

BASEL-II

Three steps of Governance

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26.06.2004 Basel Committee released the much awaited Document called 'International convergence of capital measurement and capital standards'.

History of Basel

Regulatory capital requirement is crucial in reducing the risk of insolvency, and the damage for banks and financial institutions worldwide. In 1988, the Basel Committee for Banking Supervision defined credit risk and the minimum amount of capital that should be held by the bank. In 1998, the Basel Committee incorporated market risk into the framework. This classification was ratified by over 100 signatories within the G-10 countries and is still used today to define the minimum amount of capital a bank must hold to cover loss arising from obligor default. The accord required that banks must hold a minimum of 8% capital.

The figure of 8% is not changed anywhere however the considerations to arrive at this figure have radically changed. The reason was simple. Banking, risk management practices, supervisory approaches and financial markets have seen a sea change over the years. Recent operational risk failures in financial institutions around the globe have accentuated the dangers of poor risk management. This was the fillip for Basel II, a new accord that has a more risk-sensitive framework.

BASEL-II vis a vis BASLE-I

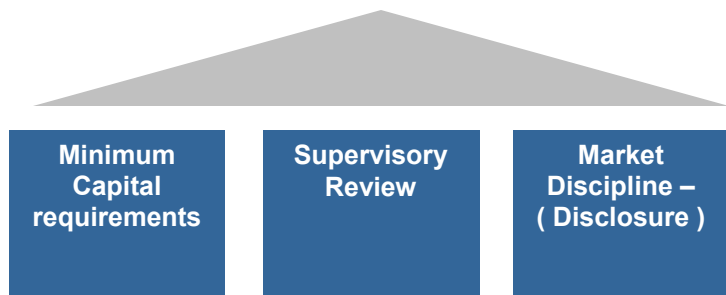
Existing Capital Accord	Proposed New Capital Accord
Focus on single risk measure	More emphasis on bank's own internal risk management methodologies, supervisory review, and market discipline
One size fits all	Flexibility; menu of approaches; capital incentives for better risk management; granularity in the valuation of assets and type of businesses and in the risk profiles of their systems and operations
Broad brush structure	More risk sensitivity by business class and asset class; multi-dimensional; focus on all operational components of a bank

Three Pillars

Basel II emphasises risk management, which can be accomplished by aligning an organisation's capital requirements with prevailing risk and ensuring that the emphasis on risk makes the way into supervisory practices and market discipline through enhanced risk and capital-related disclosures. For the first time, the Basel committee addresses operational risk. It also urges higher transparency and disclosure among banks that expect to benefit from Basel II's capital incentives.

Three Pillar Approach

How capital requirements for credit risk are calculated makes it obvious that organisations will now reconsider who they wish to deal with and what services they offer clients. Basel-II follows the three-pillar approach.



Minimum Capital Requirements

As in the current accord, the new accord will have the same provisions relating to the regulatory capital requirement: 8%. However, the difference is in the method of calculating bank risk, which would, in turn, affect capital requirement.

- Regulatory Capital / Risk weighted assets > 8%
- Risk weighted assets = {Capital requirements for Market Risk + Capital requirements for Operational Risk} * 12.5 + (Risk weighted assets for credit risk)
- The accord covers two risks
 - Credit Risk: The potential that a bank borrower or counter party fails to meet the financial obligations on the agreed terms.

External Rating Based	Internal Ratings Based	
	Foundation IRB	Advanced IRB
Calibrated on the basis of the External Ratings.	Function provided by BASEL committee	Function provided by BASEL Committee

Market Risk

- Operational Risk: The risk loss arising from the various types of human or technical error, failed internal process, fraud or the legal hurdles.

Basic Indicator	Standardized	Advanced Measurement
Capital Charge = 15% of the three years average gross income	Capital Charge = 12%-18% of the gross income per regulatory business line	Capital Charge = Internally generated data on internal & External loss data, Scenario analysis business environment & internal Control

Market Risk:

- The standardized approach which specifies the standards in five categories
 1. Interest Rate risk
 2. Equity Position Risk
 3. Foreign Exchange risk
 4. Commodities Risk
 5. Options risk
- The second approach to deal in the market risk is based on the internal assessments of the banks. The bank needs to consider following five elements in calculating the internal model based risk structure.
 1. General criteria, where the approval from the supervisory authority of the bank is mandatory.
 2. Qualitative standards regarding the maintenance of the Risk management unit
 3. Specification of Market Risk Factors
 4. Quantitative standards
 5. Stress testing to identify the events that could impact the banks.
 6. External Validation by External auditors and Supervisory authorities

Supervisory Review Process

The supervisory review process of the framework is intended not only to ensure that banks have adequate capital to support all the risks in their business but also to encourage the banks to develop and use better risk management techniques.

The key principles of Supervisory review

1. Banks should have the process for assessing their overall capital adequacy in relation to their risk profile and a strategy for maintaining their capital levels.
2. Intervention at the early stage to prevent capital from declining to below benchmark level.
3. Review of internal capital adequacy assessment and strategy
4. Assessment of overall capital in relation with risk profile.

Market Discipline

Market Discipline

With the adoption of the IRB approach of the New Accord, according to which banks have greater discretion in determining their capital needs, market discipline through public disclosure is called for. This pillar is complementary to the first two pillars of the Model. It seeks to encourage the market discipline and the public disclosure, so as to allow shareholders, stakeholders and market players to know about key information about risk profile and available capital resources. The disclosure of capital structure, risk measurement and management practices, disclosure of risk profile of the bank are expected to improve the disclosures of the banks using the Internal Risk based approaches.

Implementation of the BASEL

The framework is applicable to wide range of the banking system of G-10 countries. In respect of other countries Basel committee provides that supervisors of the nation should strengthen the supervisory system and then develop the road map for due implementation, through proper planning to switch over to BASEL. There are some benefits of proper compliance with the provisions of Basel II. If banks and financial institutions develop sophisticated internal risk-measurement processes and can show them to be sufficiently accurate, they will be allowed to use these to calculate the capital they must hold against their exposures

Improved credit rating systems and improved management of operational risk will also be of benefit. Organisations that address compliance effectively will see the up-side to Basel II to be significant improvements in customer service, risk management, decision-making, operational efficiency and cost reduction. All such improvements build consumer confidence and enhance brand and reputation.

The liability cost of non-compliance will be high, but there is equally a potential cost of attaining compliance in the wrong way, and there are no prizes for over compliance. Instead over compliance can create barriers to your customers and so the key will be to identify best business practice and implement rigorously.

6 things Banks Should Note

1. Review existing frameworks. This may be the right time to review the entire structure of enterprise-wide risk management and consolidate disparate risk management systems.
2. Decide the approach for IRB risk measurement and management. Build models and systems around this for credit risk and operational risk.
3. Build a flexible, scalable system. This system should accommodate future amendments to the new Accord.
4. Develop reliable and efficient disclosure reporting. These systems are required by Pillar 3 of Basel II.
5. Communicate your organisation's approach Reiterate the advantages and power of Basel II, including its initiatives and strategies, to employees, customers and shareholders.
6. Find the right IT partner for Basel II compliance. Given the huge complexities involved in preparing for Basel II on time, your need not just system or application vendors but expert IT partners.

