Foreword

The first Capital Accord of 1988, evolved by the Basel Committee on Banking Supervision, which sets global standards for regulation and supervision, has played a significant role in strengthening the soundness and stability of the financial system. The Accord provided a framework for fair and reasonable degree of consistency in the application of capital standards in different countries, on a shared definition of capital. However, the methods used to determine the capital charges for credit risk in the Accord are not sufficiently sophisticate. Over a period of time, financial innovation and growing complexity of financial transactions have called for a review of the existing capital adequacy framework.

Recognising the need for a more broad-based and flexible framework, the Basel Committee released in June 1999 a consultative paper on *'A New Capital Adequacy Framework'* for comments by market players. The new Framework, designed to promote more effectively the stability and soundness of the financial system, calls for better alignment of regulatory capital with underlying risks, by replacing the current broadbrush approach with preferential risk weighting treatment. The framework provides for explicit capital charge for other risks viz., operational risk and interest rate risk in the banking book for banks where interest rate risks are significantly above average (*outliers*). A three pillar approach- ***minimum capital requirement***, which seeks to develop and expand on the standardised rules set forth in the 1988 Accord, ***supervisory review*** of a bank's capital adequacy and internal assessment process, and effective use of ***market discipline*** as a lever to strengthen disclosure and encourage safe and sound banking practices - has been designed to strengthen the international financial architecture.

The adoption of the new Framework in the present form will have important implications for emerging market economies as it calls for structural changes in the current regulatory / supervisory standards. Specifically, the proposals for assigning capital on a consolidated basis, use of external credit assessments as a means for assigning risk weights, sophisticated techniques for estimating economic capital, etc., may need suitable modifications to adequately reflect the institutional realities and macro-economic factors specific to emerging market economies. Recognising the implications of the new Framework for emerging market economies like India, an internal Working Group was constituted in Reserve Bank of India, for critically evaluating the impact, applicability and problems and the transition phase required for adoption of the proposals contained in the new Framework. Based on the recommendations of the Group, RBI has formulated its comments, explicitly suggesting to the Basel Committee that some of the proposals may require modification / flexibility to fully reflect the macro-economic environment, structural rigidities and concerns of the emerging market economies.

The new proposals have generated considerable debate among the financial institutions and academia. It gives me great pleasure to release the Comments of the RBI on the new Framework. The comments are intended to provide the financial community and other readers the perspectives and concerns of the RBI and also to generate wider discussion internationally on various issues involved in operationalising the new Framework. Once the modifications suggested in the document and the views of other countries are taken into account, I am sure, the new Framework will eventually emerge as an internationally acceptable benchmark for capital standards applicable to all banks and promote greater financial stability.

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