# BASEL II ENHANCEMENTS:

# MAJOR MODIFICATIONS TO

# THE JANUARY CONSULTATIVE PROPOSALS

*Pillar 1 (Minimum capital requirements)*

(a) The market risk regime

1. The major revisions made to the Trading Book Proposals (i.e. the first two documents in paragraph 2 of the letter) include:

   (i) carving out a "correlation trading portfolio" [1] ("CTP") from trading book exposures, to which concessional market risk capital treatment may be granted by supervisors subject to strict minimum requirements being met;

   (ii) specifying the calculation of market risk capital charge for specific risk of interest rate exposures for a specified class of trading book exposures, namely n-th-to-default credit derivative contracts[2]; and

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[1] "Correlation trading portfolio" ("CTP") refers to securitization exposures and n-th-to-default credit derivative contracts that meet these criteria: (a) the positions are neither resecuritization positions, nor derivatives of securitization exposures that do not provide a pro-rata share in the proceeds of a securitization tranche; and (b) all reference entities are single-name products, including single-name credit derivative contracts, for which a liquid two-way market exists. Positions that hedge the above positions and which are neither securitization exposures nor n-th-to-default credit derivative contracts and where a liquid two-way market exists for the exposures or the underlying exposures, are included in the CTP. However, positions which reference an underlying exposure that is treated as a retail exposure, a residential mortgage loan or a commercial mortgage loan, or positions which reference a claim on a special purpose entity are excluded from the CTP.

[2] An "n-th-to-default credit derivative contract" means a credit derivative contact where the payoff is based on the n-th asset to default in a basket of underlying reference instruments. Once the n-th-to-default occurs, the transaction terminates and is settled.

(iii) introducing additional metrics (e.g. additional multiplication / plus factors) to the calculation of various market risk capital charges in order to strengthen the incentive for banks to have adequate models to quantify market risk measures.

(b) The securitization framework

2. The finalised enhancements to the securitization framework, which apply to both the Standardized Approach and IRB Approach, are basically the same as those proposed in the consultative document except for the following modifications:

(i) further elaboration on the definition of resecuritization exposures;

(ii) a new provision which allows a bank to recognise overlap in securitization exposures in its banking book and trading book (e.g. asset-backed commercial paper held by an AI in the trading book in circumstances where the AI has provided support to the issue through liquidity facilities booked in the banking book). The effect is that the higher risk-weighted amount of the overlapping portion of the exposures will be applied, instead of applying capital charges separately to the portions of the exposures that overlap.

*Pillar 2 (Supervisory review process)*

3. There are no significant changes to the supplemental Pillar 2 guidance in the final proposals except for the addition of a new section on sound compensation practices. This is a specific risk management topic of great interest to supervisors and the G20 given that misaligned compensation practices at some large financial institutions are among the various factors considered to

have contributed to the recent global financial crisis. As revealed by the crisis, high short-term profits led to generous bonus payments to employees without adequate regard to the longer-term risks their risk-taking activities imposed on their institutions. In order to improve compensation practices and strengthen supervision in this area, the Financial Stability Forum (now the Financial Stability Board) published nine high-level *Principles for Sound Compensation Practices* on 2 April 2009. The new section in the BCBS enhancements mainly restates these nine high-level principles.

*Pillar 3 (Market discipline)*

4. The enhancements to the Pillar 3 disclosure framework aim to strengthen banks' transparency in respect of securitizations, off-balance sheet exposures and trading activities in order to reduce market uncertainties about the strength of banks' balance sheets related to capital market activities. The enhancements include disclosure requirements that are relevant to computing capital requirements under Pillar 1 as well as leading disclosure practices recommended by the Senior Supervisors' Group. The finalised Pillar 3 requirements are substantially the same as those set out in the consultative document, except that a requirement for qualitative and quantitative disclosures in relation to the comprehensive risk capital charge for CTPs is added to reflect changes made to the market risk regime after the consultation (see paragraph 1 (i) above). In addition, some modifications to the January proposals have been made mainly to provide more clarification and maintain consistency of terminology.