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The New Basel Capital Accord Proposals

*Gabriela Basurto and Luis Alberto Giorgio**

Introduction

In June 2001, the Basel Committee on Banking Supervision (the Committee) announced that the deadline for finalizing the New Basel Capital Accord (NBCA) had been extended. This decision was made after more than 250 comments on the NBCA January 2001 proposals (Second Consultative Package) were submitted by institutions all over the world. A new set of proposals will be issued for consultation by the beginning of 2002 and finished by the end of that year. Thus, the implementation of the NBCA is expected to take place by 2005.

Central bank governors of the Group of Ten established the Basel Committee

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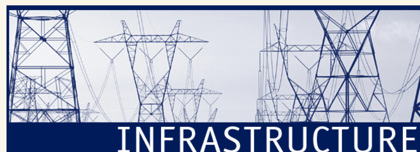

Reform in Small Electricity Markets: A Single Model?[1]

*Jaime Millan and Antonio Vives**

Background

Power sector reformers in Latin America and the Caribbean sought to attract private investors while using competition to achieve efficiency and to keep regulatory burden down. The main objective of reforms was to liberate governments from a cumbersome fiscal burden, while at the same time attaining economic efficiency goals under the constraint imposed by equity and environmental considerations. The implementation of reform in small

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[1] The positions presented in this paper are not official Bank policy and are intended to facilitate the debate on the best course of action.

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◀ p. 1 New Basel Capital

on Banking Supervision in 1974. The Committee is currently made up of senior representatives of bank supervisory bodies as well as central banks from 13 countries.[1] Its permanent Secretariat is located at the Bank for International Settlements in Basel. The Committee does not have any formal international enforcement authority, but its recommendations serve as a benchmark for assessing the strength and stability of a country's banking sector. The ability of countries to actively participate in international markets increasingly depends on the market's perception of their compliance with best practices produced by this and other international committees.

In 1988 the Committee issued the current Basel Capital Accord, which was adopted by over 100 countries, including most of the countries of Latin America and the Caribbean. The 1988 Basel Capital Accord sets out the details of an agreed framework for measuring capital and the minimum standard of capital adequacy to be achieved, mainly with regards to the risk of borrower failure (credit risk). Under the current Basel Capital Accord banks should not have aggregated risk weighted loans which exceed 12.5 times their capital, that is equivalent to a minimum ratio of capital to risk weighted assets (RWA) of 8 percent. The 1988 Accord determines that Tier I capital (i.e. equity capital and disclosed reserves) should comprise at least 50 percent of a bank's capital base.[2] The principle underlying the Basel Capital Accord is that prudent banks should only lend out a multiple of their capital in order to safeguard depositors' interests. However, not all financial assets have the same degree of risk. The safest kind of loan is one in national currency to governments and central banks of stable economies; therefore, the 1988 Accord assigns it a risk weight of 0 percent. At the other end of the spectrum, commercial companies and most real estate loans carry a risk weight of 100 percent. Mortgages on residential property, occupied as a home, are allocated a 50 percent weight.

■ Under the 1988 Basel Capital Accord banks should not have aggregated risk weighted loans which exceed 12.5 times their capital, that is equivalent to a minimum ratio of capital to risk weighted assets (RWA) of eight percent. ■

Changes to the Basel Capital Accord are being proposed to cope with the financial innovations of the 1990s. The main characteristics of the New Basel Capital Accord, along with the main comments submitted by several Latin American entities are discussed in the following sections.

The Proposed New Basel Capital Accord

The definition of capital and the minimum ratio of capital to RWA remain unchanged in the NBCA. However, the NBCA introduces a more comprehensive approach to addressing risk by examining the different characteristics of operational, credit, market and interest rate risk. The 1988 Accord allocates risk into bands, mainly relative to the status of the borrower. The NBCA uses a more refined risk weighting procedure under which credit risk may fall below the required capital ratio of 8 percent. However, once operational, market and interest rate risks are added, the minimum weighted regulatory capital remains the same.

The NBCA uses three mutually reinforcing *pillars*: minimum capital requirements, supervision, and market discipline. This framework gives greater emphasis to banks' own assessments of risks in determining capital requirements, reinforced by internal and external supervision, and enhanced disclosure. Although the new framework is primarily directed at banks that are active in international markets, its underlying principles are intended to be suitable for all significant banks.

Pillar I (on minimum capital requirement) tries to apply some of the innovations in risk management and measurement to the weighting of different categories of assets. It proposes, at one level, a *standardized* approach to credit risk with progression to a higher approach based on *internal ratings*. In the Standardized Approach borrowers are first categorized into groupings risk weights and then they are allocated according to credit assessments from external credit agencies. Recognition is

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[1] Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, United Kingdom and the United States.

[2] Supplementary capital (or Tier 2) includes elements such as undisclosed reserves and revaluation reserves, depending on each country's legal and accounting regimes.

given to credit risk mitigation techniques such as the use of collateral and guarantees.

■ *The definition of capital and the minimum ratio of capital RWA remain unchanged in the NBCA. However, the NBCA introduces a more comprehensive approach to addressing risk by examining the different characteristics of operational, credit, market and interest rate risk.* ■

The Internal Ratings-Based Approach (IRB) allows banks to use a measure of their own-recorded experience in the weighting of risk. In the IRB approach, the key statistics regarding losses include: a rating that reflects the probability of default of the borrower (PD); the loss given default (LGD); a measure of exposure at default; a granularity adjustment (diversification of portfolio); a maturity adjustment; expected losses (defined as (EL)=(PDxLGD)), and unexpected losses.

It is expected that an increasing number of banks will migrate towards the IRB approach. Once a bank adopts the IRB approach it must do so for all exposures across all significant business units. It cannot mix IRB and Standardized approaches.

The main feature of Pillar II (supervision) is represented by the role of external supervisors to test and check the IRB against benchmarks and the bank's own records, to ensure soundness and competitiveness within the banking industry. Pillar III (market discipline) will set the necessary requirements for appropriate disclosure of information and policies to allow market-informed actions.

Main Comments Provided by the Latin American Countries

The consultation process has made important contributions to the evolution and improvement of the capital adequacy framework, maintaining it on a par with the complexity and advancements of the banking industry. Throughout this consultation process, financial authorities and private sector entities worldwide have submitted detailed comments and recommendations to the Committee. Latin American banking institutions have also participated in this process. This section outlines some of the common observations (both conceptual and related to implementation) made by public and private entities in Latin America to the Second Consultative Package on the New Accord (the full set of comments can be found at http://www.bis.org/bcbs/cacomments.htm)[3]:

Claims on Sovereigns. The scale of weights assigned to the claims on sovereigns is asymmetric and unnecessarily steep. In some Latin America countries, the weight assigned for sovereign debt would increase from 0 percent to 100 percent. This could imply an increase in the cost of sovereign debt and, therefore, a decrease in capital inflows to those countries. Respondents recommended the development of an improved table with a symmetric pattern and gradual changes between weights.

Pro-cyclicality. The system of time-varying risk weight may lead to a pro-cyclicality that may induce systemic risk. In particular, the risk weights for claims on sovereigns should change gradually over a period of time.

Guidelines on Provisioning Rules. The NBCA does not set guidelines on provisioning rules, in particular, it suggests that capital requirements will be calibrated to cover both expected and unexpected losses. Therefore, a clear relationship between provisioning and loan classification vis-à-vis capital adequacy cannot be established. This is of particular concern for some Latin American countries since provisions tend to be much higher as a percentage of gross financing in the region (around 8%) than in some G10 countries.

Operational Risk. The 20 percent capital weight applied to operational risk under the Standardized Approach seems too high. Although the whole proposal has been calibrated to get an average total capital requirement equal to the current level for banks in the G10 countries, this is not the case for other countries. Therefore, the capital weight of operational risks may demand more capital than needed when applied to Latin American countries.

Application of Approaches. The NBCA does not allow flexibility to apply the Standardized or the IRB approach to different segments of the portfolio. However, many regulators think that each approach may be useful for different segments. For instance, there is a strong opinion about the use of banks' internal

■ *The NBCA uses three mutually reinforcing pillars: minimum capital requirements, supervision, and market discipline. This framework gives greater emphasis to bank's own assessments of risks in determining capital requirements, reinforced by internal and external supervision, and enhanced disclosure.* ■

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[3] The following Latin American financial institutions and private sector entities submitted comments to the Basel Committee on Banking Supervision: (1) Asociación Bancaria Costarrisense; (2) Banco de México; (3) Federación Latinoamericana de Bancos, la Asociación Bancaria de Colombia y la Facultad de Administración de la Universidad de los Andes; (4) Latin American Shadow Financial Regulatory Committee; (5) Latin American Banking Association; (6) Superintendencia de Bancos de Guatemala; (7) Superintendencia de Bancos de Chile y, (8) "The Group": Banco Central de la República de Argentina; Superintendencia de Bancos y Entidades Financieras de Bolivia; Banco de la República (Colombia); Superintendencia de Entidades Financieras de Costa Rica; Comisión Nacional de Bancos y Seguros de Honduras; Banco Central del Paraguay; Banco Central de la República Domnincana; Banco Central del Uruguay y Superintendencia de Instituciones de Intermediación Financiera del Uruguay y, Banco Central de Venezuela.

ratings for assessing sovereign risk because private external agencies have had a poor record in assessing sovereign risk. However, for claims on banks (and corporates), there may be advantages in the use of external ratings depending on national characteristics.

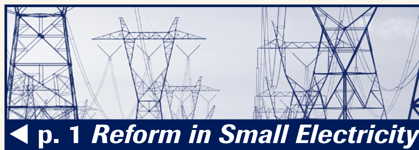
Consolidation. More precision is necessary regarding upward consolidation. That is, the equalization of accounting rules among different regulators and among countries would be a worthy objective. The treatment of a subsidiary or branch where the parent is incorporated in another jurisdiction is an issue that is not clearly defined in the proposal.

Timing. Legal and technical difficulties at the banking industry and at the supervisory level (including legal protection for the supervisor) are obstacles to the achievement of the 2004 deadline for implementation. Some countries may still be moving towards full implementation by the established date.

Conclusions

The implementation of the NBCA will pose significant challenges to the region. Several critical issues emerge for the future of the region's financial systems. In particular, the need to change the regulatory treatment of specific credit exposures (governments, banks, corporations, etc) and to evaluate the possible impact on the banking industry of a deterioration in the government's credit ratings. Moreover, an evaluation of the overall costs and benefits of the NBCA framework for banking institutions in Latin America and the Caribbean will be useful.

The Bank that has been highly involved in the region's financial sector reform process and has long-term interaction with local authorities and regional institutions. Thus, it is a natural platform for the design and provision of technical cooperation on these matters. This support could be implemented through training, technical assistance and exchange of experiences. ■



economies in the region has not been an easy task because technical and institutional constraints impose unavoidable trade-offs. Competition needs both competitors and adequate market structure. If either one is missing, unbearable regulatory transaction costs can undo the benefits of competition. Market size and the lack of an adequate institutional and human resources endowment limit the options for small economies. Institutions that are taken for granted in other countries (such as the rule of law, clear and accepted property rights, independent and competent judiciary, mechanisms for peaceful dispute resolution, enforceable contracts, quality of public bureaucracies and competition agencies) are either missing or incipient. This is a key determinant of the market structure chosen.

Some of these constraints may be removed or lessened through time and effort, thus making feasible the type of workable competition that reformers originally had in mind. Therefore, the basic issue is about recognizing which constraints can be lifted and when and which ones may not be changed in the medium term. For instance, a larger market could be obtained by integrating regional markets, as intended in the case of the countries of Central America. Such an institution would not be easy to create and will take some time to develop as the experiences from the much more integrated and developed economies of the European Union has shown.

This article presents a summary of the issues confronted by small electricity markets in the region. It is based on research conducted in the Bank during the last year and, in particular, on discussions held during a seminar (April 27, 2001) that included the participation of a distinguished panel of international experts. The debate has been helpful. It has promoted a measure of convergence of views on what is feasible and what is not. However, the devil remains in the details and the plausibility of particular proposals and their likely outcomes depends on understanding local conditions and on the relative importance given to the different issues always present in the trade-off. As such we may not have discovered the ideal solution, but we can warn against bad ones.

■ ***Some constraints may be removed or lessened through time and effort, thus making feasible the type of workable competition that reformers originally had in mind. Therefore, the basic issue is about recognizing which constraints can be lifted and when and which ones may not be changed in the medium-term*** ■

Some Shared Views

Institutional and technical constraints prevent the attainment of competitive electricity markets in small countries. This is the case in Central America and the Caribbean, at least in the short term. It may just be impossible to have the structure required for competition in the market not only because economies of scale limits the number of players in a small market but because competitive markets are highly demanding on technical skills and institutional capability. Nonetheless, most markets, even small ones, may reach to some form of competition for the market.

The global strategies of multinational companies and the importance of economies of scale, and/or scope in their operations explain their preferences for a large presence in a given country. Furthermore, having activities in both regulated and unregulated segments of the market assures a buyer for their energy and provides a competitive advantage. They may argue that high institutional risks have to be balanced by reduced commercial risk. While this may facilitate their operations, it clearly gives them a large asymmetry in their relations with the regulator and increases regulatory transaction costs because it makes vigilance of competition more difficult. This is a particularly acute problem in smaller economies as the economic power of the multinationals may overshadow that of the government. It is exacerbated by the need, in many of these countries, to attract investors with access to significant financial resources, sometimes only available to these very powerful firms.

Reliable service in small countries with large regulatory risks usually commands a premium. While there is consensus on the need to improve the capacity of regulatory institutions, it is acknowledged that there are limits to what can be expected in the short run. Furthermore, the consolidation of an integrated regional energy market may take a long time to achieve. Meanwhile, countries must deal with these regulatory failures and energy prices will reflect these risks as well as the lack of a competitive environment.

Even if competition is not feasible in the short term, care *should be taken not to foreclose future options for competition because many present constraints may be removed in the future.* The short-term constraints, sometimes structural, but some times circumstantial, should not prevent the search for better long-term efficiency. For instance, it is recognized that, given the proper considerations in the design of the regulation, it may be advisable to regulate very small markets, such as Nicaragua, as if it were a vertically integrated monopoly. However, control of the transmission system by the monopolist after conditions for regional competition are more likely may impede the free access to the Nicaraguan system. Provisions, such as clear exit strategies, should be made to avoid creating barriers that foreclose opportunities to achieve competition in a future integrated regional market. Maintaining the transmission system independent and open is key to future competition for and in the market. *Substituting wholesale competitive markets by medium-term contracts competitively procured and a cost-based spot market may be a second best solution, if properly regulated.* This approach (with some variations) is used in Panama, Guatemala and the Dominican Republic. While other forms of regulating the pass-through of generation costs to the final consumers may be explored, it should be kept in mind that there is no trouble-free solution. In any case, a clear and ex-ante exit strategy is needed to minimize future compensations for stranded costs.

■ *Decision-makers are forced to evaluate and resolve the trade-offs implicit in each particular project and condition. The issue is how to achieve the best balance given the situation.* ■

Making Trade-Offs

Faced with the limitations indicated above decision-makers are forced to evaluate and resolve the trade-offs implicit in each particular project and condition. The issue is how to achieve the best balance given the situation. A criterion for choosing solutions may be the minimization of regulatory transaction costs in the short-term to buy time to develop the necessary institutional capacity while watching that future avenues for competition are not foreclosed. To illustrate this point we summarize some trade-offs common in power projects in small countries.

■ *Institutions taken for granted in other countries –like the rule of law, clear and accepted property rights, independent and competent judiciary, mechanisms for peaceful dispute-resolution, contract enforceability, quality of public bureaucracies and competition agencies– are either missing or incipient. This is a key determinant of the market structure chosen.* ■

More Players vs. Larger Project Development Costs. Bringing in more players may involve larger project development costs. For instance, small generation projects may imply further assistance to sponsors. Also, small companies may not be as reliable as large multinationals. There may be a premium to pay for having more diversity. However, the participation of more qualified players may be essential for future market development and increasing confidence in the reliability of service.

Competition vs. Foreign Investors. Because of existing country risk and lack of credible commitment there is a trade-off between competition, which keeps prices down but increases investor's risk, and the comfort usually sought by lenders for infrastructure projects. The benefits of competition must be weighed against the costs of attaining it. Competition is not an end but a means to obtain lower prices for consumers. One may relinquish competition temporarily if there are assurances that consumers may get a reasonable deal by industry standards, properly regulated and controlled and audited by independent organizations.

Financing a Project vs. Helping to Develop Markets for Electricity. Some projects may look attractive in isolation and in the short run but they may foreclose future options for competition or may give the wrong signals to the market regarding how the country's authorities are supporting reforms intended to develop competitive

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◄ p. 5 *Reform in Small Electricity*

markets at the appropriate time. What looks to be the right project may mortgage the future.

Regulation vs. Competition. Although this may be a false dilemma in the short run, in the long run more competition reduces the regulatory burden since energy prices are determined by the market and not by regulators. Of course, distribution and transmission prices should be kept regulated, and regulators should prevent participants from achieving or exercising market power. Nevertheless, establishing a competitive market on a step-by-step basis and making market conditions evolve toward competition demands strong and consistent regulation.

Some Policy Recommendations

To maximize their impact on development, multilateral financial institutions (MFIs) should follow the following guidelines during the evaluation of support for power sector projects in small countries.

Any support to a private power project must follow the outcome of a policy dialogue (as indicated in the IDB's Energy Strategy). The dialogue should identify the kind of support needed to assure the compatibility of the electricity market adopted with the existing or foreseen country institutions (sector regulation, rule of law, judicial system, enforcement, political situation, etc.) Given that regional integration is an objective, regional market convergence should also be a consideration.

A major effort must be made to find projects that fit better with the agreed upon market conditions of the country. Support should offer incentives for players that agree to play according to the rules. The trade-offs described above should be carefully analyzed in each proposed intervention and a conscious decision made.

Projects that foreclose the development of a future integrated competitive market should not be financed or supported by MFIs. Operations imposing constraints and/or privileges to access of transmission networks should be avoided. Short-term restrictions on the access to transmission may be accepted in order to guarantee proper returns to an investment. Nevertheless, clear contractual and legal provisions should limit such restrictions.

Very small markets may be better regulated as vertically integrated monopolies if clear exit strategies are established to avoid future stranded costs. In larger markets, the existence of a single monopoly may not be advisable. Vertical integration should be waived only under careful analysis of the case at hand. Three points should be always assessed. First, there are clear assurances that the project will provide electricity to final consumers at a very low cost, measured by comparable standards. Second, provisions to ameliorate eventual future stranded costs are in place. Third, the regulatory framework includes provisions to compensate for eventual weakness in controlling a large and powerful monopoly.

Decisions should be based on a careful analysis of the institutional structure of the country. The institutional structure, market structure and set of participants must be balanced and compatible with each other. MFIs should stand ready to support the parts of this equation that need support and do so with a view to what is best for the country in the long run within a time frame compatible with the blueprint for market development. In small developing markets, it is almost impossible to have institutions capable of balancing the power of very large multinationals. In this regard, an important role of MFIs would be to help strike this balance. ■

■ ***Vertical integration should be waived only under careful analysis of the case at hand. Three points should be always assessed. First, there are clear assurances that project will provide electricity to the final consumer at very low cost, measured by comparable standards. Second, provisions to ameliorate eventual future stranded costs are in place. Third, the regulatory framework includes provisions to compensate for eventual weakness in controlling a large and powerful monopoly.*** ■

Book Reviews, Articles & Papers:

Economics of Regulation and Antitrust, by Viscusi, W.P., J. M. Vernon and J.R. Harrington, Jr., Third Edition, The MIT Press, Cambridge, 2000

Everything you always wanted to know about imperfect markets and their regulation, but did not have the time to learn. This is a comprehensive textbook and even though it is suitable for graduate courses in economics, it has the unusual virtue of being very readable, with no abuse of mathematics, explaining most of the concepts with the use of graphs based on elementary economic concepts. The book is full of short cases or examples to illustrate the concepts. It does not start with the institutional aspects and antitrust policies, but rather begins with the economics issues at stake, i.e., what particular market failures call for government interventions and how should this intervention be tailored to avoid further distortions. The approach and concepts of this textbook would be of great help in designing Bank Group support for government regulation. It covers most topics, from antitrust issues to economic regulation of monopolies (particularly in infrastructure) to health, safety and environmental regulation. It is based on cases, examples and theories applicable to the United States, but many concepts carry into less developed markets.

From State to Market: A Survey of Empirical Studies on Privatization, Megginson, W.L. and J.M. Netter, Journal of Economic Literature, Vol 39, Number 2, June 2001.

Comprehensive review (69 pages) of the most recent literature on the impact of privatization. After an analysis of recent trends and methods of divestiture, the paper reviews a considerable number of empirical papers dealing with the economic efficiency of public versus private ownership, welfare gains, relative firm performance, financial market development and corporate governance practices. Results from privatization all over the world are analyzed. Although the review is biased towards the former communist countries, where most of the research has been done, some papers from Latin America are reviewed.

***"Risk Management"* by Michel Crouhy, Robert Mark, Dan Galai, McGraw-Hill Professional Book Group, 2001, ISBN 0071357319, Hardcover, 1st ed., 752 pages.**
***"Value at Risk, The Benchmark for Managing Financial Risk"* by Philippe Jorion, McGraw-Hill Professional Book Group; 2001, ISBN 007135502; Hardcover, 2nd edition, 544 pages.**

The financial crises of the 80s and 90s have increased the awareness of risk management and have paved the way to new research, techniques and theories and public policy recommendations in the field. Books and articles appear regularly and all devote attention to the new developments in the Basle Banking Committee, the mathematical and statistical analysis and tools, and the public policy implications and /or to some combinations of these three main areas of research.

Both the Jorion and the CGM books provide a comprehensive introduction to the subject of risk management within the framework of the New Basle Accord and the regulatory implications (probably Jorion's book develop to a greater extent the international and "political" background). The books include the various most relevant areas of risk (e.g., market risk, credit risk, liquidity and operational risk) and provide the mathematical tools and analysis, avoiding sophisticated calculations. You will not find, in both books, theoretical justifications of risk management or Value at Risk (VAR).

The book of Jorion focuses more on market risk, the use of Value at Risk, deals with liquidity risk and seems to indulge more on technical jargon, even though it emphasizes core ideas, beyond mathematical calculations. The book of CGM probably does a better job on covering less in details the various risks (with an extended analysis of credit risk, which does not appear in the Jorion's book), the structuring and managing of the risk management function in a financial institution.

While covering exhaustevely the technical areas, the books constitute an important tool for practitioners and to a certain extent for policy makers. A thorough analysis of credit and market risks is the most important contribution of the books. However, operational risk is also accurately dealt with. In Chapter 14 and 15 of the book of CMG, the authors make an effort to put everything together, while a similar attempt does not seem to emerge from the book of Jorion, which concentrates more on the technical aspects and the risk strategies.

Probably, form the point of view of a reader who wants not only the analytical tools, indispensable for understanding the issues and make decisions, but also the big picture like, for instance, the link between risk management and pricing, the two books do not provide a direct an satisfactory answer and he/she should look elsewhere. Needless to say, there is scant reference in the two books about countries outside the US and more importantly emerging countries and their specificity.

The books are based on the vast experience of the authors, who are well known in academics and in the practice. The books are mainly oriented toward banks, (the CGM includes a very

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interesting chapter on risk management in nonbank corporations) and could be used in a classroom, as a handbook for a market professional or for a policy maker and a regulator.

The book of CGM seems to be a more systematic and comprehensive overview of modern financial risk management with emphasis on banking. The book of Jorion is a very significant complement, certainly an industry standard for value at risk.

The New Basel Capital Accord.

The Basel Committee on Banking Supervision (the Committee), which is part of the Bank for International Sttlements (BIS), issued the New Basel Capital Accord in early 2001 to replace the original 1988 Capital Accord. (A draft was released in June 1999.) This new accord can be found in the BIS site (www.bis.org) in several documents: An explanatory Note (16 pages), an Overview (39 pages), the Accord itself (139 pages).

Other recommended documents.

Also included are the supporting documents: Standardised Approach to Credit Risk (56 pages), The Internal Ratings-Based Approach (108 pages), Asset Securitization (32 pages), Operational Risk (30 pages), Pillar 2 on the Supervisory Review Process (16 pages), Principles for the Management and Supervision of Interest Rate Risk (42 pages) and Pillar 3 on Market Discipline (63 pages). This work is indeed a monumental task. Also posted on the site are several hundred comments issued on the Second Consultative package (the New Accord) by the financial community. Do not overload your printer! The Committee is expected to release a complete and fully specified proposal for an additional round of consultation in early 2002 and will finalize the new accord during 2002. The Basel Committee envisions an implementation date of 2005 for the new accord.

The Infrastructure and Financial Markets Division of the Sustainable Development Department provides technical and advisory support, research and dissemination within the IDB group. This mission is accomplished through the development of policies and strategies, training programs, and dissemination of best practices.

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