Box 4 proposals for a review of capital adequacy rules

On January 16 this year, the Basel Committee on Banking Supervision published the New Basel Capital Accord proposing new capital adequacy rules for credit institutions. Aimed to replace the Basel Capital Accord of 1988, it is expected to be implemented in 2004.

If adopted, the new Accord will be more complex and detailed than 1988 Accord. A more complex framework is considered as a natural reflection of the evolution of credit institutions' activities in recent years, and also represents a response to their demands for a review of the 1988 Accord. An effort has been made to introduce flexible principles that take into account the different characteristics and degrees of risk, and at the same time enable a choice between assessment methods. The scope for employing more risk-sensitive and precise methods for calculating capital requirements is regarded as an encouragement to credit institutions to make ongoing enhancements to their risk assessment procedures and risk management. Furthermore, more sophisticated risk assessment procedures for credit institutions are also seen as contributing to global financial stability.

The proposals consist of three interconnected pillars: minimum capital requirements, internal and external supervisory review and market discipline through increased disclosures by credit institutions.

Regarding *minimum capital requirements*, the effect of new framework on the activities of banks will depend upon the sophistication of their risk assessment methods. Smaller banks will be able to apply the simplest procedures which are based on the standards from 1988 and only slightly more complicated. Banks with more advanced risk management capabilities and also fulfil more stringent supervisory requirements will be able to apply the internal ratings-based approach. This approach leaves it to the discretion of the banks themselves to assess many key factors in credit risk, such as the probability of default of the borrower. New requirements are also introduced for operational risk and the choice of measurement approaches for it. On average, the new standards are not expected either to raise or to lower average capital adequacy requirements for credit institutions at global level. However, those made towards individual institutions may increase or decrease, according to their overall risk profile. Since only a small part of Icelandic credit institution will qualify to use the more complex version of the planned rules, their present capital requirement can be expected to increase on average after the reform.

The proposals underline that the new capital adequacy rules will be followed up with a closer *internal and external supervisory review* of their implementation. Greater responsibility on the part of the credit institutions and more effective official supervision are suggested. It is proposed that credit institutions should adopt methods that enable official supervisory institutions to assess whether each one has the capability and internal procedures to assess capital requirements in accordance with its degree of risk.

The report underlines a stronger role for *market discipline* in credit institutions' activities and in financial markets in general. Financial market participants should thereby be able to assess critical information describing the institutions' capital adequacy and risk profile. This goal should be achieved with effective disclosures of capital structure, risk exposure and capital adequacy.

It should be mentioned that, if accepted, the new Accord will not automatically become legally binding in Iceland. Current rules for Icelandic credit institutions (and securities companies) in this area are based on EEA law which reflects the 1988 Accord, cf. Council Directive 93/6/EEC of 15 March 1993 on the capital adequacy of investment firms and credit institutions, with subsequent amendments. The European Commission has been closely watching the Basel Committee's work and presented proposals for adapting them to the European banking and securities market environment. Both the Basel Committee's proposals and those of the Commission have now been referred for comments to interested parties. New rules in this area are expected to be implemented in Europe in 2004.