data and react proactively to any signs of trouble.

"In our experience, trouble comes more quickly to insurance companies than it does to banks," Littrell said.

He said APRA sees the managerial differences between banks and insurers.

"Banks in general are run by people who are, or have been, risk managers and by people who understand that regulation has its good points. In Australia at any rate, many insurance companies have been dominated by salesmen, who often viewed regulation as something to be avoided. Having come up the career ladder by dealing with actuarial restrictions, they tended to treat regulatory requirements as another annoyance to overcome, rather than a guide to good practice".

Littrell added that compounding the issue were opaque insurance accounting practices and relatively weak corporate governance and management.

The new regime encourages a better man-

aged, more risk sensitive and returns focussed industry to reduce the cyclical pricing swings that were an unfortunate feature of the past, he said.

APRA will review the new insurance act in 2003. It is unlikely that any material changes will be necessary, Littrell said.

But the agency will consider the pros and cons of releasing some of the insurer statistical information it collects.

"By providing appropriate individual company and industry information, APRA may be able to encourage market responses to relative risk profiles, generating a market discipline as well as a regulatory discipline in the Australian general insurance

**In Australia at any rate, many insurance companies have been dominated by salesmen, who often viewed regulation as something to be avoided.**

market," Littrell said. But he added this approach would require considerable public and industry consultation before any decisions were made.

APRA has recently created a stronger risk rating model – PAIRS – which borrows from British and Canadian regulator models and alerts the agency to the likely failure rate of firms and the impact should they fail.

APRA has also bought several competing risk models to avoid "model myopia," Littrell said. "It is cheap for us to engage with a suspect entity to determine that it won't fail; it is very expensive indeed to react too slowly to signs of potential failure".

The competing risk models include ratings agencies, models based on equity prices and corporate governance ratings against a background of more openness to whistleblowers, the media and industry sources. **GRR**

*Next month in Global Risk Regulator:*  
New thinking on insurance risk from Ernst & Young

# Poor countries will be hit by new rules

Urgent need to change Basel II to avoid unfairness in loan costs. SME solution proposed

The planned Basel II bank safety accord must be changed to reflect the cut in overall credit risk that banks secure by diversifying their loan portfolios when they lend to developing countries, a UK-based research body said in December.

The Institute of Development Studies (IDS), which fears the risk-based Basel II accord could push up the costs of lending to poorer countries, argues that in this respect the Basel II proposals fail to meet the express purpose of the accord.

Basel II's purpose is to align regulatory capital, the minimum capital that banking supervisors require banks to hold as a buffer to absorb unexpected losses, with the risks banks actually face, the institute noted.

Lending to individual developing and emerging market borrowers is generally deemed a riskier proposition than lending to borrowers in the leading economies and could therefore require higher levels of protective capital under Basel II.

However, a Bank of England paper also published in December said Basel II is unlikely to cause a marked cut in the supply of loans to emerging market borrowers as banks' loan pricing already reflects the borrower's creditworthiness (see box).

The Bank also said it isn't obvious that the best response would be to amend Basel II, even if the new accord did raise the cost of borrowing for certain emerging economies.

The IDS said its empirical research supported the view that a bank making loans to a wide range of different developing, emerging and mature economies needed relatively less capital to guard against unexpected losses from credit risk. This is because the bank is less likely to face simultaneous problems in all those markets than a bank with loans concentrated in a smaller number of similar markets, added the institute which is based at

Sussex University, England.

"At present the (Basel II) proposals contain no such considerations, suggesting that, in this area at least, capital requirements may not accurately reflect actual risk," IDS

**A bank making loans to a wide range of different developing, emerging and mature economies needed relatively less capital to guard against unexpected losses from credit risk.**

researchers said in a paper\*.

The paper said one solution would be to adopt the approach to lending to small and medium-sized enterprises (SMEs) worked out last year by the Basel Committee on Banking Supervision, the architect of Basel II.

Several countries feared Basel II would penalise lending to smaller companies, which they regard as key to their economic growth, because historically individual SMEs are generally a greater credit risk than large corporations.

But the SME solution, which means capital charges against banks loans to SMEs will in fact be lower than charges against lending to larger companies, recognises that the chance of a large number of SMEs defaulting simultaneously is lower than that for a smaller group of large borrowers, the IDS said.

Technical experts with the Basel Committee, which in effect regulates international banking, were studying the IDS paper, regulatory sources said. A response from regulators was likely by mid-January, they added.

In a previous paper in September last year, the IDS argued that widespread adoption of the Basel II internal ratings based approach

to measuring credit risk by internationally active banks would lead to significant increases in capital charges for loans to lower-rated borrowers. This would imply a sharp rise in the cost of lending to developing and emerging economies, and/or a reduction in its quantity.

In its latest paper the institute said its own research strongly supported the view that a major benefit of investing in developing and emerging economies is their relatively low correlation with mature markets. Developing economies don't move in unison with mature economies and investing in them thus provides a way of hedging against the risk of deteriorating financial markets in mature economies.

IDS researchers said a range of financial, market and macro economic variables - return on assets, syndicated loan spreads, bond market indexes, GDP growth rates, for instance - showed that the degree of correlation between the real and financial sectors of developed economies is greater than that between developed and developing economies.

Testing with two simulated loan portfolios showed that unexpected losses in the portfolio focused on developed country borrowers were on average almost 23% higher than for the portfolio diversified across developed and developing countries, IDS said.

It added the specific manner that these findings might be incorporated into Basel II was best left to the Basel Committee. But the institute said the results of its empirical work strongly suggested a modification similar to the SME solution was justified in terms of international diversification.

"A modification would not only be technically correct, but also supportive of the stated aims of the Group of Seven governments to increase the role of private capital flows to developing and emerging economies, as an engine of growth and development," the paper concluded. **GRR**

\**Basel II and Developing Countries: Diversification and Portfolio Effects*, by Stephany Griffith-Jones, Miguel Segoviano and Stephen Spratt is available on the website of the Institute of Development Studies: [www.ids.ac.uk](http://www.ids.ac.uk).

## Basel regime unlikely to cut lending to emerging markets

The Basel II bank capital accord is unlikely to cause a marked cut in the supply of loans to emerging market borrowers, even low credit quality borrowers, because banks' loan pricing already reflects the borrower's creditworthiness, the Bank of England said in December.

But it isn't obvious that it would be right to amend the Basel II proposals (see feature opposite) even if the accord did raise the cost, or restricted the supply, of loans for certain emerging economies through a more accurate reflection of risk. Other policy options might well be more appropriate, if the intention were to provide finance on more favourable terms.

The proposed new accord aims to ensure that international banks' regulatory capital reflects more closely the credit quality of their loan portfolios, the UK central bank said in a paper\*.

Some commentators are concerned that this might provoke a sharp increase in borrowing costs for debtors in emerging markets because lending to such borrowers is riskier than lending to borrowers in mature economies, the Bank noted. But it said the regulatory capital charge will not rise under Basel II, and may indeed fall, for several emerging markets.

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**The proposed new accord aims to ensure that international banks' regulatory capital reflects more closely the credit quality of their loan portfolios, the UK central bank said.**

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It's also important to bear in mind that the new accord, which will take effect for the large international banks of the world's leading economies from late 2006, applies only to a subset of banks' claims on emerging market economies. Trading book assets - marketable exposures such as certain bonds and equities, for instance - will not be affected, the

Bank said.

More generally, finance is available to emerging markets through non-bank channels such as foreign direct investment and investment in bonds and equities by non-bank foreign and domestic investors, which will also be unaffected by Basel II.

The Bank noted Basel II links the capital charge for credit risk to explicit indicators of credit quality, measured either externally under the standardised approach or internally under the internal ratings based (IRB) approach.

### OECD status unimportant

This is in contrast to the current, Basel I, accord under which capital charges against sovereign and inter-bank loans are based on whether the borrower is a member of the Organisation for Economic Co-operation and Development (OECD). Lending to an OECD country, for instance, attracts a 0% charge whereas lending to a non-OECD country generally carries a charge of 8%.

There is no clear link between OECD membership and a country's ability to service its debt, the Bank said. OECD-member Turkey, for example, is rated B- by credit rating agencies, but its debt attracts a lower regulatory charge than that of Chile which is rated higher, at A-, but is not an OECD member.

"The removal of this distinction under the new accord seems to be generally welcomed," the Bank said.

Most international banks are likely to adopt the two-level IRB approach, the Bank said. The IRB foundation approach sets minimum capital as a function of the banks' own assessment of the probability of the borrower defaulting. For the IRB advanced approach banks make an estimate of likely losses in the case of default.

The Bank estimated the change between the average minimum charge under Basel I and that under the Basel II IRB foundation approach for a portfolio of bank, company

and sovereign debt in a sample of 33 emerging market economies.

The Basel II OECD effect is clear, the Bank said. Capital charges on lending to OECD borrowers with relatively low credit standing, such as Turkey, could increase markedly under the new accord.

There is a clear relationship between credit quality and regulatory capital. The average regulatory charge for lending to emerging market economies that have a relatively high credit standing, for example countries such as Chile, South Africa and Malaysia with debt rated around or above investment grade by credit rating agencies, will generally be reduced.

But the average minimum regulatory capital for loans to lower credit quality countries will generally increase. However, the key question is whether the higher minimum requirements will exceed the economic capital that banks hold on their own assessment of the risk.

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**The Basel II OECD effect is clear. Capital charges on lending to OECD borrowers with relatively low credit standing such as Turkey could increase markedly under the new accord.**

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If it does, then a rise in loan prices might ensue.

But it does seem that banks' loan pricing takes credit risk into account - actual loan pricing clearly varies positively with credit risk, the Bank said.

The study showed that economic capital held by banks against a sovereign portfolio, for instance, was 10.2%. This was higher than an estimated 8.8% minimum charge under Basel II, which in turn was higher than the 5.1% minimum charge under the current accord. **GRR**

*\*The impact of the new Basel Accord on the supply of capital to emerging market economies is published in the Bank of England's Financial Stability Review of December 2002 and is available on the UK central bank's website: [www.bankofengland.co.uk](http://www.bankofengland.co.uk).*

# Lifting the veil on the Basel Committee

Disclosed, for the first time, the individual members of the powerful committee that oversees international banking

So, just who are the members of the hugely influential, if somewhat shadowy, Basel Committee on Banking Supervision? Who are the men and women whose decisions will, indirectly, have a bearing on the borrowing costs of individuals, small businesses, multinational companies and emerging market countries around the world?

Well, don't bother to look on web pages, or seek elucidation from the committee's secretariat, housed at the Bank for International Settlements (BIS), the central bankers' bank, in Basel. Committee members' names are, it seems, something close to a state secret. In fact, you have to drill down several layers on the BIS website even to discover the 24 bodies - central banks and regulatory agencies from 13 countries - represented on the committee.

All very curious given the emphasis that is now placed on transparency by regulators. Indeed, one pillar of the Basel II capital accord is concerned specifically with the requirements upon banks for greater information disclosure. Evidently, there is one rule for regulators

and another for those that they regulate.

However, the committee members' names are now published, for the first time, in *Global Risk Regulator* (see list below). Every effort has been made to ensure accuracy, but not all the bodies involved have been willing to cooperate. The Basel Committee secretariat was asked to confirm the names, but declined, indicating only that the list contained errors. Some institutions, notably the Bank of France insisted that only the Basel Committee was authorized to provide this information, although, in a kind of Kafkaesque circularity, the committee secretariat maintains that it has no permission to disclose members' names, and that only the individual bodies, themselves, can do that.

The secretariat argues that there is no compunction to publish names because the committee is not a public body, and has no powers to enforce its decisions. This is casuistry. It may be the formal position that the committee has no legal status, but the individual regulators on the committee often have enormous power to enforce any collectively agreed

decisions in their own countries.

As the members' list shows, there are about 30 people on the committee. Of the 13 countries represented, eleven have two representatives each (typically, one from the central bank and one from the bank regulatory agency). Luxembourg has only one representative, while the US has four, reflecting its greater number of regulators. As the New York Federal Reserve Bank president William McDonough is also the current Basel Committee chairman, that particular US regulatory agency has an additional member on the Committee, in the form of its executive vice president, William Rutledge.

The committee secretariat is represented by its secretary general and her two deputies

*Global Risk Regulator's* intention is to maintain this list in as accurate and current form as possible.

We welcome any corrections and updates from readers. Please send them to Melvyn Westlake:

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## Techie Talk

### Get with the process

The right IT is crucial in the era of risk-based regulation and Basel II. Centerprise's *Reto Tuffli* and *Marnie Rosenberg* argue the merits of BPM - business process management

Several recent developments in banking supervision and regulation will force banks to re-examine how they manage and control their business processes.

In particular, as more bank supervisors adopt risk-based and continuous approaches to supervision, it will be of greater importance for banks to implement the right enterprise technology to support the new regulatory styles and focus. This article examines how enterprise-wide business process management (BPM), built on top of a strong information technology foundation, can be used by financial services firms both to satisfy regulators and create a stronger risk management control infrastructure. Policies, once just static documents, then become the gateway to exploring activities and compliance by topic in a much more dynamic, integral, and ongoing fashion.

Two important trends in bank supervision are forcing bank managements to modernise the operational and technological infrastructure within their institutions.

First is the trend towards risk-focused supervision. The main objective of a risk-based approach is to sharpen the supervisory focus on 1) those areas which pose the greatest risk to the soundness of banking organizations, and 2) the assessment of management processes to identify, measure, monitor, and control institutions' risk exposures.

Although strong risk management has always been key to conducting sound banking activities, it has become even more critical as new technologies and products, as well as the size and speed of financial transactions, have changed the nature of banking markets.

How does this specifically change the nature of a regulatory inspection or examination? First, less focus is now placed on specific transaction testing, particularly when internal risk management processes are determined to be adequate or risks are considered low.

Examiner findings pertaining to the level of risks are therefore based on internal management assessments of those risks rather than on the results of more extensive transaction testing by examiners. However, this will not be the case if initial reviews of the risk management system - or efforts to verify the integrity of the system - raise material doubts as to the system's effectiveness. No significant reliance is then placed on the system, and a more extensive series of transaction testing is typically conducted. In this latter case, regulators will generally demand more time from bank employees to gather information and ask questions.

Continuous supervision is a related trend which can signifi-

cantly improve regulatory oversight: it can also result in increased demands on the institution in terms of time and resources.

Supervision has been transformed from a single annual onsite-examination conducted over several weeks or a couple of months, depending on the bank's size, to a continuous process of year-round on-site and off-site monitoring that includes targeted reviews focusing on significant aspects of the institution's businesses.

Then there is Basel II, the risk-focused bank capital accord that the global banking regulators of the Basel Committee on Banking Supervision want to bring into effect for the large international banks of the world's leading economies from late 2006.

One of the most significant aspects of Basel II, especially with respect to the internal model proposals for operational and credit risks, will be increased process management and data collection requirements.

For example, on the operational risk side, an infrastructure to collect operational loss and key risk indicator data from throughout the enterprise will be required. The process management demands are also significant - a bank's credit rating structure alone, which supports assessment of credit risk, assignment of internal risk weightings and quantification of loss estimates, will require many new processes to be developed or existing ones to be strengthened.

What does this all mean for regulated institutions? It simply means that the practice of enterprise risk management has become an exercise in good process management. Simply having best practice policies and procedures is not enough. An organisation needs the technological tools to implement procedures and monitor compliance and results on an enterprise-wide basis.

### The Case for Enterprise-wide Business Process Management Technology

An enterprise workflow-based solution that also supports integration of a firm's policies into the application is a strong means for bridging the gap between bank policies and actual processes. It enables proactive, real-time monitoring of mission-critical processes with notification trigger rules and other alert features for identifying problems. A firm can show its regulators and auditors the direct connection between a specific internal policy, the workflow template used to implement that policy, and the audit trail that shows in detail how and when that policy was implemented and by whom.

The workflow audit trail allows execution data to be stored automatically by the system and subsequently used as a source of risk exposure indicator metrics for a firm's operational risk system. The number of times a specific risk manager has not read his risk report is clearly a key risk indicator for the organisation. Audit trail data and other outputs gathered from a workflow solution are a very effective way to collect such key risk indicator data.

Perhaps more importantly, the process of implementing a BPM

solution forces a careful re-examination of individual processes, including an explicit delineation of the roles and responsibilities associated with each activity. This promotes a more disciplined engineering of a firm's operational practices and leads to a more operationally resilient organisation.

A BPM solution also requires a strong foundation in organisational management, which sounds easy, but is surprisingly lacking in many firms.

At its core is a single, centralised repository and management tool that is used to define and maintain organisational and legal reporting structures as well as all employee roles and responsibilities. This includes the many detailed and critical sets of responsibilities, such as those of support staff with respect to front-office units, that are not typically formalised or captured.

This tool should also support the complex, multidimensional reporting lines, for example matrix management structures, often found in banking organisations that have intersecting managerial responsibilities. The firm's legal structure should be integral to this framework as well. While organisational management serves as a foundation for implementing workflow technology, it also has numerous utilities on its own. Regulators, most notably the UK's Financial Services Association (FSA), require both organisational management and accountability definition.

Within wholesale financial services organisations, the following broad classes of processes can be addressed through an enterprise approach to workflow technology:

- Core transaction and settlement-related processes. While there has been a lot of progress made on straight-through trade processing (STP), many of the steps will continue to require navigating a trade through different roles, functions and even external parties.
- Risk control processes. These refer to any financial or risk control processes, such as those pertaining to credit, market and operational risk management, new product approval, collateral management and financial and model control.
- Report production processes. The generation of management reports, such as those showing profit and loss, risks and balance sheet, involves a fairly complex process. BPM technology combines data collection, exception rules definition (for reporting missing and/or incomplete feeds), and review and approval steps into a single framework.
- Reference data administration processes: Financial services firms require careful orchestration when making changes or additions to reference data. Workflow can help to manage this in a more organised fashion and reduce ambiguity or control-related problems.
- Other processes include customer relationship management (CRM), including handling customer requests, as well as administrative functions such as budgeting and the filing of expense reports.

In all these cases, BPM not only improves efficiency, but also eliminates or significantly reduces control gaps, which regulators and auditors seek to identify.

There are several key enterprise-wide IT demands that are being propelled by supervisory and regulatory developments, such as

Basel II.

The first is a robust, collaborative data collection and management framework. Typically, data from hundreds of existing front, middle, and back-office systems are created and handled in a very decentralised manner. Yet the management of risks must encompass the collection of data feeds as well as the monitoring of their readiness and completeness. Enterprise Application Integration (EAI) tools facilitate the monitoring of data feeds and support the data transformation required to gather data from various sources and bring it into consistent formats. These tools must be able to monitor data feeds and their status - that is, for identifying inconsistencies, the types of data the feeds contain and the organisational entities that 'own' the data. Exception reporting for missing or incomplete feeds must also be included in this framework, and BPM technology may also be leveraged here.

### The importance of IT integration

The UK's FSA has highlighted the importance of strong IT integration in its recent consultation paper 142 on operational risk systems and controls. CP 142 requires firms to have adequate systems and controls to prevent breakdowns.

It recommends that firms consider the integration of systems, in particular for high volume products. The FSA wants firms to identify process failures to permit prompt rectification, and to consider whether the design and use of a firm's processes and systems allow it to comply adequately with regulatory and statutory requirements.

There is a second key IT infrastructure requirement that pertains to enterprise-wide management reporting. Continuous supervision places greater demands on banks in terms of formal and ad-hoc reporting. This will require an extremely flexible reporting framework in which information can be 'sliced and diced' across various managerial domains and reporting line structures, for example functional and regional reporting. Moreover, the ability to 'drill across' the organisation is just as important as vertical navigation. Compliance with disclosure recommendations of pillar 3 of Basel II will also require banks to provide more information more frequently.

A third important enterprise-wide IT requirement is a robust data management system. This allows the firm to store data from throughout the enterprise, for example counterparty and instrument information. Gathering and maintaining consistent and accurate reference data across individual silos continues to be an enormous challenge within financial services organisations. Basel II will encourage, if not force, banks to disclose counterparty reference data, instrument, product and market data, rating and industry classification schemes, and internal reporting structures. **GRR**

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## Diary - meetings, conferences and deadlines.

### January

January 15 and 16 – Risk management group of the Basel Committee meets in Basel, Switzerland.

January 17 – Basel Committee's securitisation working group meets informally at British Bankers' Association in London to discuss Basel II asset securitisation proposals with industry bodies.

January 21 and 22 – Capital Allocation 2003 conference organised by IIR Finance (www.iir-conferences.com). Patricia Jackson, head of regulatory policy at the Bank of England and chair of Basel Committee's quantitative impact study (QIS) working group, speaks on Basel II on second day of conference.

January 27 – Basel Committee's QIS working group starts three-week session, hosted by the Bank of England, analysing responses to the QIS 3 survey that sought information from banks in nearly 50 countries on how the Basel II bank

accord might affect them.

### February

February 3 and 4 – Risk Waters' advanced credit risk management and modelling techniques conference – London (www.riskwatersevents.com)

February 14 – Deadline for industry comment to Monetary Authority of Singapore on proposals for risk-based regulation of general insurance companies in Singapore

Mid-February – Capital Task Force subgroup of Basel Committee meets (ahead of early March meeting of full Basel Committee) to review QIS 3 findings.

February 24 and 25 – Risk Waters' advanced credit risk management and modelling techniques conference, New York (www.riskwatersevents.com).

Late February – US House of Representatives Financial Services Committee may hold hearings on the operational risk aspects of the Basel II capital accord proposals.

### March

Early March – Basel Committee meets to review QIS 3 findings and agree framework for the third consultative paper on the Basel II accord that's expected to be published in May.

March 3 and 4 – IIR Finance's alternative risk transfer conference, Zurich (www.iir-conferences.com)

March 11 and 12 – Risk Waters' Operational Risk Europe 2003, London (www.riskwatersevents.com)

Mid-March – Basel Committee Capital Task Force subgroup meets ahead of a late April meeting of the Basel Committee that will approve the final version of third consultative paper on Basel II for planned publication in May.

March 25 and 26 – Risk Waters' Operational Risk USA 2003, New York (www.riskwatersevents.com)

March 27 and 28 – Basel II Masterclass in London, organised by IIR Conferences (www.iir-conferences.com).

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