



BASEL II AND ITS IMPLICATIONS

November 2004

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Group: Bahamas Institute of Chartered Accountants

What's in a Name?

Basel II ?

..... *OR*

International Convergence of Capital Measurement and Capital Standard !!

What is Basel II?

Simply put:

A new standard for the measurement of risks in banks, and for the allocation of capital to cover those risks.

Published by the Basel Committee of G10 Central Banks

What Does Basel Committee Do?

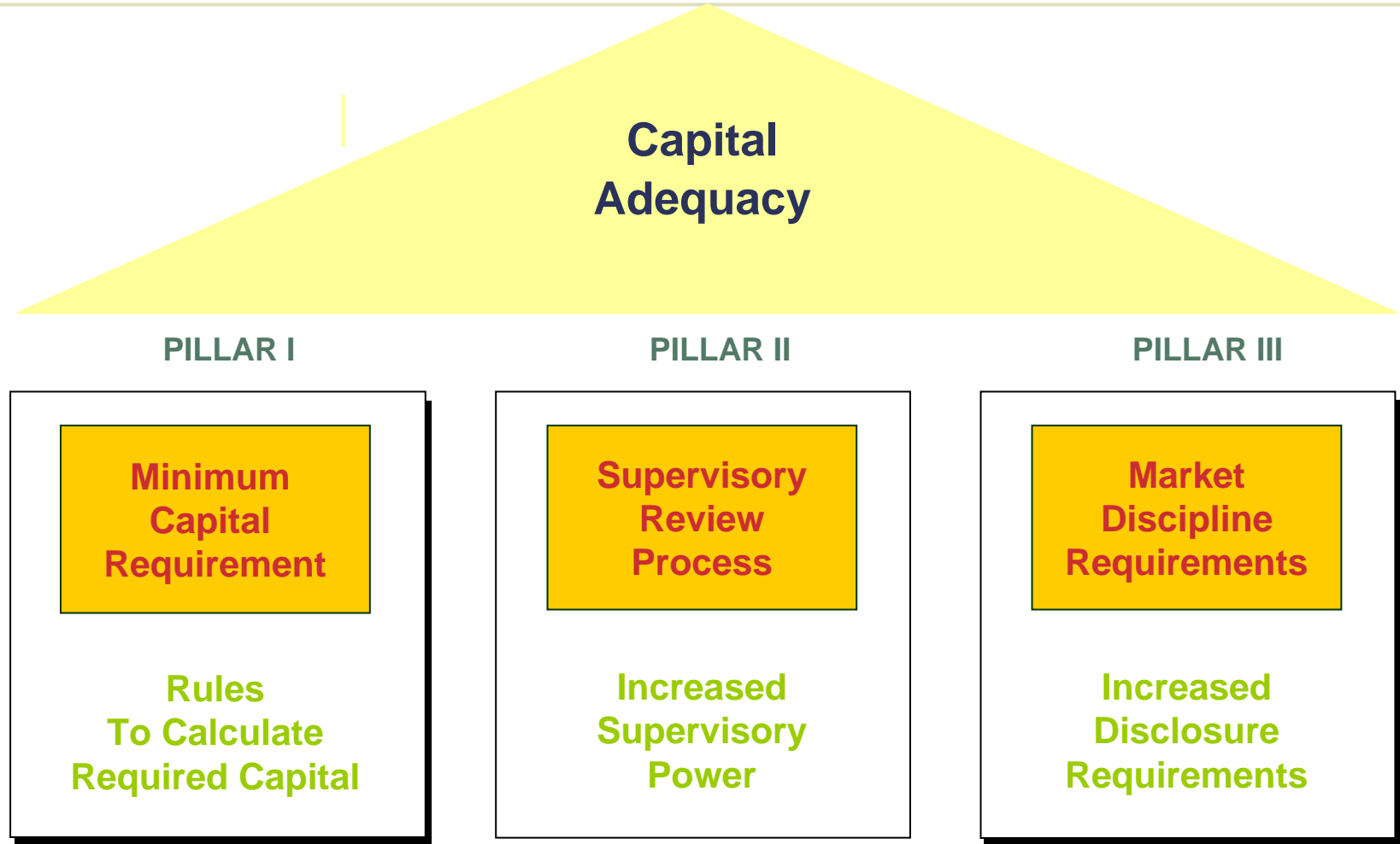
- Acts as Think-Tank for banking regulators
- Issues guidance on best practice for banks
- Standards accepted worldwide (authoritative, best practices)
- Generally incorporated in national banking regulations

Reason For a New Accord

“The fundamental objective of the Committee’s work has been to develop a framework that would further strengthen the soundness and stability of the international banking system while maintaining sufficient consistency that capital adequacy regulation will not be a significant source of competitive inequality among internationally active banks. The Committee believes that the revised framework will promote the adoption of stronger risk management practices by the banking industry, and views this as one of its major benefits ”

Basel Committee on Banking Supervision, June 2004

Basel II – the Three Pillars



New Regulatory Structure Based on Three Pillars

Comparison of Basel Accords

1998: Basel I	2004 : Basel II
Focus on single measure - Capital	Three pillars : Capital adequacy Supervisory review Market discipline
One size fits all	Menu of approaches
Broad brush	Greater risk sensitivity

Change in Capital Requirements

Accord	Calculation	Benchmark Result
<p>Basel I</p> <p>Minimum Regulatory Capital</p>	$\frac{\text{Capital}}{(\text{Credit \& Market}) \text{ Risk Adjusted Assets}}$	<p>> or = 8%</p>
<p>Basel II</p> <p>Minimum Regulatory Capital</p>	$\frac{\text{Capital}}{\text{Credit Risk} + \text{Market Risk} + \text{Operational Risk}}$	<p>> or = 8%</p>

The Risk Categories in Basel II

- Credit risk – the risk that a borrower or counterparty might not honour its contractual obligations
- Market risk – the risk of adverse price movements such as exchange rates, the value of securities, and interest rates
- Operational risk – the risk of loss resulting from inadequate or failed internal processes, people, and systems, or from external events (**NEW**)

Credit Risk – Key Points

- The main area of banks' exposure
- Credit risk is main source of problems at banks
- Effective management of credit risk is critical for all banks

Credit Risk

- Basel II places emphasis on improving the management and measurement of credit risk
- The measurement of credit risk implies assessing the borrower's creditworthiness.
- A loan should, therefore, be priced to reflect how much risk it involves.

Credit Risk Approaches

For each portfolio, banks must choose One approach from a set of Three:

- Standardised Approach
- Foundation Internal Ratings Based Approach
- Advanced Internal Ratings Based Approach

The Three Approaches Compared



- One size fits all
- No capital incentives for better Credit Risk Management

- Risk based
- Incentive to manage risks

Simple

Sophisticated

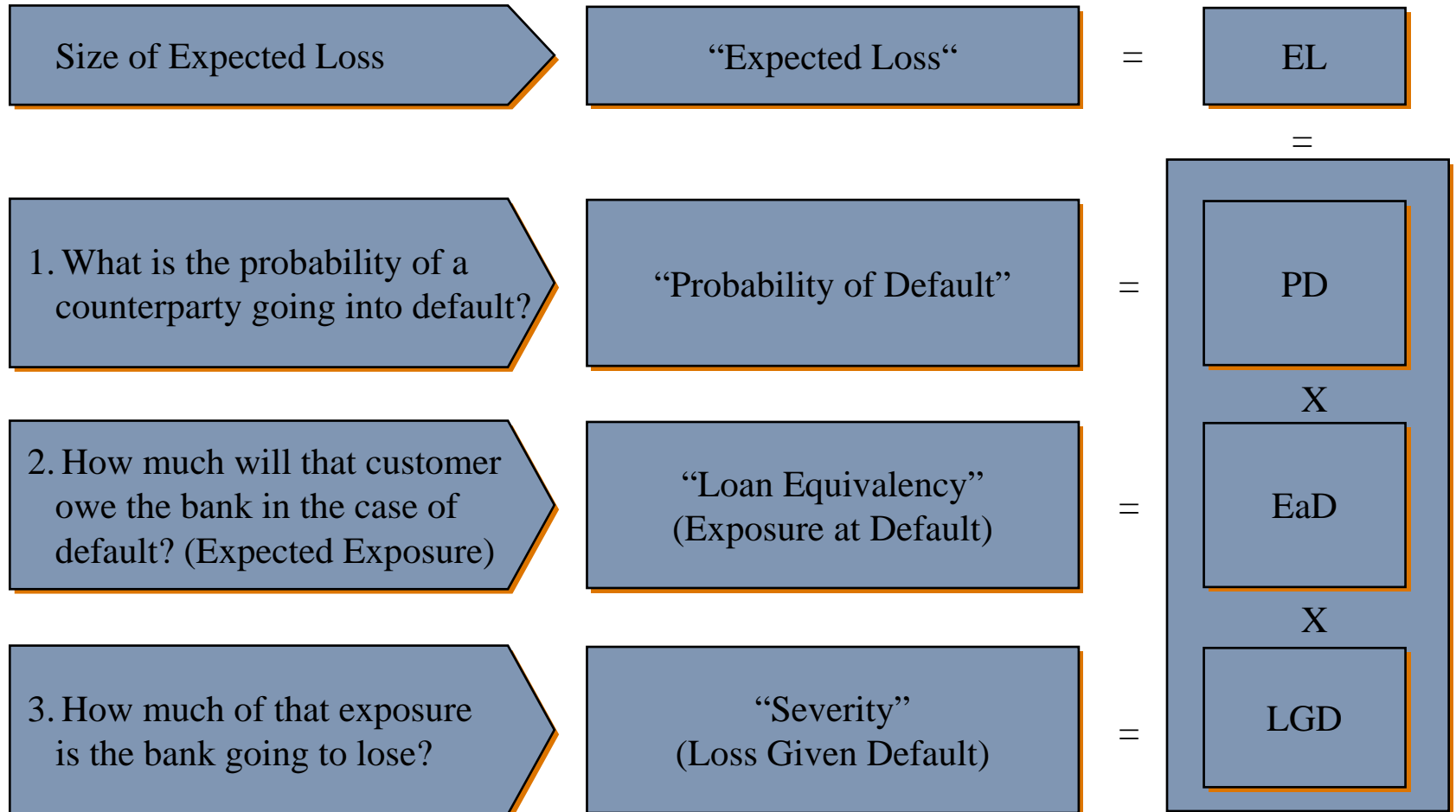
Low level of detail

High level of detail

Little sensitivity to risk

High sensitivity to risk

Credit Risk Components



Credit Risk Components

Expected Loss
(EL)

Probability of
Default
(PD)

Severity of Loss
(LGD)

Exposure at
Default

Standardised = External Rating x Regulatory Imposed x Regulatory Imposed

IRB Foundation = Proprietary Rating x Regulatory Imposed x Regulatory Imposed

IRB Advanced = Proprietary Rating x Proprietary Severity x Proprietary Exposure

Comparison of Approaches

Standardised Approach

- Similar to current Basel I method
- New risk weights (0%; 20%; 50%; 100%, 150%)
- used for assessing capital required.
- Uses External Ratings (where available)
- Unrated weighted at 100%
- 35% weight for claims secured by Residential Mortgage
- 100% weight for claims secured by Commercial Mortgage

Foundation Internal Ratings Based Approach

Components provided by banks:

internal ratings (probability of default - requires sophisticated database)

Components provided by Basel Accord

loss given default ; exposure at default; Maturity

Advanced Internal Ratings Based Approach

-Same principles as for Foundation Approach, but all items are provided by the bank, based on internally developed models

Operational Risk

- Capital requirement for Operational Risk (OR) introduced
- Banks' OR models not as developed as for Credit Risk
- Operational Risk (OR) will add to banks' regulatory capital requirements
- Increased cost for OR might offset any capital savings on Credit Risk
- Operational risk is not restricted to banks, it's present in all organisations

Pillar II – Supervisory Review

- Based on Four Core Principles (nothing new here?)
 - Banks should have a process for assessing their overall capital adequacy in relation to their risk profile and a strategy for maintaining their capital levels
 - Supervisors should review and evaluate bank's internal capital adequacy assessments and strategies, as well as their ability to monitor and ensure their compliance with regulatory capital ratios. Supervisors should take appropriate action if they are not satisfied with results of the process.
 - Supervisors should expect banks to operate above a minimum regulatory capital ratios and should have the ability to require banks to hold capital in excess of minimum.
 - Supervisors should seek to intervene at an early stage to prevent capital from falling below the minimum level required to support the risk characteristics of a particular bank and should require rapid remedial action if capital is not maintained or restored

Pillar III – Market Discipline

Purpose:

- To complement Pillar I & II
- To encourage market discipline by developing a set of disclosure requirements which will allow market participants to assess key pieces of information on:
 - Capital risk exposure
 - Risk assessment process
 - Capital adequacy of the bank

CAPITAL ADEQUACY DISCLOSURE SHOULD BE CONSISTENT WITH HOW SENIOR MANAGEMENT AND THE BOARD OF DIRECTORS ASSESS AND MANAGE THE RISKS OF THE BANK.

- Tell what you do and how you do it
- (e.g. IRB vs. AIRB for credit risk or Standardize vs. AMA for operational)
- (IAS 30, 32, 39 and CBB minimum disclosure requirement should be paid attention to)

ISSUES & Related Developments

- More risk sensitive approach
- Regulatory Capital vs. Economic Capital vs. Accounting Capital
- EU Directive of adoption and application of IAS
- IAS 39 (Hedge and Fair Value accounting)
- Greater consistency across border
- Home vs. Host supervisors
- Accuracy of measurements (advance approaches)
- Availability of historical information (should be building up)
- Benefiting from effective Risk management
- Role of Accountants (Auditors)
- Solvency II
- USA Approach to application (Top banks vs. others)

Wrap Up

Questions?



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