

5 Aug 2005

To The Chief Executive Officers of Singapore-incorporated Banks

Dear Sir

UPDATE ON BASEL II IMPLEMENTATION IN SINGAPORE

I am writing to update you on some of the initiatives that MAS will be undertaking in preparation for Basel II implementation in Singapore.

Consultation on CAR computation rules and guidelines under Basel II

2 MAS issued for consultation today some elements of the proposed rules and guidelines for computing minimum capital adequacy requirements under Basel II. The proposed rules and guidelines issued today cover the scope of application, the constituents of regulatory capital under Basel II, and the simpler approaches for calculating capital requirements for operational risks. MAS plans to issue other elements of the CAR computation rules and guidelines for consultation over the course of this year and the first half of next year.

3 MAS intends to finalise the rules and guidelines for computing minimum capital adequacy requirements by early 2006 so as to give Singapore-incorporated banks (“Reporting Banks”) ample time to prepare for Basel II implementation. To meet this timeline, I urge your bank to participate actively in the consultation process and submit your responses within the stipulated deadlines.

5th Quantitative Impact Study

4 Another initiative that MAS will undertake in partnership with Reporting Banks is the 5th Quantitative Impact Study (“QIS 5”)¹ coordinated by the Basel Committee on Banking Supervision (“BCBS”). Similar to previous quantitative impact studies coordinated by the BCBS, QIS 5 is a global survey to assess how Basel II implementation will affect regulatory capital requirements. A copy of the indicative schedule for QIS 5 is at the Annex of this letter.

5 QIS 5 will provide a valuable opportunity for your bank and MAS to re-assess the impact of Basel II adoption on regulatory capital requirements. This re-assessment is important since the last quantitative impact study that Singapore participated in – QIS 3 – was conducted more than 2 years ago, and recent evidence from countries such as the United States and Germany suggests that the impact on regulatory capital requirements arising from Basel II implementation could potentially be significant. In addition, the exercise will allow your bank and MAS to assess your bank’s readiness to calculate regulatory capital requirements using the approaches available under Basel II. Singapore’s participation in QIS 5 will also mean a greater representation of the portfolios of Asian

¹ Banks for which MAS is the consolidated supervisor are expected to submit their QIS 5 results on a consolidated basis to MAS. A Singapore-incorporated subsidiary of a foreign bank will submit QIS 5 data for its Singapore operations only.

banks in the data set that will be used for calibrating the scaling factor to be applied to the IRB benchmark risk weight functions.

Assessment of Reporting Banks' readiness to adopt the Internal Ratings-based ("IRB") Approach

6 As mentioned at our meeting in April this year, MAS considers the assessment of a Reporting Bank's readiness to adopt the IRB Approach to be part of MAS' ongoing supervisory activities. Consistent with this approach, MAS has held a series of discussions with Reporting Banks on their respective progress on preparations for IRB. MAS intends to intensify the pace of these discussions going forward. Where necessary, MAS will conduct onsite visits to better understand Reporting Banks' readiness to adopt the IRB Approach as scheduled in their respective IRB implementation plans. MAS will be looking into, among other things, the current state of risk management practices, management culture and governance framework of your bank. The comprehensiveness and quality of the information that your bank submits under QIS 5 will also be taken into account. MAS would share any major concerns that we may have about your bank's preparations to adopt the IRB Approach arising from these discussions and/or visits. MAS will, however, make an assessment on your bank's readiness to adopt the IRB Approach for calculating minimum capital adequacy requirements, only after your bank formally submits an application to MAS to adopt the IRB Approach.

Use requirements for Reporting Banks intending to adopt the IRB Approach

7 At our meeting in April this year, some Reporting Banks asked whether the minimum use requirements of three years for a Reporting Bank intending to adopt the IRB Approach can be relaxed. We explained that our objectives for the use requirements are to foster the integration of the internal rating systems into a Reporting Bank's day to day operations, and for the Reporting Bank to demonstrate to MAS that it has undertaken robust quality assurance processes in respect of its internal ratings and IRB estimates and has confidence in its IRB systems.

8 Consistent with these objectives, the duration of use of IRB systems is an important but not the only aspect that MAS will consider in our assessment of a Reporting Bank's readiness to adopt the IRB Approach. MAS will also consider whether a Reporting Bank uses its internal ratings and IRB estimates in decision-making in a pervasive and consistent fashion across its IRB portfolios. In this regard, MAS will be issuing more detailed standards on the minimum use requirements for consultation shortly. These would provide guidance on MAS' expectations on, among other things, the scope of use (i.e. the type of uses), the coverage (i.e. the number of portfolios covered) and the importance accorded by a Reporting Bank to its internal ratings and IRB estimates (i.e. the extent to which the Reporting Bank relies on its internal ratings and IRB estimates in decision making).

9 Specifically on the scope of use, MAS' current thinking is that a Reporting Bank's internal ratings and IRB estimates should at minimum feature in credit approval, risk management, capital

allocation and pricing, credit targeting and portfolio rebalancing, provisioning, and reporting of credit risk information. The Reporting Bank should also demonstrate that it has a robust governance framework surrounding the design and operations of its rating systems, the setting of parameters for IRB estimates, the use of internal ratings and IRB estimates as well as stress tests. On coverage, MAS' view is that a Reporting Bank should meet the use requirements for those IRB portfolios that the Reporting Bank intends to include in its rollout (in accordance with the minimum rollout thresholds set out in the Guidelines on IRB Adoption issued by MAS in January 2005). MAS will accept a shorter duration of two years. However, the Reporting Bank must demonstrate, notwithstanding the shorter use duration, that it has met MAS expectations. In making this assessment, MAS will consider, among other things, the comprehensiveness and quality of the information that the Reporting Bank submits under QIS 5.

Adoption of IRB risk management practices for sovereign exposures and management of country transfer risks

10 Another issue that was raised at our meeting in April this year was whether Reporting Banks will be required to adopt the IRB Approach for their sovereign exposures. While MAS will not require Reporting Banks to use the IRB Approach for sovereign exposures and management of country transfer risks², Reporting Banks are expected to adopt risk management practices that are commensurate with the risk and sophistication of their businesses.

² This is provided the Reporting Banks are able to meet the rollout thresholds specified in the Guidelines on IRB Adoption issued by MAS in January 2005.

11 Given that all Reporting Banks conduct or belong to banking groups that conduct significant cross-border banking activities, there are clear advantages from investing in a framework and processes for making internal risk assessments of sovereign exposures and country transfer risks. It would enable a Reporting Bank to make more meaningful and timely assessments of risks, and take steps to control or mitigate such risks. Furthermore, a robust internal risk assessment framework would help a Reporting Bank to set aside an appropriate level of provisions for its sovereign exposures and country transfer risks.

12 While we recognise that it may be difficult to make precise internal risk assessments for sovereign exposures due to the paucity of default and loss experience, there is an emerging consensus towards the implementation of robust internal assessments of sovereign exposures and country transfer risks. In this regard, MAS participates in the Validation Sub-group of the Accord Implementation Group which is developing guidance on how to make more meaningful risk assessments for low-default portfolios such as sovereign exposures that would provide some measure of flexibility for IRB banks. MAS will update the Reporting Banks when the guidance is published.

13 Should a Reporting Bank decide to adopt the Standardised Approach instead of the IRB Approach for its sovereign exposures, the Reporting Bank must be satisfied that its sovereign exposures are immaterial in size and risk profile and must ensure that the sum of its sovereign exposures and other non-IRB exposures do not exceed the permitted limits set out in the Guidelines on IRB Adoption issued by MAS in January 2005. MAS will consider the ability of the Reporting Bank to manage its sovereign exposures and

country transfer risks under Pillar 2, taking into account market practices. MAS will also consider whether the minimum capital requirements under the Standardised Approach are commensurate with the Reporting Bank's risks, particularly if the national discretion for 0% risk weight for sovereign exposures denominated and funded in domestic currency is implemented in many jurisdictions.

Next steps

14 MAS will continue to engage your bank on its preparations for Basel II. MAS will also continue the discussions we have started with the relevant foreign supervisors and work towards resolving any cross-border issues arising from Basel II implementation to the extent possible.

15 We look forward to working with your bank during the consultations on CAR computation rules and guidelines, the QIS 5 exercise, and further discussions on your bank's preparations for IRB adoption.

Yours faithfully,

LEE BOON NGIAP
EXECUTIVE DIRECTOR
COMPLEX INSTITUTIONS SUPERVISION DEPARTMENT

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INDICATIVE TIME TABLE FOR QUANTITATIVE IMPACT STUDY 5

Jul 2005	Draft workbooks on QIS 5 put on BIS website
Sep 2005	Final workbooks, instructions and questionnaire on QIS 5 sent out to banks
early Dec 2005	Banks to submit QIS 5 spreadsheets (based on end-Sep 2005 data) and answers to questionnaire to their national supervisors
1Q 2006	Checking on bank data/ work on data quality
Spring 2006	BCBS to review recalibration of Basel II
Mid 2006	BCBS decision on Basel II calibration