Basel II Overview

For

Interview

With A

Major Bank in North Carolina

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Basel II – Final Rule Summary

July 8–9, 2009 update creating the Final Rule

A final package of measures to enhance the three pillars of the Basel II framework and to strengthen the 1996 rules governing trading book capital was issued by the newly expanded Basel Committee. These measures include the enhancements to the Basel II framework, the revisions to the Basel II market-risk framework and the guidelines for computing capital for incremental risk in the trading book.

The final rule adopts without change the proposed criteria for identifying **core banks (banks required to apply the advanced approaches)** and continues to permit **other banks** (opt-in banks) to adopt the advanced approaches if they meet the applicable qualification requirements.

Core banks are those with consolidated total assets (excluding assets held by an insurance underwriting subsidiary of a bank holding company) of $**250 billion** or more or with consolidated total **on-balance-sheet foreign exposure of $10 billion or more.**

A depository institution (DI) also is a core bank if it is a subsidiary of another DI or bank holding company that uses the advanced approaches.

The **final rule** also provides that a bank's primary Federal supervisor may determine that application of the final rule is not appropriate in light of the bank's asset size, level of complexity, risk profile, or scope of operations (see preamble sections II.A. and B.).

As noted above, **the final rule includes only the advanced approaches**.

The July 2007 interagency press release stated that the agencies have agreed to issue a proposed rule that would provide non-core banks with the option to adopt an approach consistent with the standardized approach included in the New Accord.

Basel II Concept Overview

Three Pillars:

The Three Pillars define "Minimum Capital Requirements" (addressing risk), "Supervisor Review", and "Market Discipline:.

1. **Pillar I** - Regulatory Capital, as calculated for three major components, including:

    a. Credit Risk, as calculated by one of three approaches, including:
        i. Standardized Approach for Internal Rating-Based Approach (IRB),
        ii. Foundation Approach IRB, and
        iii. Advanced Approach IRB

    b. Operational Risk consists of three components, which are:
        i. Basic Indicator Approach (BIA),
        ii. Standardized Approach (TSA), and
        iii. Internal Measurement Approach (an advanced form of which is the **Advanced Measurement Approach** or AMA).

    c. Market Risk is calculated by Value at Risk, or VaR

As the Basel 2 recommendations are phased in by the banking industry it will move from standardized 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 **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. Standardized Approach

2. Foundation IRB (Internal Ratings Based) Approach

3. Advanced IRB Approach

The standardized approach sets out specific Risk Weights for certain types of credit risk.

The standard risk weight categories used under **Basel 1** were 0% for government bonds, 20% for exposures to OECD Banks, 50% for first lien residential mortgages and 100% weighting on consumer and loans unsecured commercial loans.

Basel II introduced a new 150% weighting for borrowers with lower credit ratings. The minimum capital required remained at 8% of risk weighted assets, with Tier 1 capital making up not less than half of this amount.

Banks that decide to adopt the standardized ratings approach must rely on the ratings generated by external agencies. Certain banks used the IRB approach as a result.

2. The second pillar

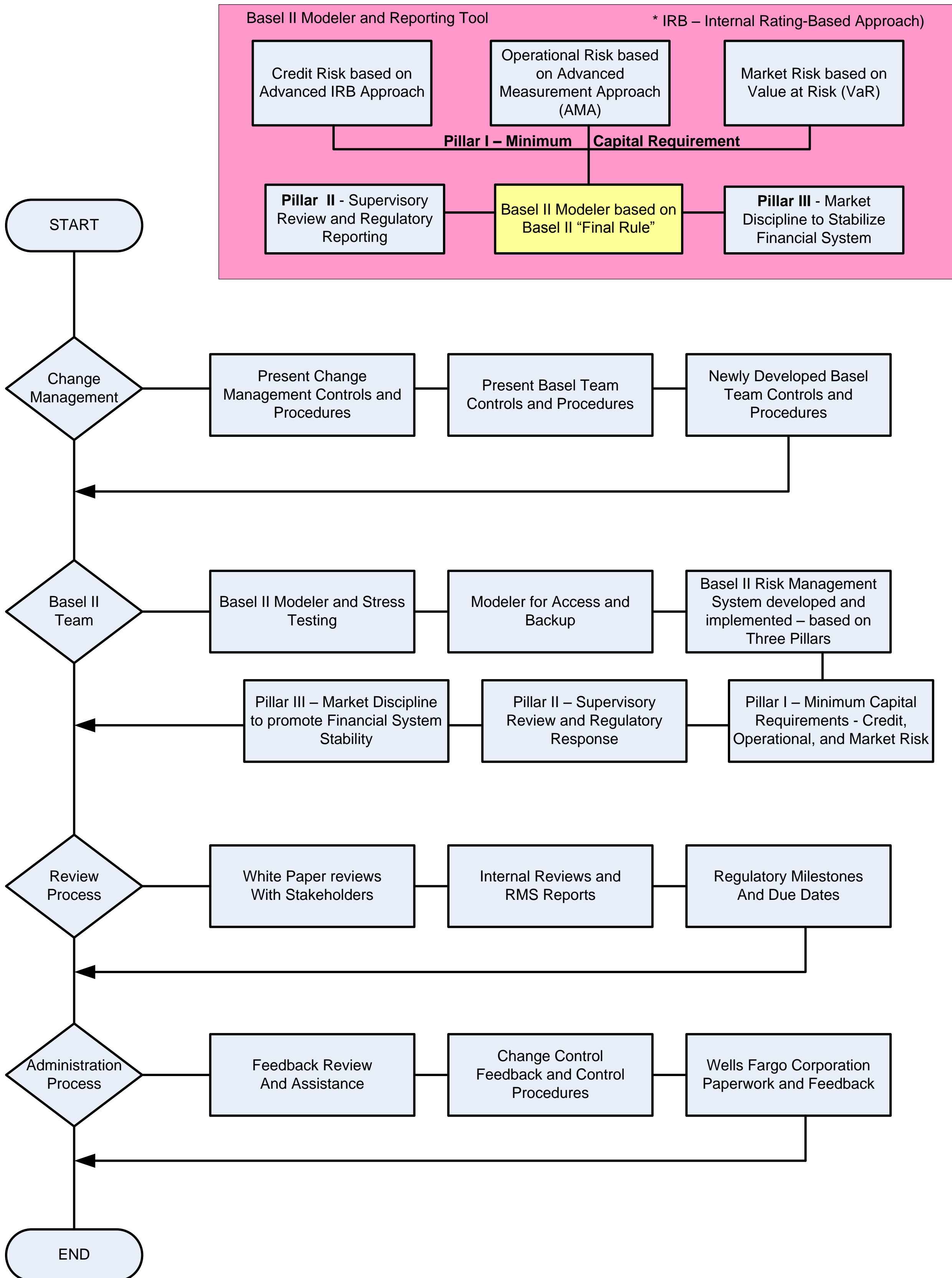
The second pillar deals with the regulatory response to the first pillar, giving regulators much improved 'tools' over those available to them under Basel I. It also provides a framework for dealing with all the other risks a bank may face, such as systemic risk, pension risk, concentration risk, strategic risk, reputational 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.

3. The third pillar

This pillar aims to promote greater stability in the financial system

Market discipline supplements regulation as sharing of information facilitates assessment of the bank by others including investors, analysts, customers, other banks and rating agencies. It leads to good corporate governance. The aim of pillar 3 is to allow market discipline to operate by requiring lenders to publicly provide details of their risk management activities, risk rating processes and risk distributions. It sets out the public disclosures that banks must make that lend greater insight into the adequacy of their capitalization. When marketplace participants have a sufficient understanding of a bank’s activities and the controls it has in place to manage its exposures, they are better able to distinguish between banking organizations so that they can reward those that manage their risks prudently and penalize those that do not.

Basel II Project Management Objectives



Basel II Modeler and Dashboard concept