

Basel II Accord

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Basel II is the second of the Basel Accords, which are recommendations on banking laws and regulations issued by the Basel Committee on Banking Supervision. The purpose of Basel II, which was initially published in June 2004, is to create an international standard that banking regulators can use when creating regulations about how much capital banks need to put aside to guard against the types of financial and operational risks banks face. Advocates of Basel II believe that such an international standard can help protect the international financial system from the types of problems that might arise should a major bank or a series of banks collapse. In practice, Basel II attempts to accomplish this by setting up rigorous risk and capital management requirements designed to ensure that a bank holds capital reserves appropriate to the risk the bank exposes itself to through its lending and investment practices. Generally speaking, these rules mean that the greater risk to which the bank is exposed, the greater the amount of capital the bank needs to hold to safeguard its solvency and overall economic stability.

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Basel II

Bank for International Settlements
Basel Accord - Basel I
Basel II

Background

Banking
Monetary policy - Central bank
Risk - Risk management
Regulatory capital
Tier 1 - Tier 2

Pillar 1: Regulatory Capital

Credit risk
Standardized - F-IRB - A-IRB
PD - LGD - EAD
Operational risk
Basic - Standardized - AMA
Market risk
Duration - Value at risk

Pillar 2: Supervisory Review

Economic capital
Liquidity risk - Legal risk

Pillar 3: Market Disclosure

Disclosure

Business and Economics Portal

Objective

The final version aims at:

1. Ensuring that capital allocation is more risk sensitive;
2. Separating operational risk from credit risk, and quantifying both;
3. Attempting to align economic and regulatory capital more closely to reduce the scope for regulatory arbitrage.

While the final accord has largely addressed the regulatory arbitrage issue, there are still areas where regulatory capital requirements will diverge from the economic.

Basel II has largely left unchanged the question of how to actually define bank capital, which diverges from accounting equity in important respects. The Basel I definition, as modified up to the present, remains in place.

The Accord in operation

Basel II uses a "**three pillars**" concept – (1) minimum capital requirements (addressing risk), (2) supervisory review and (3) market discipline – to promote greater stability in the financial system.

The Basel I accord dealt with only parts of each of these pillars. For example: with respect to the first Basel II pillar, only one risk, credit risk, was dealt with in a simple manner while market risk was an afterthought; operational risk was not dealt with at all.

The first pillar

The first pillar deals with maintenance of regulatory capital calculated for three major components of risk that a bank faces: credit risk, operational risk and market risk. Other risks are not considered fully quantifiable at this stage.

The credit risk component can be calculated in three different ways of varying degree of sophistication, namely standardized approach, Foundation IRB and Advanced IRB. IRB stands for "Internal Rating-Based Approach".

For operational risk, there are three different approaches - basic indicator approach or BIA, standardized approach or TSA, and the internal measurement approach (an advanced form of which is the advanced measurement approach or AMA).

For market risk the preferred approach is VaR (value at risk).

As the Basel 2 recommendations are phased in by the banking industry it will move from standardised requirements to more refined and specific requirements that have been developed for each risk category by each individual bank. The upside for banks that do develop their own bespoke risk measurement systems is that they will be rewarded with potentially lower risk capital requirements. In future there will be closer links between the concepts of economic profit and regulatory capital.

Credit Risk can be calculated by using one of three approaches

1. Standardised Approach
2. Foundation IRB (Internal Ratings Based) Approach
3. Advanced IRB Approach

The standardised approach sets out specific risk weights for certain types of credit risk. The standard risk weight categories are used under Basel I and are 0% for short term government bonds, 20% for exposures to OECD Banks, 50% for residential mortgages and 100% weighting on unsecured commercial loans. A new 150% rating comes in for borrowers with poor credit ratings. The minimum capital requirement (the percentage of risk weighted assets to be held as capital) remains at 8%.

For those Banks that decide to adopt the standardised ratings approach they will be forced to rely on the ratings generated by external agencies. Certain Banks are developing the IRB approach as a result.

The second pillar

The second pillar deals with the regulatory response to the first pillar, giving regulators much improved 'tools' over those available to them under Basel I. It also provides a framework for dealing with all the other risks a bank may face, such as systemic risk, pension risk, concentration risk, strategic risk, reputation risk, liquidity risk and legal risk, which the accord combines under the title of residual risk. It gives banks a power to review their risk management system.

Recent chronological updates

September 2005 update

On September 30, 2005, the four US Federal banking agencies (the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision) announced their revised plans for the U.S. implementation of the Basel II accord. This delays implementation of the accord for US banks by 12 months.^[1]

November 2005 update

On November 15, 2005, the committee released a revised version of the Accord, incorporating changes to the calculations for market risk and the treatment of double default effects. These changes had been flagged well in advance, as part of a paper released in July 2005.^[2]

July 2006 update

On July 4, 2006, the committee released a comprehensive version of the Accord, incorporating the June 2004 Basel II Framework, the elements of the 1988 Accord that were not revised during the Basel II process, the 1996 Amendment to the Capital Accord to Incorporate Market Risks, and the November 2005 paper on Basel II: International Convergence of Capital Measurement and Capital Standards: A Revised Framework. No new elements have been introduced in this compilation. This version is now the current version.^[3]

November 2007 update

On November 1, 2007, the Office of the Comptroller of the Currency (U.S. Department of the Treasury) approved a final rule implementing the advanced approaches of the Basel II Capital Accord. This rule establishes regulatory and supervisory expectations for credit risk, through the Internal Ratings Based Approach (IRB), and operational risk, through the Advanced Measurement Approach (AMA), and articulates enhanced standards for the supervisory review of capital adequacy and public disclosures for the largest U.S. banks.^[4]

July 16, 2008 update

On July 16, 2008 The federal banking and thrift agencies (The Board of Governors of the Federal Reserve System; the Federal Deposit Insurance Corporation; the Office of the Comptroller of the Currency, and; the Office of Thrift Supervision) issued a final guidance outlining the supervisory review process for the banking institutions that are implementing the new advanced capital adequacy framework (known as Basel II). The final guidance, relating to the supervisory review, is aimed at helping banking institutions meet certain qualification requirements in the advanced approaches rule, which took effect on April 1, 2008.^[5]

Basel II and the regulators

One of the most difficult aspects of implementing an international agreement is the need to accommodate differing cultures, varying structural models, and the complexities of public policy and existing regulation. Banks' senior management will determine corporate strategy, as well as the country in which to base a particular type of business, based in part on how Basel II is ultimately interpreted by various countries' legislatures and regulators.

To assist banks operating with multiple reporting requirements for different regulators according to geographic location, there are several software applications available. These include capital calculation engines and extend to automated reporting solutions which include the reports required under COREP/FINREP.

For example, U.S. FDIC Chairman Sheila Bair criticized the Basel II standards during June 2007: "There are strong reasons for believing that banks left to their own devices would maintain less capital -- not more -- than would be prudent. The fact is, banks do benefit from implicit and explicit government safety nets. Investing in a bank is perceived as a safe bet. Without proper capital regulation, banks can operate in the marketplace with little or no capital. And governments and deposit insurers end up holding the bag, bearing much of the risk and cost of failure. History shows this problem is very real ... as we saw with the U.S. banking and S & L crisis in the late 1980s and 1990s. The final bill for inadequate capital regulation can be very heavy. In short, regulators can't leave capital decisions totally to the banks. We wouldn't be doing our jobs or serving the public interest if we did."^[6]

Implementation progress

Regulators in most jurisdictions around the world plan to implement the new Accord, but with widely varying timelines and use of the varying methodologies being restricted. The United States of America's various regulators have agreed on a final approach.^[7] They have *required* the Internal Ratings-Based approach for the largest banks, and the standardized approach will not be available to anyone.(See

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<http://www.federalreserve.gov/newsevents/press/bcreg/20080626b.htm> for an update on proposed Standardized Approach)

In India, RBI has implemented the Basel II standardized norms on 31st March 2009 and is moving to internal ratings in credit and AMA norms for operational risks in banks.

In response to a questionnaire released by the Financial Stability Institute (FSI), 95 national regulators indicated they were to implement Basel II, in some form or another, by 2015.^[8]

The European Union has already implemented the Accord via the EU Capital Requirements Directives and many European banks already report their capital adequacy ratios according to the new system. All the credit institutions will adopt it by 2008.

Australia, through its Australian Prudential Regulation Authority, implemented the Basel II Framework on 1 January 2008^[9].

See also

- <http://www.occ.gov> Office of the Comptroller of the Currency
- Operational risk
- Operational risk management
- Risk
- Capital adequacy
- Solvency II
- Procylical
- Data governance

References

1. ^ Federal Reserve (<http://www.federalreserve.gov/boarddocs/press/bcreg/2005/20050930/default.htm>)
2. ^ BIS (<http://www.bis.org/publ/bcbs118.pdf>)
3. ^ BIS (<http://www.bis.org/publ/bcbs128.pdf>)
4. ^ OCC (<http://www.occ.gov/ftp/release/2007-123.htm>)
5. ^ OCC (<http://www.occ.gov/ftp/release/2008-81a.pdf>)
6. ^ Shelia Bair Speech (<http://www.fdic.gov/news/news/speeches/archives/2007/chairman/spjun2507.html>)
7. ^ OCC Notice of Proposed Rulemaking (<http://www.occ.treas.gov/fr/fedregister/71fr55830.pdf>)
8. ^ BIS (<http://www.bis.org/fsi/fsipapers06.htm>)
9. ^ Information Paper: Implementation of the Basel II Capital Framework (http://www.apra.gov.au/ADI/upload/APRA_IP_PillarII_122007_v3.pdf)

External links

- <http://www.occ.gov/ftp/release/2008-81a.pdf>
- <http://www.occ.gov/ftp/release/2007-123.htm> OCC Approves Basel II Capital Rule for U.S. Banks
- <http://www.bis.org/publ/bcbsca.htm> Basel II: Revised international capital framework (BCBS)
- <http://www.bis.org/publ/bcbs107.htm> Basel II: International Convergence of Capital Measurement and Capital Standards: a Revised Framework (BCBS)
- <http://www.bis.org/publ/bcbs118.htm> Basel II: International Convergence of Capital Measurement and Capital Standards: a Revised Framework (BCBS) (November 2005 Revision)
- <http://www.bis.org/publ/bcbs128.pdf> Basel II: International Convergence of Capital Measurement and Capital Standards: a Revised Framework, Comprehensive Version (BCBS) (June 2006 Revision)
- Impact of Basel II on IT investments (<http://www.dmstudy.info>) Global Data and Risk Management Survey 2005
- <http://www.math.ethz.ch/~baltes/ftp/Responsev3.pdf> An academic response to Basel II
- <http://www.math.ethz.ch/~delbaen/ftp/preprints/CoherentMF.pdf> Coherent measures of risk. a widely quoted paper
- <http://www.bos.frb.org/economic/wp/wp2006/wp0613.htm> FRB Boston paper on measurement of operational risk.
- Danielsson, Jón. "The Emperor Has No Clothes: Limits to Risk Modelling." *Journal of Banking and Finance*, 2002, 26, pp. 1273–96.
- <http://www.info.gov.hk/hkma/eng/bank/spma/attach/CA-G-4.pdf> Validating Risk Rating Systems under the IRB Approaches, HKMA
- <http://www.info.gov.hk/hkma/eng/basel2/index.htm> Return of capital adequacy ratio (final version) - Completion instructions, HKMA
- [http://www.info.gov.hk/hkma/eng/bank/reform/pdf/MA\(BS\)3.pdf](http://www.info.gov.hk/hkma/eng/bank/reform/pdf/MA(BS)3.pdf) Return Templates of capital Adequacy Ratio, HKMA
- http://www.osfi-bsif.gc.ca/app/DocRepository/1/eng/guidelines/capital/guidelines/car_a1_e.pdf Canada Capital Adequacy Requirements, OSFI

Other links

- Articles on Risk Management & Modelling (<http://riskanalytics.wordpress.com/>)
- <http://bis2information.org>: Practical articles, on BIS2 and risk modelling, submitted by professionals to help create an industry standard.
- Approaches and Challenges in implementation of Basel II (<http://www.basel2implementation.com>)
- A Nontechnical Analysis of Basel I and II (<https://jscholarship.library.jhu.edu/bitstream/handle/1774.2/32826/Basel%20I%2c%20Basel%20II%2c%20and%20Emerging%20Markets%20a%20Nontechnical%20Analysis052008.pdf?sequence=1>)

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