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## The New Capital Adequacy Framework for Banking Institutions

### Proposed Topics<sup>1</sup>

#### 1. Overall costs and benefits of the new Capital Adequacy Framework for banking institutions

- Incentives for banks to develop innovations and/or improvements in risk mitigation techniques
  - Rewarding the use of credit derivatives, securitization, guarantees, guarantors, and on-balance-sheet netting.
  - Using internal models to determine capital charges for credit risk
  - Leveling of the “playing field” and arbitrage of regulatory capital
- Uncertainty
  - Subjective elements included in the new framework, in particular, the powers given to bank supervisors to require additional capital based on their assessment of the risk profiles and global strategies of banking institutions and aspects beyond bank’s direct control such as the effects of the economic cycle.
- Impact on the overall credit level (pro-cyclical nature of new regulations)

#### 2. Changes to the regulatory treatment of specific credit exposures: governments, banks, corporations, etc.

- The new framework to determine risk weights: fairness and consistency
- Risk weights scale: simplicity and transparency of a framework comprising only 4 different risk weight categories vs. diminished sensibility of the framework to adequately capture credit risk
- Explicit consideration of credit risk factors such as loan portfolio maturities, currency denomination of loans and their corresponding funding, guarantees

#### 3. Using the output of credit rating agencies as the standard approach of the new framework

- Moral commitment by the supervisory authority and/or other financial authorities when authorizing the use of information produced by a specific credit rating agency
  - Transparency and independence of credit rating agencies
- Objectivity: possibility of prejudice and inequalities in the ratings provided by selected credit rating agencies
- New global influence of credit rating agencies.

#### 4. Additional effects of the New Capital Adequacy Framework

- Government motivation to subscribe the IMF Special Data Dissemination Standards to be eligible for a country risk weight below 100%
- Deterioration in the credit rating of a government:
  - The impact on its credit relation with the international banking community
  - Sudden capital needs in banks with large exposures to that government
- Market discipline: disclosure of the level and structure of capital, risk exposures and capital adequacy. Should disclosure be mandatory? Homologation of this information among countries?

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<sup>1</sup> Based on the proposals of the Central Bank of Venezuela and those elaborated by CEMLA.