



BANK OF ZAMBIA

OFFICE OF THE DEPUTY GOVERNOR - OPERATIONS

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To : All Commercial Banks

IMPLEMENTATION OF THE NEW BASEL CAPITAL ACCORD (BASEL II) IN ZAMBIA

The Bank of Zambia wishes to advise all commercial banks operating in Zambia that the Basel Committee on Banking Supervision finalized the new capital adequacy framework, commonly known as Basel II, in June 2004. Subsequent to this, and in line with world-wide trends and international best practice, the Bank of Zambia has decided to introduce Basel II as a basis for regulatory capital measurement for all banks operating in Zambia.

WHAT IS BASEL II?

Basel II is the revised framework that replaces the 1988 Capital Accord as a standard for measuring a bank's capital. The new framework consists of three mutually reinforcing parts which are referred to as pillars. Pillar I relates to minimum capital requirements and prescribes the methodology for capital allocation against credit, market and operational risks. The risks that are not captured under Pillar I are covered in Pillar II. Pillar II outlines the supervisory review process for assessing the capital adequacy of banks and requires banks to establish a robust risk management framework to identify, assess and manage major risks inherent in the institution and allocate adequate capital against those risks. Pillar 3 sets out disclosure requirements for banks concerning their risk measures taken to mitigate against them.

The three pillars are described below:

Pillar 1 – Minimum Capital Requirements

The definition of eligible regulatory capital has fundamentally remained the same with very minor modifications [paragraph 41 of the Basel II document]. However, banks will be required to compute an operational risk capital charge in addition to the credit and market risk capital charge [Paragraph 40].

The revised framework provides a range of options for measuring minimum regulatory capital, therefore allowing banks and supervisors to select the approaches that best suit their operations and financial markets. In the case of Zambia, initially only the simpler approaches will be adopted because of resource and expertise constraints.

Pillar II – Supervisory Review Process

The supervisory review process is intended to not only ensure that banks have adequate capital to support all their business risks, but also to encourage them to develop and use better risk management techniques in monitoring and managing their risk exposures [Paragraphs 719 – 809].

Under Pillar II, banks are expected to develop a framework that identifies and measures all their other business risks that are not captured and measured under Pillar I. These include concentration risk, liquidity risk, strategic risk, reputation risk, business cycle risk, etc. Banks are also expected to develop capital adequacy assessment programmes that ensure that banks hold enough capital to cover all their risks, including weaknesses in internal controls and management. On their part, bank supervisors under Pillar II are expected to have mechanisms that ensure that they evaluate how well banks assess their business risks relative to their capital. Bank supervisors are also required to develop mechanisms to intervene at an early stage should a bank's capital fall below the minimum levels required to support the risk characteristics of a particular bank.

The Bank of Zambia is expected to issue Risk Management Guidelines to banks and at the same time enhance the Risk Based Supervision framework in order to improve its capacity to assess the banks' capital needs.

Pillar III – Market Discipline

The purpose of Pillar III is to encourage the on-going monitoring of banks by market participants and creditors. Basel II promotes market discipline and transparency by developing a set of disclosure requirements which will enable market participants to assess key information about the bank, such as, its risk profile, risk assessment processes and the amount of capital held to cover business and other risks [Paragraphs 808 – 826].

Pillar III therefore complements the minimum capital requirement (Pillar I) and the supervisory review process (Pillar II) in strengthening the oversight function.

The Bank of Zambia will issue prudential guidelines on disclosures taking into account the requirements of the International Financial Reporting Standard No.7 on Financial Instruments: Disclosures.

RATIONALE FOR MOVING TO BASEL II

Since the launch of the 1988 Capital Accord, the banking industry has experienced tremendous changes as a result of advances in technology, financial innovation, globalisation and advances in risk management. This has led to increased sophistication and risk taking by banks thus rendering the 1988 Capital Accord inadequate as a standard for measuring all banking risks. These developments have exposed the financial system to instability. However, Basel II is more risk sensitive than the 1988 Accord and encompasses a wide range of risks. It also gives banks various options when computing minimum capital. Further, it encourages better risk management as it gives incentives to banks that employ better risk management practices.

METHODOLOGIES TO BE ADOPTED IN ZAMBIA FOR COMPUTATION OF REGULATORY CAPITAL

It has been acknowledged that unlike the 1988 Capital Accord, Basel II is a complicated and resource intensive framework. Its implementation, especially for the more advanced approaches, therefore poses numerous challenges, especially in areas like data, financial, technical and human resources, and Information Technology infrastructure amongst others. Given these limitations, the Bank of Zambia will adopt the simpler approaches to Basel II. It is expected that with improvements in data availability and various resource capacities, the advanced approaches will be adopted later on.

The methods to be adopted by the Bank of Zambia for the computation of Pillar I capital charge will be as follows:

Credit Risk – Simplified Standardised Approach [Annex 11 of the Basel II Document];

Market risk – Standardised Approach [Amendments to the Capital Accord to incorporate Market risk (January 1996, updated in April 1998)]; and

Operational Risk – Basic Indicator Approach [paragraph 649 – 651 of the Basel II Document].

TIME FRAME FOR ADOPTION OF BASEL II

The Bank of Zambia intends to adopt Basel II in a phased manner. However, in view of the various challenges associated with the implementation of Basel II, this process will be carried out in a flexible manner. To this end, the Accord therefore will be implemented as follows:

The Bank of Zambia will initially implement Pillar II and Pillar III. To this effect, the Bank of Zambia is working on minimum risk management guidelines and minimum disclosures to be adopted by all banks operating in Zambia.

Pillar I will be implemented after the successful implementation of Pillars II and III. Detailed information will be provided at the implementation stage of each of the Pillars.

In order to ensure the smooth, realistic and undisrupted transition from the current capital adequacy framework to Basel II, all banks are required to designate one senior officer from their institution who will supervise all activities relating to Basel II within the bank and will serve as the point of contact with the Bank of Zambia. Such a person could be the Head of Risk Management, Credit, or the Chief Financial Officer. For this purpose, banks may also put in place a support person to assist the person in charge, if considered appropriate. Banks are required to establish an adequate set up and report to the Bank of Zambia – Bank Supervision Department the name and other particulars of the coordinator for Basel II as soon as possible, but not later than June 30, 2007.

BASEL II JOINT IMPLEMENTATION LIAISON COMMITTEE

In order to have an effective implementation process, the Bank of Zambia is proposing that a Basel II joint implementation liaison committee, comprising representatives from the Bankers Association of Zambia (BAZ), Zambia Institute of Chartered Accountants (ZICA) and the Bank of Zambia (BOZ) be constituted. Formation of such committees is common in many countries that are implementing Basel II. Some of the objectives of the committee will be to obtain input from the various stakeholders in the implementation process and to disseminate information regarding Basel II to all stakeholders.

Correspondence to this effect will be initiated by the Bank of Zambia to the respective organisations.

Please find attached the updated Basel II document released by the Basel Committee on Banking Supervision in November 2005. Banks are strongly advised to thoroughly review the updated Basel II document which is available on the Bank for International Settlements (BIS) website, at www.bis.org/bcbs/publ/index.htm, to get more information regarding Basel II and other guidance published by the Basel Committee on Banking Supervision.

For any further clarifications, please do not hesitate to contact the Director – Bank Supervision Department at the Bank of Zambia.



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DEPUTY GOVERNOR OPERATIONS

AND REGISTRAR OF BANKS AND FINANCIAL INSTITUTIONS

Cc: Governor

Deputy Registrar of Banks and Financial Institutions