BANK OF NAMIBIA

CIRCULAR BIA 3/07

TO: **ALL BANKING INSTITUTIONS**
DATE: **5 JULY 2007**

BASEL II – IMPLEMENTATION UPDATE

1. Introduction

In view of the re-assessment of the progress of the Basel Project, the Bank felt it necessary to introduce this Circular to provide guidance and clarity on the way forward that would ensure a successful adoption of the New Capital Accord.

The intention of this Circular is mainly to amplify that a framework for a collaborative approach between all banking institutions and the Bank is a critical and necessary ingredient for successful delivery of this project. The main objective of this project is to ensure the successful implementation of the standardized approach for all banking institutions within the jurisdiction of the Bank but at the same time to ensure the full integration of Risk Based Supervision, Consolidated Supervision, and Basel Core Principles for Effective Banking Supervision with that of the Basel II methodologies and principles.

On an earlier occasion, the Bank engaged the Bankers Association on the introduction of a consultative approach, which will be involving the relevant stakeholders throughout the whole implementation process. This suggestion was very well received by the banking leaders on the Association.

2. The Basel II Approach in Namibia

The main objectives of Basel II are to promote adequate capitalization of banking institutions and encourage improvements in risk management, thereby strengthening the stability of the financial system. These objectives will be achieved through the implementation of three components of Basel II known as “Pillars”. These pillars reinforce each other and create incentives for banking institutions to enhance the quality of their risk control processes.

Pillar 1 refers to the minimum capital requirements each banking institutions must hold to cover its exposure to credit, market and operational risk.

Pillar 2 is concerned with supervisory reviews that aim to ensure that banking institutions' capital levels are adequate to cover their overall risks. The supervisory review process of the framework is crucial to the sound operation of banking institutions in Namibia because it is intended to encourage banking institutions to develop and use better risk management techniques in monitoring and managing their risks.

Pillar 3 relates to market discipline and details minimum levels of public disclosure. The purpose of market discipline is to complement the minimum capital requirements (under Pillar 1) and the supervisory review process (under Pillar 2) by emphasizing the importance of risks disclosure in banking institutions' financial statements.

With regard to the calculation of minimum capital requirements under Pillar 1, the Bank has opted for the Standardised Approach for credit, market and operational risks for the foreseeable future. The main reasons for the proposed adoption of this approach relate to the size, and complexity of the banking industry in Namibia. Furthermore, the Bank has realized that a significant investment across the industry (including the Bank) is required to develop the commensurate skills and expertise to effectively manage the requirements of the New Accord. It should therefore be noted that, it is not a requirement for foreign owned and / or controlled banking institutions that operate in the Namibian jurisdiction, to adopt the same approach with regard to the calculation of minimum capital as that embraced by their parent banking institutions.

The Bank will assess the merits in future to adopt the advanced approach for calculating minimum capital charges for credit, market and operational risks after being satisfied that the Basel II methodology is well embedded in the risk management systems of the industry and the supervisory framework of the Bank.

3. Industry readiness

Within 30 days after the acceptance of this Circular, banking institutions are required to provide this Office with a comprehensive report on the progress made to date on their individual implementation schedules. This report should include information on the risk management frameworks set out by their parent banking institution's for the adoption of subsidiaries in Namibia and the type of support that parent banking institutions would render to such subsidiaries toward implementation. A similar risk management framework is expected from the parent companies of any Namibian owned and / or controlled banking institutions. Further, it is expected of the executive management of all incorporated banking institutions in Namibia to make available such information to the Bank upon request.

4. Progress to date

The Bank made a conscious decision to go ahead with a phased approach for the transition towards full implementation and formulated an implementation strategy for the Basel II principles. The reason for using a phased program is to finalise the amendments to the legislative framework, strengthen our supervisory structures and systems, and together with the banking industry prepare ourselves for full implementation of Basel II.

Towards the end of 2005, the Bank committed a team consisting of four senior regulatory officials to the Basel II project, which had been assigned dedicated responsibilities with regard to specific risk areas or aspects of a particular risk area. These responsibilities include, among others, the provision of technical guidance to banking institutions on the standardized approach adopted by the Bank.

At the time of completion of the program schedule, it was shared with the banking industry. This program schedule referred to above includes some, but not all the phases (subject to change) highlighted below, together with the exercises carried out to date and those which are still to be dealt with.

Phase 1: The first half of 2006, saw the Bank carry out an assessment on the risk management practices in all banking institutions, a process which consisted of the following steps: (1) the compilation of a questionnaire pertaining to the risk areas pertinent in the Basel principles; (2) conducting interviews with the risk management teams of banking institutions, in order to identify the current range of techniques applied; and (3) to identify the key gaps that needs to be address within the supervisory review process. Following this exercise, the team compiled a report containing the shortcomings identified throughout this phase, for further assessment and action at the task group forum to be established.

Phase 2: During the latter part of 2006, the Bank prepared part of the prudential standards and rules that are necessary to operationalise certain key Basel II principles, such as the compilation of the amendments to incorporate Market Risk. Similarly, the industry saw the promulgation of the Determination on Country Risk to strengthen our regulatory processes. Due to the complex nature of the Market Risk amendments, the Bank solicited comments from other regulatory experts before promulgation.

Phase 3A: The first quarter of 2007 saw the start of the first leg of phase 3, which consisted of an assessment of the impact of the new rules on the industry's capital levels (i.e. Quantitative Impact Study). Positive contributions were made at meetings held with the industry. In this regard, an industry profile is formulated by the Bank on the impact of the new capital changes on banking institutions, and will be shared at the task group forum before being discussed with the industry.

Phase 3B: This phase saw the introduction of a national discretion framework, which specifically emphasizes a lower risk weight bucket for certain assets classes (e.g. 35% compared to current 50% for residential mortgages). The introduction of a possible lower risk weight bucket, necessitated the Bank to re-visit this aspect by performing default data studies in order to evaluate whether the proposed risk-weights of the new capital framework will be appropriate based on the default experience for such exposures.

The outcome of this exercise would mainly justify the possible reduction of the applicable risk-weight to exposures secured by residential mortgage property from the current 50% to a proposed 35%. The outcome of this default study is yet to be discussed at the task group forum before it will be shared with the industry.

Phase 4: The third quarter of 2007 will be dedicated to the formulation of both credit and operational risk determinations to further operationalise the Basel II rules for these risk areas. It is our intention to solicit comments from the banking industry upon the completion of these regulatory requirements. As cautionary note however, all banking institution should be aware that the introduction of the above two determinations will be run concurrently, which may provide additional pressure on the industry's existing workload.

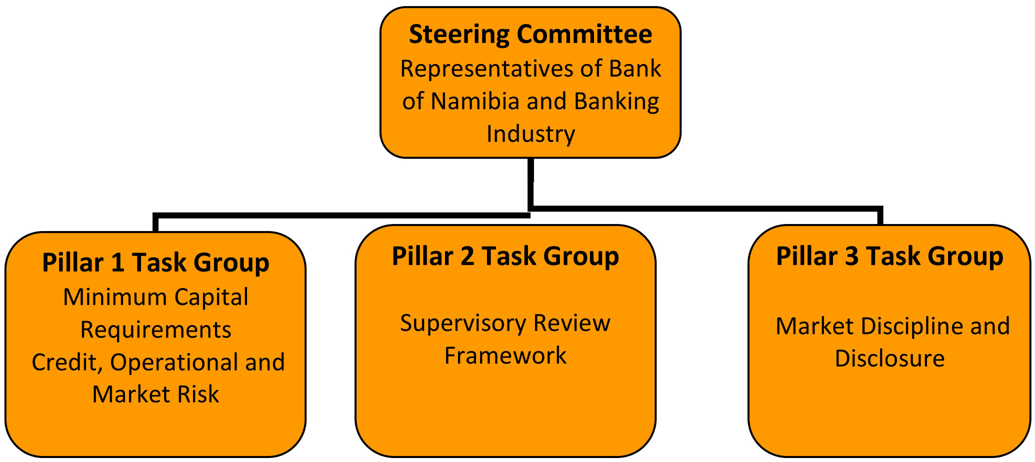
Phase 5: Throughout the remainder of 2007 and the first quarter of 2008, the Bank will focus on developing additional guidelines on the implementation process. They will contain among others supervisory directives (including technical guidelines on the requirements and measurement of capital adequacy), for a common market disclosure framework, supervisory review framework, probable common procedures and assessment criteria for the recognition of eligible credit assessment institutions, and the validation and stress testing of internal models for credit risk and operational risk.

In developing all the abovementioned regulatory tools, the Bank will try and maintain an appropriate balance between detailed guidance that promotes legal certainty, and principle based guidelines that will accommodate future developments in these requirements and provide some flexibility in our supervisory approaches.

It should also be noted that some of the anticipated items in our programme schedule, have already been initiated and is anticipated to be complete way before the expected parallel run commencement in 2009.

5. Project Governance Principles

In view of the stated need for collaboration between the Bank and the banking industry to ensure the successful adoption of the Basel II framework, a two tier structure is proposed to oversee, co-ordinate and management the project as shown in the organogram below.



It is envisaged that membership of the Steering Committee is to include the Director: Banking Supervision and Chief Financial Officers and / or Heads of Risk of all banking institutions. The Bank shall chair this Committee and take responsibility for the secretariat duties. This Committee should be the only decision-making body having the responsibility to direct and guide the work of the task groups. It is suggested that the Steering Committee formulate a project charter for the consideration and adoption by the Bank and the industry. It is envisage that the Steering Committee will report on progress on a quarterly basis to the Bank of Namibia / Bankers Association Namibia forum.

The composition of the tasks groups should include risk, compliance and finance officers of banking institutions and examiners and analysts of the Bank. It is also suggested that representatives of the external auditors of banking institutions to be co-opted into the Pillar 3 Task Group. A brief outline of the key functions of the task groups are described hereto.

Pillar 1 Task Group

Pillar 1 Task Group shall be responsible for drafting minimum capital requirements for all banking institutions to hold cover against exposures for credit, market and operational risk and align their internal processes with the requirements of the Standardized Approach.

Pillar 2 Task Group

In terms of the framework of Pillar 2 requirements, the task group is to look into matters pertaining to banking institutions which is to develop and use better risk management techniques in assessing, monitoring and managing their risks, while at the same time facilitate for the Bank to review the processes to enable the Bank to intervene where and when appropriate.

Pillar 3 Task Group

The task group is to look into Market discipline and details of minimum levels of public disclosure to ensure that this Pillar is to complement the minimum capital requirements (under Pillar 1) and the supervisory review process (under Pillar 2) by emphasizing the importance of risks disclosure in banking institutions' financial statements. These disclosures enable market participants to better evaluate banking institutions' risk profiles and adequacy of their capital positions.

The banking institutions are expected to inform the Bank of their representatives, including contact details to serve on the Steering Committee and Tasks Groups at the time of acceptance of this Circular. Furthermore, banking institutions with Parent Companies in South Africa are required to provide the Bank with details of person(s) at an appropriate organisational level**.**

6. Time lines

It should be noted that, the initial exercises carried out in terms of the Basel II program schedule was not without its challenges, which necessitated the Bank to re-adjust the previously communicated implementation date from 1 January 2008 to an effective date of 1 July 2009. On this proposed new date, all banking institutions will be expected to successfully perform parallel calculations for both the standardised approach and the current capital framework. Further to this, we are thus expecting full transition to start as from the 1 January 2010.

7. Additional copies

Two additional copies of this Circular are enclosed for the use of your banking institution's independent auditors. The attached "Acknowledgement of Receipt" duly completed and signed by both the Managing Director of the banking institution and the said auditors should be returned to this Office at your earliest convenience.

LIONEL J. MATTHEWS
DIRECTOR: BANKING SUPERVISION