What is Basel Capital Accord?

Basel Capital accord is a capital adequacy framework developed by the Basel committee. In 1988, the Basel Committee decided to introduce a capital measurement system commonly referred to as the Basel Capital Accord. This system provided for the implementation of a credit risk measurement framework with a minimum capital standard of 8% by end-1992, which is also known as "Basel – I". Since 1988, this framework has been progressively introduced not only in member countries but also in virtually all other countries.

What is Basel II?

Basel-II is also a capital adequacy related standard framed by Basel committee. After the successful implementation of 1988 accord in more than 100 countries, the Basel Committee on Banking Supervision reached an agreement on a number of important issues for promoting best and uniform banking practices as well as setting standards and guidelines for supervisory function. Following extensive interaction with banks, industry groups and supervisory authorities that are not members of the Committee, the revised framework was issued on 26 June 2004. The latest revision on the framework was issued on November 2005.

The Basel-II aims to replace Basel I and to make the capital framework more risk sensitive. Basel II has recommended major revision on the international standard on bank's capital adequacy, which requires banks to implement risk management policies that align capital adequacy assessment with underlying credit risk, market risk, and operational risk. The Basel II has been introduced basically for the protection of depositor's interest by preserving the integrity of capital in Banks.

What is Basel Committee?

The Basel Committee, established by the central bank Governors of the Group of Ten countries (G-10) at the end of 1974, meets regularly four times a year. It has about twenty-five technical working groups and task forces, which also meet regularly.

The Committee's members come from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, United Kingdom and United States. Countries are represented by their central bank and also by the authority with formal responsibility for the supervision of banking business where this is not the central bank.

The Basel Committee provides a forum for regular cooperation on banking supervisory matters. Over recent years, it has developed increasingly into a standard-setting body on all aspects of banking supervision, including the Basel II regulatory capital framework.
The Committee encourages contacts and cooperation between its members and other banking supervisory authorities. It circulates to supervisors throughout the world both published and unpublished papers providing guidance on banking supervisory matters.

The Committee does not possess any formal supranational supervisory authority, and its conclusions do not, and were never intended to, have legal force. Rather, it formulates broad supervisory standards and guidelines and recommends statements of best practice in the expectation that individual authorities will take steps to implement them through detailed arrangements - statutory or otherwise - which are best suited to their own national systems. In this way, the Committee encourages convergence towards common approaches and common standards without attempting detailed harmonization of member countries' supervisory techniques.

**Is Basel-II Mandatory?**

Basel-II has been designed to provide options for banks and banking systems worldwide, the Basel Committee acknowledges that moving towards its adoption in the near future may not be the first priority for all central banks in all non-G10 countries in terms of what is needed to strengthen their supervision.

Basel II aims to build on a solid foundation of prudent capital regulation, supervision, and market discipline, and to enhance further risk management and financial stability. As such, the Committee encourages each national supervisor to consider carefully the benefits of the new Framework in the context of its own domestic banking system and in developing a timetable and approach to implementation. Given resource and other constraints, these plans may extend beyond the Committee’s implementation dates. That said, supervisors should consider implementing key elements of the supervisory review and market discipline components of the new Framework even if the Basel II minimum capital requirements are not fully implemented by the implementation date. National supervisors should also ensure that banks that do not implement Basel II are subject to prudent capital regulation and sound accounting and provisioning policies.

**What are the approaches of Basel II?**

A major innovation of the proposed Basel II is the introduction of distinct options for the calculation of three types of risk. For credit, operational and market risk, there are different approaches of increasing risk sensitivity to allow banks and supervisors to select the approach or approaches that they believe are most appropriate to the stage of development of banks’ operations and of the financial market infrastructure. The following table identifies primary approaches available by risk type.

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<th>SN</th>
<th>Credit Risk</th>
<th>Operational Risk</th>
<th>Market Risk</th>
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</thead>
<tbody>
<tr>
<td>1</td>
<td>Standardized Approach</td>
<td>Basic Indicator Approach</td>
<td>Standardized Approach</td>
</tr>
<tr>
<td>2</td>
<td>Foundation IRB Approach</td>
<td>Standardized Approach</td>
<td>Internal Model Approach</td>
</tr>
<tr>
<td>3</td>
<td>Advanced IRB Approach</td>
<td>Advanced Measurement Approaches (AMA)</td>
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What are the basic characteristics of Basel-II?

- It captures the risk through its three pillar.
  1. Minimum Capital requirement
  2. Supervisory review process
  3. Market discipline
- It addresses not only the credit & market risk but also the Operational risk.
- The risk is computed based on the actual risk profile of the counter part. It is not ad hock or general. Hence the capital is truly risk based.

What approaches are will be followed in Nepal?

Nepal Rastra Bank will have the flexibility of choosing one of the above approaches. Based on the local circumstances, we have selected most simple and appropriate approaches from the Basel Framework that shall be practicable and workable in our industry. It is decided to propose that commercial banks in Nepal will initially adopt following approaches:

1) Simplified Standardized Approach for Credit Risk
2) Basic Indicator Approach for Operational Risk
3) Net Open Position Approach for Market Risk

When advanced approaches are adopted?

We understand that the new framework developed by the Basel committee is a product of long exercise in the globe. It is mainly the outcome of sophistication in to developed economy and complex product introduced in to the global market. The approach to Basel II in Nepal is to confirm to best international standards and in the process emphasis is on harmonization with local context. We plan to adopt more advance approaches gradually as the market attains maturity and emerges as more sophisticated.

Those banks planning for the advance approaches are requested to collect loss data and also adhere to the sound practice for risk management. Banks will be encouraged to move along the advance approaches as they achieve increasing sophistication in their risk management systems and processes. However, banks must obtain prior approval of the Nepal Rastra Bank if they intend to use any one of the advanced approaches namely Standardized Approach, IRB Approach, Advanced Measurement Approach.

Is proposed "capital adequacy framework" of Nepal different from Basel Capital Accord?

Nepal Rastra Bank has developed and enforced capital adequacy requirement based on international practices with appropriate level of customization based on domestic state of market developments. The existing regulatory capital is based on the Basel committee's 1988 recommendations.

The proposed "capital adequacy framework" outlines the Nepal Rastra Bank's proposed guidelines based on the Basel II framework.
When Basel-II related "capital adequacy framework" shall be implemented?

Draft capital adequacy framework is aimed to solicit comments from all interested parties until end-September 2006. This framework is set to implemented by the financial year 2007/08.

Is proposed "capital adequacy framework" applicable to all financial Institutions?

No. As per the proposed draft, only "A" Class financial institutions, licensed to conduct banking business in Nepal under the Bank and Financial Institution Ordinance-2005 are subject to this capital framework.

What is Tier I capital and Tier II capital?

Capital that is fully paid up and having no fixed servicing or dividend costs attached to it and freely available to absorb losses qualify as Tier-I capital. Capital also needs to have a very high degree of permanence if it is to be treated as Tier 1. Tier-I capital is also subject to specified deductions from it.

Tier 2 Capital consists of general loan loss provision, revaluation reserve, exchange equalization reserve, investments adjustment reserves, other reserves, redeemable preference share and subordinated term debt. Tier-II capitals shall be subject to the certain limitations and restrictions.

Sum of Tier I and Tier II capital is Total Capital.

What is rate of proposed capital requirement?

It is proposed that every commercial bank shall maintain capital requirement set out below:

(a) Tier I capital of not less than 6 per cent of total risk weighted exposure;

(b) Total capital (Tier-I and Tier-II) of not less than 10 per cent of its total risk weighted exposure.

What is Risk Weighted Exposure?

Risk weighted exposure is of maximum amount of risk attached to a portfolio or a transaction or underlying assets. It is the sum of risk weight for credit risk market risk and operational risk.

Is it a Global need?

It is the need for the developed & emerging banking industry. However there seems to be some reluctance on implementation even in the developed country. Based on their arguments they have their own capital requirements more stringent than the present recommendation. Likewise it is also equally needed in to the emerging
markets that are more exposed to new product. The risk of new products is timely address and shall capture through Basel-II capital framework.

With respect to developing or under developed market it may not be the need for them right now. In Nepalese context Basel-II is not the need of the country at present. Our market is not complex as it was think of by the accord. Similarly market is not prepared for the adoption of the Basel-II in a true sense. However, since a global exercise is carried out and a concrete framework is finalised, no one should keep away from the international developments. Every one tries to keep in touch and get benefits from the international exercise. Based on this most developing and under developed country plan to take journey towards the Basel-II.

Is Basel-II practicable to our context?

The true Basel-II is almost impracticable for the numbers of years in our context. However the journey should be started and should keep in touch to the international developments and be prepared to capture the principle in full when the need is arises. It is encouraged by the different simplest options available in the framework. The simplest approaches are practicable and it is proposed to start from them. The destination to advance approaches is really a long one in our context.

What about the compliance assessment by the international agencies?

IMF and World Bank are of the view that future financial sector assessments will not be conducted on the basis of adoption of or compliance with the Basel-II, if a country has not chosen to implement it. Rather, assessments will be based on the adequacy of the regulatory/supervisory standards adopted by the respective country and the country's performance relative to the chosen standards, consistent with the requirements of the Basel Committee's Core Principles for Effective Banking Supervision ("BCP, September 1997").

Based on this Basel-II shall not be the assessment criteria for any countries financial sector assessment program right now. Hence the risk of non-compliance is minimum if any country is not chosen to implement it.

Is there any commitment from the NRB for adoption?

No. There is no any commitment for the adoption of Basel-II. The initiation towards the Basel-II is voluntary one and to follow the international best practice in time.

What are the challenges for the Basel-II implementation?

The Basel-II is challengeable to supervisor as well as banking industry. The Supervisory capacity building, Market discipline, issue of poor governance in to the industry, poor governance in to the market, poor data base, lack of credit rating agencies and lack of adequate, accurate and reliable financial data are some of the challenges ahead for effective implementation of Basel-II.