

6 January 2005

To The Chief Executive Officers of Singapore-incorporated Banks

Dear Sir,

BASEL II IMPLEMENTATION IN SINGAPORE: FOSTERING IMPROVEMENTS IN RISK MANAGEMENT

In preparation for the implementation of Basel II in Singapore¹, this letter sets out MAS' objectives in implementing Basel II, how MAS intends to meet these objectives, and MAS' expectations of Singapore banks' preparations for Basel II.

Basel II Implementation in Singapore

2 In implementing Basel II, an important objective is to foster ongoing improvements in the risk management practices of Singapore-incorporated banks that will contribute to a safe and sound financial system. While all the Pillar 1 approaches for calculating minimum capital requirements under the Basel II Framework will be available to Singapore-incorporated banks, MAS would expect a bank to adopt the approach that is commensurate with the complexity and sophistication of its businesses and operations. Notwithstanding this, MAS would encourage the bank to move toward the risk

¹As announced previously, the MAS intends to implement Basel II at the same time as banking supervisors represented on the Basel Committee on Banking Supervision.

management practices embodied in the Internal Ratings-based Approach (“IRB”) even when it is not yet ready to fully adopt the IRB approach for computing minimum capital requirements.

3 In its design of Pillar 1 of the Basel II Framework, the Basel Committee on Banking Supervision (BCBS) has provided incentives for banks to adopt IRB. To complement Pillar 1, MAS will consider the adequacy and effectiveness of a bank’s risk management practices as part of the supervisory review process under Pillar 2. A bank that has inadequate risk management practices, relative to the complexity and sophistication of its businesses and operations, will be subject to greater supervisory scrutiny. Such a bank may also be required to hold capital in excess of the Pillar 1 minimum.

Approach towards Supervisory Permission

4 MAS’ approach to granting a bank permission to adopt IRB will reflect the above considerations. A bank should satisfy itself that it is able to adopt and continue to use IRB before it applies to MAS for permission to do so.² MAS will want to be assured that the bank’s intention in adopting IRB is not just to meet the minimum standards for IRB contained in the Basel II Framework, but to seek continual improvements in its risk management practices. MAS will consider whether the bank has the necessary management culture and governance framework, including the appropriate organisational structures and control mechanisms, to support its intention.

5 Consistent with this approach, a bank should not regard the guidance on IRB adoption that MAS will be issuing during 2005

² Please see the “Guidelines on IRB Adoption: Supervisory Permission and Rollout Parameters” attached at Annex 1.

as an exhaustive checklist to be satisfied in order to adopt IRB. Instead, MAS will outline general principles and set appropriate baseline parameters in order to give banks flexibility to improve their risk management practices, taking into account their specific circumstances.

6 In developing guidance on the adoption of IRB, MAS is cognisant of the cross-border dimension of supervisory expectations. To encourage consistent and complementary approaches among national supervisors, the Accord Implementation Group under the BCBS has established a subgroup to examine issues related to “IRB validation”. This subgroup has reached agreement on what constitutes validation and the principles that should inform the validation process for the purposes of its work going forward (see Annex 2). As a member of the subgroup, MAS endorses these principles and will incorporate them in the guidance we intend to issue in 2005.

Basel II Implementation Survey

7 To help MAS to better understand your bank’s plans and preparations for Basel II, please complete the survey at Annex 3 and return it to us by 31 Jan 05. As preparation for Basel II implementation must be a bank-wide effort, the survey should be signed-off by the heads of the risk management and finance functions as well as the heads of significant business units of your bank. The completed survey should have your endorsement and be brought to the attention of your Board of Directors at an appropriate time.

8 The survey results will serve as a useful platform to initiate discussions on the bank’s preparations for Basel II and its

choice of the appropriate Pillar 1 approach at the outset of the implementation of Basel II in Singapore.

9 We look forward to working with your bank towards the successful implementation of Basel II.

Yours faithfully,

JOHN PALMER

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