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THE NEW CAPITAL ACCORD AND ITS POSSIBLE IMPACT ON SMALL JURISDICTIONS*

Karol J. Gabarretta[§]

Abstract: This paper describes the salient features of the New Capital Accord and its implications for regulators in small jurisdictions. It is argued that the provisions of the Accord will have to be implemented in small jurisdictions in spite of the fact that they were intended primarily for banks operating internationally. This is likely to create a number of problems for regulators in such jurisdictions concerning primarily the interpretation of the Accord, the exchange of information and the collection of data of sufficient quality for the purposes of the Accord.

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Introduction

The regulation of financial services, particularly that with respect to banking, is a constantly evolving process. Supranational institutions such as the Basel Committee on Banking Supervision (BCBS)[1], the International Monetary Fund and World Bank – particularly through their joint Financial Sector Assessment Programme (FSAP) – the European Commission (EU) immediately come to mind as being the drivers in the global development for more comprehensive prudential regulatory and supervisory standards.

It has been the general practice, especially up to a decade ago, for regulators (including the entities mentioned above) to devise new prudential and systemic regulator standards[2] aimed at enhancing the safety and soundness of financial institutions largely in response to the increasingly sophisticated products and techniques churned out by the world's larger banks and other financial institutions coming predominantly from developed countries. Moreover, while regulatory initiatives are frequently developed and implemented after a relatively long incubation process, these are being formulated in an environment characterized by a rapidly changing background of financial innovation. All this implies that, inevitably, the regulatory response tends to be more a reactive one rather than a proactive one.

A significant example that illustrates this drawback in the prudential regulatory framework is the 1988 Basel Capital Accord (hereafter the 1988 Accord) which provides that G-10 internationally active banks would have a minimum 8% risk-weighted capital adequacy ratio. "The agreement was made against a background of concerns about a decline in capital held by banks and worries that banks from some jurisdictions were seeking a short-term competitive advantage by maintaining too low a level of capital" (Jackson and Emblow, 2001: 119). Although the 1988 Accord has often been described as being a milestone in the history of banking regulation, it has received widespread criticism to the effect that, at best, its somewhat simplified methodology regarding the risk weighting of assets is a very crude measure of economic risk. This is primarily because degrees of credit risk disclosure are not sufficiently calibrated as to adequately differentiate between borrowers' differing default risks (June 1999 proposal by Basel Committee as quoted in *The Banker*, April 2001: 6).

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1. The Basel Committee on Banking Supervision is a committee of banking supervisory authorities, which was established by the central bank governors of the Group of Ten countries in 1975. It consists of senior representatives of bank supervisory authorities
and central banks from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States. It usually meets at the Bank for International Settlements in Basel, where its permanent
Secretariat is located.

2. Prudential regulation concerns the safety and soundness of financial institutions vis-àvis consumer protection while systemic regulation is about the safety and soundness of financial institutions for purely systemic reasons (see Goodhart *et al*, 1998: 5).

This inability of the 1988 Accord to distinguish clearly between investment grade borrowers and junk borrowers could have possibly contributed to entice some financial institutions to be more risk-seeking, instead of helping them control their risks. Another related problem with the existing 1988 Accord is the ability of banks to arbitrage their regulatory capital requirement and exploit differences between the true economic risk and risk measured under the 1988 Accord (*ibid*). Due to the limitations of the crude rules of the 1988 accord, there has been broadbased pressure to radically review this Accord. It can be said that in effect the review process which originated in the early 1990s, culminated in the publication in June 1999 of the *First Consultative Package on the New Accord by the BCBS*. This was followed by the Second Consultative Package (or CP2) in January 2001. As a result of this lengthy and often torturous consultative process, the BCBS is firmly committed to developing the New Basel Capital Accord (hereafter the New Accord) whose implementation is scheduled for the end of 2006.

While the introduction of common minimum capital requirements against credit risk as specified in the 1988 Accord was primarily directed at strengthening the soundness and stability of internationally active G-10 banks, one today finds that the 1988 Accord has been adopted by more than 100 countries (Bank for International Settlements, 2001: 2). Undoubtedly, small states and islands also featured among these countries given that, the 1988 Accord, in spite of its shortcomings, gradually became universally accepted as the minimum international benchmark that one had to adhere to. By the same token, one can expect that notwithstanding that the New Accord specifies that it will be applicable to internationally active banks – that is those with foreign branches and subsidiaries or those undertaking significant cross-border or Eurocurrency business (Cornford, 2001: 2) – the proposed Accord will in future also have to be adopted by a large number of countries including jurisdictions falling within the small state and island category, irrespective of whether or not the New Accord is suited for such small states or small operators.

This paper is divided into two main parts. The first part, besides looking briefly into the rationale for the adoption of New Accord, is mainly devoted to reviewing its salient points. The second focuses on the premise that adoption of the New Accord by regulators responsible for small jurisdictions is virtually a foregone conclusion in spite of the fact that the New Accord has been drawn up primarily with internationally active banks in mind. Given this assumption, the remainder of the second part is devoted to evaluating the possible impact that implementation of the New Accord could have on small jurisdictions. The paper concludes by referring to the experience that Malta underwent when implementing the 1988 Accord and expounds on the approach which is expected to be adopted with respect to the New Accord so as to highlight particular problems which small jurisdictions might face in the future implementation of this Accord.

Rationale for Adoption of the New Accord

The main reasons for the adoption of the New Accord have already been hinted at in the introduction above. However, it is worth examining these reasons in more detail in order to formulate a general idea as to what led the BCBS to undertake such a drastic rework of

the 1988 Accord. It has been said that the main attributes of the 1988 Accord could be summed up under six headings (Magnusson and Andonov, 2002). These relate to the:

- financial stability aspect (the ‘safety and soundness’ consideration);
- levelling of the competitive field (with particular regard to ‘internationally active’ banks);
- introduction of minimum requirements (the 8% capital adequacy ratio);
- standardisation element (common measure of qualifying capital);
- prudential requirements against credit risk;
- simplicity aspect (relatively simple to implement).

Subsequent to its implementation, the 1988 Accord was hailed as having contributed significantly towards stopping the decline in capital held by banks from some jurisdictions (mainly G-10) and having ensured, “through the adoption by…[most] countries of common rules, that this would not lead to competitive distortions” (Hadjiemmanuil, 2002: 1). Notwithstanding this contribution, criticism soon started to emerge from both developing and developed countries on the functioning of the 1988 Accord which forced, as will be seen below, a (radical) rethink of some of the principles underlying the present Accord. In fact, it has been stated that

> “... from a developing country perspective, the OECD/non-OECD distinction in risk-weights is crude, unfair and provides a distorting incentive for developing countries to seek OECD membership. Most importantly, the lower (20%) risk-weights attached to short-term loans for emerging markets created a bias in their favour whilst credit to non-OECD banks with over one year maturity was discouraged by a far higher (100%) risk weight.” (Griffith-Jones and Spratt, 2001: 1).

On the other hand, “from the perspective of international banks…current regulations i.e. the 1988 Accord, have created a disincentive to the holding of prime quality loans – the uniform 100% risk weight attributed to private borrowers – regardless of their creditworthiness” (Cornford, 2000: 3)]… “Consequently, banks have an incentive to hold a disproportionate quantity of poorer quality loans. Also of concern has been the limited recognition of credit mitigation instruments in the calculation of capital requirements” (Griffith-Jones and Spratt, 2001).

Furthermore, though unsurprisingly not recognised enough in the early stages of the Accord’s life, there was subsequently widespread realization that “the very broad risk categories in the Basle Accord give scope for banks to arbitrage between their economic assessment of risk and the regulatory capital requirements” (BIS, 1999: 21). According to the research carried out by the BIS’s Working Party on Bank Capital and Behaviour to assess the empirical evidence on the impact of the 1988 Accord over a ten year period,

significant amounts of securitisationrelated[3] capital arbitrage have been undertaken by US [4], Canadian, European and Japanese banks.

Therefore, the 1988 Accord though "praised for the international convergence of capital standards and for the improvement of these standards in many countries" (BIS, 2000:1) has, because of the "broad-brush nature of the risk categories" (Jackson and Emblow, 2001: 119), been held responsible "for several distortions to the business of banking" (*Ibid*). Besides these shortcomings, the lobbying by internationally active banks to utilise the sophisticated systems they had developed "for commercial risk management and performance measurement purposes [through] internal models which estimate credit risk arising in significant geographical and product business lines" (Hadjiemmanuil, 2002: 3), as a basis for determining their regulatory capital requirements (against credit risk) undoubtedly was also a determining factor behind the BCBS' decision to undertake a comprehensive review of the 1988 Accord. Moreover, the widespread criticism of the 1988 Accord particularly in the second half of the 1990s coincided with a series of dramatic crises in the international financial world, with catastrophic contagious effects, especially on the financial sector in Asia, Eastern Europe and Latin America. These events led the world's major financial organisations, including the International Monetary Fund, the World Bank and the Bank for International Settlements, to marshal their resources for the formulation of a new financial architecture in order to be able to address the new threats and challenges facing the financial sector worldwide.

Table I reproduced from the BIS consultative package of documents issued in January 2001 summarises the reasons for the adoption of the New Accord.

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3. "Securitisation involves the sale of assets to a "special purpose vehicle" (SPV), which finances this purchase through issuance of asset-backed securities (ABSs) to private investors. For bankruptcy, accounting and regulatory purposes, SPVs generally are treated as legally separate from the sponsoring bank, and so are not consolidated into the sponsor's financial statements and regulatory reports. In many cases, a bank can treat securitised assets as "true sales" for accounting and regulatory purposes, even though the bank retains most of the underlying risks through credit enhancements it provides to the ABSs". Source: Bank for International Settlements, 1999: 23.
4. "As of March 1998, outstanding non-mortgage ABSs and [Asset-Backed Commercial Paper programmes] ABCP issued by…[the ten largest US bank holding companies] exceeded $200 billion, or more than 12% (25%), on average, of the institutions' total riskweighted assets (loans). For several [of these] institutions, the combined issuance of ABSs and ABCP approached 25% (50%) of total risk-weighted assets (loans)". Source: Bank for International Settlements, 1999: 26.

Table 1
Reasons for the Adoption of the New Accord

The existing Accord	The Proposed New Accord
Focus on a single risk measure	More emphasis on bank's own internal methodologies, supervisory review, and market discipline
One size fits all	Flexibility, menu of approaches, incentives for better risk management
Broad brush structure	More risk sensitivity

After the setting up by the BCBS of a *Task Force on the Future of Capital Regulation* in December 1998, the process of amending the 1988 Accord was initiated through the issue for comment, in June 1999, of a proposal (i.e. the *First Consultative Document*) to amend the original framework for setting capital charges for credit risk. The document also proposed to develop capital charges for risks not taken into account by the present Accord, such as interest rate risk in the banking book and operational risk (Santos, 2000:1). Despite the issue of the *Second Consultative Package* in January 2001 as well as several working papers, press releases and impact studies, the basic structure of the New Accord as proposed in the *First Consultative Document* remains largely unchanged.

The Proposed New Accord – Key Aspects

This section draws extensively from the BIS document "The New Basle Capital Accord: An Explanatory Note", which forms part of the 2001 package, and highlights the main features of the proposed New Accord.

The proposed time schedule for the implementation of the New Accord is as follows:
•October 2002 – January 2003: Third Quantitative Impact Study (QIS3)
•Spring 2003: Third Consultative Document
•Autumn 2003: Final Paper

Parallel calculations of the old and new Capital Adequancy ratio (during 2006) with actual implementation of the Accord is scheduled for end 2006 for BCBS members (or internationally active banks) although it has been recognised that other countries may need more time to adopt it in its entirety (Nouy, 2002).

Although perhaps not immediately apparent from the guarded words of the BCBS itself, the New Accord is a radical departure from the previous one. In fact:

> [t]he new framework intends to provide approaches which are both more comprehensive and more sensitive to risks than the 1988 Accord, while maintaining the overall level of regulatory capital. Capital requirements that are more in line with underlying risks will allow banks to manage their businesses more efficiently. The new framework is less prescriptive

than the original Accord. At its simplest, the framework is somewhat more complex than the old, but it offers a range of approaches for banks capable of using more risksensitive analytical methodologies. These inevitably require more detail in their application and hence a thicker rulebook." (Bank for International Settlements, 2001: 1).

The proposed New Accord is based on three mutually reinforcing pillars that allow banks and supervisors to evaluate properly the various risks that banks face (Jeanneau, 2001: 61). Accordingly, the New Accord is structured as follows:

- First pillar: Minimum capital requirements;
- Second pillar: Supervisory review process;
- Third pillar: Effective use of market discipline.

Pillar 1: Minimum Capital Requirements

Table 2 reproduced from the BIS document – *The New Basel Capital Accord: an Explanatory Note* – summarises the principal elements found under this pillar. As can be expected, a substantial part of the documentation pertaining to the New Accord is taken up by the various methodologies and approaches falling under this pillar.

Table 2
How Capital Adequacy is Measured

Total capital (unchanged) / Credit risk + Market risk + Operational risk	= the bank's capital ratio (minimum 8%)
Standardised Approach (a modified version of the existing approach)	
Foundation Internal Rating Based Approach	
Advanced Internal Rating Based Approach	
Menu of approaches to measure market risk (unchanged)	
Standardised Approach	
Internal Models Approach	
Menu of approaches to measure operational risk	
Basic Indicator Approach	
Standardised Approach	
Internal Measurement Approach	

For the measurement of credit risk, two principal options have been proposed. The first is the *standardised approach*, and the second the *internal rating based (IRB) approach*. The *standardised approach* is conceptually the same as that found in the present Accord, but is more risk sensitive. Under this approach, the bank allocates a risk-weight to each of its assets and off-balance-sheet positions and produces a sum of risk-weighted asset values. A risk weight of 100% means that an exposure is included in the calculation of risk weighted assets at its full value, which translates into a capital charge equal to 8% of that

value. Similarly, a risk weight of 20% results in a capital charge of 1.6% (i.e. one fifth of 8%).
Table 3 summarises the various options allowed under the *standardized approach* for slotting exposures according to ratings from eligible external rating agencies (Bank for International Settlements, 2001: 3-4)

Under the *IRB approach*, banks will be allowed to use their internal estimates of borrower creditworthiness to assess credit risk in their portfolios, subject to strict methodological and disclosure standards. The use of the *IRB approach* will be subject to approval by the supervisor, based on the standards established by the BCBS in the New Accord. Distinct analytical frameworks will be provided for different types of loan exposures, for example corporate and retail lending, whose loss characteristics are different. Accordingly, a bank estimates each borrower's creditworthiness, and the results are translated into estimates of a potential future loss amount, which form the basis of minimum capital requirements. The framework allows for both a *foundation* method and more advanced methodologies for corporate, sovereign and bank exposures. In the *foundation* methodology, banks estimate the probability of default associated with each borrower and the supervisor will supply the other inputs. In the *advanced* methodology, a bank with a sufficiently developed internal capital allocation process will be permitted to supply other necessary inputs as well. Under both the *foundation* and advanced *IRB approach*es, the range of risk weights will be far more diverse than those in the *standardised approach*, thus resulting in greater risk sensitivity.

Credit risk mitigation and securitisation. The new framework introduces more risk sensitive approaches to the treatment of collateral, guarantees, credit derivatives, netting and securitisation, under both the *standardised approach* and the *IRB approach*.

Operational risk. The 1988 Accord sets a capital requirement simply in terms of credit risk (the principal risk for banks), though the overall capital requirement (i.e., the 8% minimum ratio) was intended to cover other risks as well. In 1996, market risk exposures were removed from the framework hitherto adopted and given separate capital charges. In its attempt to introduce greater credit risk sensitivity, the BCBS worked with the industry to develop a suitable capital charge for operational risk (for example, the risk of loss from computer failures, poor documentation a. Risk weighting based on risk weighting of sovereign in which the bank is incorporated, but one category less favourable or fraud). Although many major banks allocate a proportion of their internal capital to operational risk, it should be emphasised that the work on operational risk is still in its developmental stage. However, three different approaches of increasing sophistication (*basic indicato*r, *standardised*, and *internal measurement*) have been proposed in the *Accord*. The *basic indicator approach* utilises one indicator of operational risk for a bank's total activity. The *standardised approach* specifies different indicators for different business lines while the *internal measurement approach* requires banks to utilise their internal loss data in the estimation of required capital. It should be noted that the calibration in the latest working paper relating to operational risk is based on 12% of the current minimum regulatory capital meaning that there has been a reduction from the 20% charge proposed in January 2001.

Table 3

The Standardised Approach
Broad Summary using Standard & Poor's Methodology

Claim				**Assessment**		
	AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to B-	Below B-	Unrated
Sovereigns(if Export Credit Agencies)	0% (1)	20% (2)	50% (3)	100% (4-6)	150% (7)	100% (8)
Banks Option 1[a] Option 2[b] (	20% 20% (20%)c	50% 50% (50%)c	100% 50% (20%)c	100% 100% (50%)[c]	150% 150% (150%)[c]	100% 50% (20%)[c]
				BB+ to BB-	Below BB-	Unrated
Corporates	20%	50%	100%	100%	150%	100%
RetailMortgages Other retail						40% 75%

a. Risk weighting based on risk weighting of soverign in which the bank is incorporated but one category less favourable.
b. Risk weighting based on the assessment of the individual bank.
c. Claims on banks of a short original maturity, less than three months, would generally receive a weighting that is one category more favourable than the usual risk weight on the bank's claim.
Source: Daniele Nouy, BIS

Pillar 2: Supervisory Review Process

The supervisory review process requires supervisors to ensure that each bank has sound internal processes in place to assess the adequacy of its capital based on a thorough evaluation of its risks. The new framework stresses the importance of bank management developing an internal capital assessment process and setting targets for capital that are commensurate with the bank's particular risk profile and control environment.

More specifically, the supervisory review under the New Accord is based on four interlocking principles (Bank of England , 2001: 57), namely:

1. banks are required to have a process for assessing their capital requirements in relation to their individual risk profile. They should go beyond the scope of the Pillar 1 minimum requirements to consider risk concentrations, areas of risk without a specific capital charge such as interest rate risk in the banking book, and the appropriate level of capital to meet their particular strategic needs;
2. this process will be evaluated by supervisors, who will take action if they are not happy with any aspect of the bank's internal process;
3. banks are expected to operate with capital above the Pillar 1 minimum, both to reflect their specific profile and provide a cushion and if necessary, supervisors may use their powers to enforce this;
4. supervisors should intervene at an early stage to prevent capital from falling below the level required to support the bank's risk characteristics.

Under the new supervisory review process, supervisors would be responsible for evaluating how well banks are assessing their capital adequacy needs relative to their risks. This internal process would then be subject to supervisory review and intervention, where appropriate. The implementation of these proposals will in many cases require a much more detailed dialogue between supervisors and banks. This in turn has implications for the training and expertise of bank supervisors, an area in which the BCBS and the BIS's Financial Stability Institute will provide assistance.

Pillar 3: Effective use of Market Discipline

The third pillar of the new framework aims to bolster market discipline through enhanced disclosure by banks. Effective disclosure is essential to ensure that market participants can better understand banks' risk profiles and the adequacy of their capital positions. The new framework sets out disclosure requirements and recommendations in several areas, including the way a bank calculates its capital adequacy and its risk assessment methods. The core set of disclosure recommendations applies to all banks, with more detailed requirements for supervisory recognition of internal methodologies for credit risk, credit risk mitigation techniques and asset securitisation.

The Applicability of the New Accord

It has been stated time and again that the scope of application of the New Accord is to internationally active banks. Moreover, the New Accord specifically states that it would be "extended to include, on a fully consolidated basis, any holding company that is the parent entity within a banking group to ensure that it captures the risk of the whole banking group" (Bank for International Settlements, 2001: 1). Therefore, because the New Accord differentiates between internationally active and non internationally active banks *prima facie* it would appear that the New Accord should not be applied to banks classified under the latter category. Despite this, the following passage shows that the BCBS recognizes the limitations of being categoric, and the rather narrow scope of application mentioned above is further qualified in the New Accord itself.

> Although the new framework's focus is primarily on internationally active banks, its underlying principles are intended to be suitable for application to banks of varying levels of complexity and sophistication. More than 100 countries have adopted the 1988 Accord, and the Committee [the BCBS] has consulted with supervisors world-wide in developing the new framework. The goal of this effort has been to ensure that the principles embodied in the three pillars of the new framework are generally suitable to all types of banks around the globe. The Committee therefore expects the New Accord to be adhered to by all *significant* [my italics] banks after a certain period of time. " (Bank for International Settlemetns, 2001: 9).

Therefore, although the majority of banks coming from small jurisdictions might not be internationally active, at least a number of these banks would surely possess those inherent characteristics that render them *significant* banks in their own particular country. From the above it appears then that the New Accord will eventually be expected to be applicable to banks in different jurisdictions and of different size and sophistication, rather than solely to internationally active banks.

Another factor which should also be considered is that "[i]n an increasingly globalised financial system, small countries especially small states and islands cannot afford any more to indulge in regulatory regimes which are less onerous than others" (Gabarretta, 2000). While it is not within the scope of this paper to enter into detail on this aspect (see Gabarretta, 2001) it also worth mentioning that in recent years the Financial Stability Forum has, by working closely with various standard- setting bodies, succeeded in agreeing on best practice core standards in twelve important policy areas that promote financial stability by strengthening financial regulation, improving market integrity and facilitating better informed lending and investment decisions.

Although there might be significant costs in implementing global standards relating to the safety and soundness aspect of banking supervision (namely, the *Core Principles for Effective Banking Supervision* issued by the BCBS of the BIS), if a small island economy

> " .... opts not adopt them, because it envisages that the costs of doing so would be too high, it would be penalised on two counts. Firstly; stability in that economy's financial system would be threatened since its institutional and regulatory framework would not be in line with that commonframework being used by others to lessen the likelihood of a financial crisis in the future. Secondly there would be a high degree of probability that foreign participation in that economy would not be attracted by a regime which would be deemed as too risky to invest in " (Gabarretta, 2001: 13).

Similarly, it can be concluded that on the basis of this premise small jurisdictions would have little option other than to adopt the New Accord also.

Assessment of the Potential Impact of the New Accord

The request made by the BCBS for feedback on the proposals found in the January 2001 consultative document has definitely elicited more than its fair share of comments. These originated from a variety of parties, ranging from the most obvious such as central banks and regulatory authorities, to others such as various banking associations, individual banks, development banks and agencies, auditing and accounting firms, consultancy firms and individuals. In fact, 259 replies in all have been published on the BIS website (www.bis.org). However, out of these replies one finds, arguably, only about 37 replies that had originated either from institutions coming directly from developing countries or from other entities that were connected in some way or other with such countries (primarily bankers' associations, individual banks, development banks and finance ministries). Moreover, out of this total less than half (15) originate from parties coming from small states and islands. Perusal of this, albeit small, pool of responses would shed light on the major concerns faced by small jurisdictions in respect of the future implementation of the New Accord.

It should, at the same time be emphasised that, following the submission of the comments on the New Accord, a number of changes which have addressed some of the concerns expressed have been issued by the BCBS. These include extension of the timetable for implementation to end 2006; lower risk weight for retail exposures – from 50% to 40% for residentialmortgages and from 100% to 75% for other retail; reduction of the minimum regulatory capital for operational risk – from 20% to 12%. Therefore, using this source and also contemporary literature on the subject (amongst others Griffith-Jones and Spratt, 2001; Cornford, 2001; Parrenas, 2002), it can be postulated that the most significant impacts resulting from the implementation of the New Accord can be summarized (not in any order of significance) as follows:

- the pro-cyclicality aspect, defined as the "amplification of financial and economic cycles that occurs as an unintended consequence of regulations" (Nouy, 2002: 9). The review of this factor will also highlight the close relationship of this factor with the *IRB approach*.
- the complexity of the Accord and increased responsibilities for both supervisors and banks (Cornford, 2000: 1).
- the possible consequences for access to and cost of international lending (Nouy, 2002: 10).
- possible increase/generation in/of 'local' or home grown rating agencies.
- collateral implications.
- the question of costs and resources.
- the competitive aspect.
- project finance.
- disclosure of information aspect.

The Pro-Cyclicality Aspect

This aspect has been amply covered in the literature and is also one of the most significant concerns in respect of the January 2001 proposals that has been voiced, albeit by both developed and developing countries. In fact, the charge that the New Accord could "exacerbate pro-cyclical tendencies within the banking system" (Griffith-Jones and Spratt 2001: 12) has been fully recognised by the BCBS since it seeks to reduce procyclicality "by finding the adequate trade-off between risk sensitivity and pro-cyclicality and by using a few specific tools. These are (a) encouraging banks to hold extra capital buffers; (b) the carrying out of stress tests (for those banks using the *IRB approach*); (c) external and internal ratings should be based on long data runs" (Nouy, 2001: 10).

Griffith-Jones and Spratt make a further point that while the BCBS acknowledges that the New Accord could have probable pro-cyclical effects, it "believes that the benefits of a risk-sensitive capital framework outweigh this potential concern" (Griffith-Jones and Spratt 2001: 12).

However, they stress that "as is the case with much of the New Accord, the trade-offs in terms of costs and benefits are viewed in terms of their impact on the major banks. For the developing world it is likely that they will feel the costs disproportionately (reduced lending coupled with increased scale of crises) while simultaneously attracting none of the benefits. " (Griffith-Jones and Spratt 2001: 13).

At the same time they premise that pro-cyclicality could be increased through future adoption and more widespread use of *IRB approach*es. To the extent that locally incorporated banks originating from small jurisdictions are probably not as sophisticated as their counterparts in developed countries [6] then one can discount their use of the *IRB approach*, at least in the initial stages after adoption of the New Accord.

The result could be an increased utilisation of the *standardised approach* by small jurisdictions. As will be seen, this should not necessarily be deemed as having negativeconsequences. Correspondingly, it has been shown (Griffith-Jones and Spratt, 2001: Table 5) that "adoption of the *IRB approach* would reduce the capital requirements for loans to borrowers rated BBB or above. Conversely, for borrowers rated below this, capital requirements will be significantly higher; the capital required [to be allocated by banks] under the *IRB approach* increases sharply as ratings fall" (*Ibid).* Table 4 illustrates this more clearly.

Given this scenario, one can envisage that, in the downside of an economic cycle, those banks operating the *standardised approach* could possibly be affected less than those operating the *IRB approach*. Albeit somewhat conjectural, this supposition has far reaching implications for the future adoption of the more advanced approaches by small

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6. According to Laurence H. Meyer (2001) as quoted by Griffith-Jones and Spratt (2001), "[i]n the US for example, it is estimated that only 20 of the country's banks are likely to be in a position to adopt an *IRB approach*."

jurisdictions when the perceived disadvantages of this approach, compared to those of the *standardised approach*, are taken into account.

Table 4
Capital Requirements (%) as Ratings Fall

Rating	PD	Current Capital	Standardised Approach	IRB Foundation
AAA [a]	0.03	8	1.6	1.13
AA	0.03	8	1.6	1.13
A	0.03	8	4.0	1.13
BBB	0.2	8	8.0	3.61
BB	1.4	8	8.0	12.35
B	6.6	8	12.0	30.96
CCC	15.0	8	12.0	47.04

[a.] Floor PD of 0.03 set by the Committee (BCBS).
Source: "Bank Capital Standards: the New Basel Accord" *Bank of England Quarterly Bulletin: Spring 2001: 56.*

Complexity of the Accord and Related Responsibilities

This is another example of those issues that have given rise to substantial concerns on the part of both supervisors and banks coming particularly from developing countries. Thus, it has been noted that the burden on regulators will increase significantly both due to the responsibilities emanating from the supervisory review process set out in Pillar II and also through the operational risk framework and an (eventual) adoption of the *IRB approach* (Central Bank of Malta, 2001: 7). At the same time, given the detail in which the supervisory review process goes into, extra care on the part of supervisors will be required so as not to appear too paternalistic.

The Pillar II proposals have also been criticised (Racocha, 2002) as not having a very clear demarcation line between the responsibilities of the banks themselves and those of the supervisors. The latter must ensure that their duties do not appear to encroach in any way on those areas that should be the exclusive reserve of banks' management (Central Bank of Malta, 2001: 6). This effect could arguably be more of an issue in small jurisdictions than much larger ones possibly due to a higher level of expertise at regulatory agencies than in the financial institutions themselves.

In other words, “the complexity of the Accord would bring about high compliance and implementation costs, not only for banking institutions in…[small states and islands] but also for regulators, who might not have enough resources to analyse and validate the procedures set up by local banks, and by local subsidiaries of international financial conglomerates” (Resti, 2002: 20).

The Competitive Aspect

It has been seen earlier on that the purported disadvantage of utilizing the *IRB approach* instead of the *standardised approach* could *prima facie* preclude the majority of banks in small jurisdictions from using the former approach. This also has implications regarding their competitive position. As such, in those small jurisdictions where international financial services centres located there contribute substantially to these economies, it is not unrealistic to assume that ‘local’ banks compete directly with any internationally active banks present. The latter category of banks would be able to utilise the more advanced approaches requiring less capital while less developed banks, in an attempt to switch to these approaches (as envisaged after all in the New Accord), would find it extremely complicated and demanding to do so in the short to medium term (Griffith-Jones Spratt, 2001: 2). The result of this could ultimately be greater consolidation in the banking industry with more internationally active banks and less ‘local’ banks in small jurisdictions.

Implications for International Lending

On this issue the implementation by small jurisdictions of the New Accord could result in negative consequences on three counts, namely through:

- a decrease in the overall level of access to international capital through the possible consolidation in the banking sector (as outlined in the previous point);
- the higher risk profile of the majority of borrowers coming from small jurisdictions resulting from a historical propensity towards low ratings [7] could result in higher cost of credit as a direct consequence of both the application of the Standardised and *IRB approach*es and
- the consequent rise in the price of loans could cause an upsurge in the cost of credit not only for governments and banks in small jurisdictions through the rise in the ‘risk-free’ base rates to which credit spreads on private loans are added (Resti, 2002: 20).

Activities of ‘Local’ or ‘Home-grown’ Rating Agencies

The standardised approach found in the New Accord assigns risk weights for exposures to various types of counterparties based on the assessments of external credit assessment

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7. Out of a sample of 50 developing countries’ sovereign ratings rated by Standard and Poor’s as at June 27 2002, only 2 sovereigns (highest A- and lowest BBB-) – which could be classified as being small states or islands – out of a total of 18 countries rated at Investment Grade (up to BBB-) qualified for this rating. Moreover, out of the remaining 32 classified as being Sub-Investment Grade (below BB+), 5 others (highest BB- and lowest B-) were small jurisdictions also (Griffith-Jones Spratt, 2002: 54).

institutions (ECAIs) – more commonly known as rating agencies. Notwithstanding that the incentive to move to more sophisticated approaches is inherent in the structure of the New Accord, one can safely say that the *Standardised Approach* will be used by most banks in both developed and developing countries. Moreover, the New Accord provides national supervisors the possibility of determining whether an ECAI meets a number of eligibility criteria in order for its ratings [7] to be used for capital purposes as laid down in the *standardised* methodology.

Hence, one can envisage that in developing countries and in small jurisdictions, where the coverage by the major ECAIs of 'local' companies and banks in extremely low, there could be a need for more 'localised' rating agencies which would specialise in assessing local companies and banks. However, the issue is not as straightforward as it looks since these agencies have to fulfil the eligibility criteria for recognition by the regulators of small jurisdictions as laid down in the New Accord. Additionally, it should be emphasised that the ratings resulting from these localised rating agencies have to be 'mapped' by regulators so that a risk weight assignment would be consistent with that of the level of credit risk found in Table 3 above. Only through this process can it be determined whether the use of mapped 'local' ratings would be cost-effective with respect to the general 100% risk-weight for unrated exposures stipulated in the New Accord.

Recognition and Valuation of Collateral Implications

The New Accord proposes to adopt a very restrictive definition of commercial real estate. Accordingly, the BCBS holds the view that mortgages on commercial real estate do not in principle justify other than a 100% weighting of the loans secured. However, several countries drew attention to the fact that "commercial real estate tends to be a more important source of collateral in developing than developed countries owing to the more underdeveloped state of financial markets in the former and thus the lesser availability of financial instruments suitable for this purpose." Given the rather limited range of collateral instruments eligible for recognition in the (simple approach of the) *standardized approach* (see above) it has been proposed that, "subject to appropriate haircuts to allow for the volatility of the value of such property, commercial real estate should be recognised as allowable collateral alongside of the eligible financial instruments under the *standardized approach*" (Cornford, 2000: 6).

Costs and Resources

In view of the much higher complexity of the New Accord regime, the cost of setting up an appropriate Basel II – compliant risk control system is likely to be a formidable challenge for both banks and regulators. It has been estimated that the implementation and compliance costs – using a net present value basis over a 5 year period with a 5% reference rate – of Basel II could possibly exceed US$1,000 billion (Resti, 2002: 30). This is equivalent to about one half of the value of Tier One capital held by banks worldwide. In other words, the first impact of the reform in the New Accord – which supposedly is intended to improve the banks' capital adequacy – could possibly be to

erode a substantial share of such capital (*ibid*). The question of costs resulting particularly from implementation of the first two pillars of the New Accord could impact even more acutely on small jurisdictions in a number of ways. Thus, it is likely that the adoption by banks of the more sophisticated approaches found in the New Accord could require a huge cost outlay especially if the concept of *internal ratings* is a new one for these jurisdictions. At the same time the issue of cost-effectiveness in this regard cannot be ignored. Would it be feasible for local banks in small jurisdictions to go for the more advanced approaches if the benefits of doing so are not so marked? Further to this, the need for additional human resources in the supervisory functions could penalise particularly small jurisdictions where technically proficient personnel is relatively scarce (Central Bank of Malta, 2001: 6) and prone to being 'poached' or, at the very least, to 'capture' (see Persaud, 2002).

Project Finance

The current proposals of the New Accord assume that project finance is of higher risk than corporate lending, implying an increase in capital requirements for loans belonging to the former category. Griffith-Jones and Spratt (2000; 55) note that this could be particularly problematic for developing countries, which require very large private investment in infrastructure for their development, and project finance is often the key mechanism to achieve this. While this is certainly fundamental for larger jurisdictions it is perhaps of less concern for small jurisdictions possibly in view of the latter's somewhat different macroeconomic framework.

Disclosure of Information

A recurrent theme in the comments of developing countries involved disclosure issues mainly covered under Pillar III of the New Accord and centred on two issues (Cornford, 2000:8). The first concerned the way "in which financial markets in developing countries [and by implication, small jurisdictions also] would absorb and respond to the greater disclosure [provisions found in the New Accord]" while the second applied to the competitive effects resulting therefrom. Hence, a typical comment stated that "in small economies with a limited number of large corporations in particular sectors, certain disclosure requirements [as envisaged in the New Accord], in particular the publishing of details of past due/ impaired loans, could lead to the disclosure of proprietary data." (Central Bank of Malta, 2001: 7). In fact, other comments also referred "to market participants' capacity to interpret the increased information resulting from enhanced disclosure, some going even so far as to suggest that such disclosure could be a source of financial instability" (Cornford, 20900: 8). The second is obviously related to the first and is concerned with "the likelihood of pressures associated with the rules of the New Accord for disclosure of proprietary information of a kind capable of unfavourably affecting a bank's competitive position" (*ibid*).

Concluding Remarks

There are many repercussions which could affect small jurisdictions (though not exclusively) when the New Accord is implemented, as explained above. This, in turn, suggests that the intervening period up to implementation can be used to try to mitigate as far as possible the negative implications for small jurisdictions.

One important issue that, perhaps, was taken for granted, is that all the literature produced to date describing the implications arising from implementation of the New Accord – this paper not excluded – is totally conjectural or better, is the result of an *ex-ante* analysis. Evidently, it is only after a certain amount of time has passed subsequent to implementation of the New Accord that a valid and meaningful *ex-post* analysis can be obtained. However, with respect to the central topic of this paper, from whatever perspective one looks at it, this latter situation is definitely not ideal. On the other hand, an *ex-ante* analysis is extremely useful in that it could enable one to identify certain difficulties inherent in the current proposals. Furthermore, since the analyses have to date been carried out using Consultative Papers II or I as the models for the New Accord it is possible that these studies are too pessimistic on certain areas of the Accord. Accordingly, the very fact that a significant amount of contemporary literature has pointed out certain deficiencies in the proposed Accord could result in, at least, a partial redressing of these issues in the final version of the New Accord. In that case some of the implications outlined above could perhaps not have so deep an effect on small jurisdictions.

That the BCBS is fully cognisant of certain undesirable effects of the proposed New Accord – in its present form – is evident by the number of studies it has carried out and is still carrying out in order to try to achieve as far as possible the same level of overall capital as the current Accord. In fact, the BCBS is currently undertaking a fourth [8] so-called *Quantitative Impact Study* (QIS 3). This is intended to provide some more insight into the BCBS' perspective to revise the current Accord; including if need be any major elements of the proposals that will be tested by the banking industry during the QIS3. It is estimated that about 300 banks from about 50 countries are participating in this study. Hence, the importance of this exercise especially for small jurisdictions cannot be emphasized enough. If through a wide participation from this category the results of this study confirm that there is certainly room for improvement then it – the current study – commenced in Autumn 2002. could be possible to calibrate the forthcoming proposals (CP3) so as to eliminate or at least mitigate as much as possible those effects, some of which have been postulated above.

At the same time it should be stressed that the level of consultation and information on the proposals relating to the New Accord is very high. Furthermore, apart from the QIS3 there are other fora, where small jurisdictions are also represented. These fora have put the message across in the sense that the proposals are not to be construed as being a *fait accompli* but still leave room for amendment on certain crucial aspects in order to

8. QIS1 started in Autumn 2000, QIS2 in Summer 2001, QIS 2.5 in Autumn 2001 and QIS3 – the current study – commenced in Autumn 2002

achieve the least possible negative impact on these jurisdictions. In this regard one can think of the sterling work which the Financial Stability Institute (FSI) of the BIS has been carrying out, for a number of years, now on the various aspects of the proposed New Accord. Thus, attendance by regulators and supervisors coming from small jurisdictions at the numerous seminars/training workshops which are going to be organised in the coming months and years by the FSI could contribute significantly to the furthering of their knowledge on what is definitely, a complex piece of regulation.

It goes without saying that the coming years are going to be extremely tough and challenging for both developed and developing countries since they have to marshal all available resources in order to implement the New Accord by 2006. On the other hand, if one takes Malta as an example of how a small island state plans to undertake such a momentous task, one immediately recognises that, for various reasons, the challenges facing all the participants in the local banking system could be far higher for this category of jurisdiction than if this financial system was more developed, deep and sophisticated and enjoying the presence of major global players. Thus, in the coming months, using the limited resources available to regulators, it is probable that a core group of 'experts' together with representatives from the banks and the banking association would start to meet on a regular basis in order to:

- understand further the concepts of the New Accord;
- exchange all relevant information including the possibility of sharing certain data among the banks;
- discuss, analyse and recommend action required;
- disseminate information to the public in respect of the capital adequacy structure and publish articles both of general interest and in academic journals;
- collect data to determine its 'quality' with a view to its eventual possible utilisation for the more advanced approaches.

This paper has highlighted some of the implications which could result from the implementation of the New Accord. As seen above, many of the implications, besides straining the scarce resources of small jurisdictions, could *ex-ante* result in negative effects that would impact on the financial systems of these jurisdictions in a number of ways. However, the overriding objective for the implementation of the New Capital Accord should have a beneficial and positive effect for all jurisdictions even at the cost of possible increases in capital requirements particularly for small jurisdictions. If, on the other hand, through the future implementation of the New Accord, overall improvements by using better risk assessment techniques and practices for all jurisdictions are achieved, then the increasingly globalised financial system would have moved closer to achieving a higher level of financial stability through the much-trumpeted safety and soundness objectives.

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