Proposed Treatment of Expected and Unexpected Losses

On the basis of its public consultation process, the Basel Committee is convinced that a major improvement in the New Accord is possible in relation to the treatment of expected losses. This note summarises the conclusions that the Committee has reached in this regard. In light of the value that the Committee places on transparency and public consultation, as well as important implications of these decisions, the Committee is requesting public comment on this proposed modification to its framework by 31 December 2003.

The internal ratings-based ("IRB") approach produces a statistical measurement of both the unexpected losses and the expected losses that banks face in relation to their credit risk exposures. The Third Consultative Paper's ("CP3") framework incorporated both expected and unexpected loss components into the IRB capital requirement.

The Committee now believes that a separation of the treatment of unexpected and expected losses within the IRB approach would lead to a superior and more consistent framework. Under this modified approach, the measurement of risk-weighted assets (that is, the IRB capital requirement) would be based solely on the unexpected loss portion of the IRB calculations. Accordingly, certain offsets within the IRB framework, in particular future margin income, would no longer be necessary.

Importantly, however, the Committee believes that it is critical to put into place a separate treatment of expected losses with the objective of ensuring strong incentives for banks to provision properly against expected losses. Under this separate treatment, banks will compare the IRB measurement of expected losses with the total amount of provisions that they have made, including both general and specific provisions. For any individual bank, this comparison will produce a "shortfall" if the expected loss amount exceeds the total provision amount, or an "excess" if the total provision amount exceeds the expected loss amount.

The Committee is proposing that shortfall amounts, if any, be deducted from capital. This deduction would be taken 50% from Tier One capital and 50% from Tier Two capital, in line with other deductions from capital included in the New Accord.

Excess provision amounts, if any, are proposed to be eligible as an element of Tier Two capital, similar to the current treatment of general provisions. The Tier Two eligibility of such excess amounts is further proposed to be subject to limitation at supervisory discretion, but in no case would be allowed to exceed 20% of Tier Two capital of a bank. In proposing this treatment, the Committee recognises that banks may have valid reasons for setting provisions in excess of the expected loss amount calculated by the IRB approach and wishes to avoid discouraging banks from doing so where appropriate.

This treatment of shortfall and excess amounts would be in lieu of the current inclusion of general provisions in Tier Two capital.

It is important to note that the incorporation of this new approach into the IRB framework may require some re-calibration of that framework to ensure that the overall impact of its proposals is consistent with the Committee's objectives. The Committee is undertaking further efforts to identify where such adjustments may be needed.

Although the Committee does not believe that adjustments to the standardised approach to credit risk are necessary in conjunction with this proposal, the Committee welcomes comments on this issue.

The Committee invites interested parties to provide comment on all aspects of this specific proposal by 31 December 2003 to relevant national supervisory authorities and central banks and may also be sent to the Basel Committee on Banking Supervision at the Bank for International Settlements, CH-4002, Basel, Switzerland. Comments are also invited by e-mail: BCBS.Capital@bis.org or by fax: 41 61 280 9100, and should be directed to the attention of the Basel Committee Secretariat.