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 I 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

Baseline II Overview

Basel II Modeler and Reporting Tool

Credit Risk based on Advanced IRB Approach
Operational Risk based on Advanced Measurement Approach (AMA)
Market Risk based on Value at Risk (VaR)

Pillar I – Minimum Capital Requirement

Pillar II - Supervisory Review and Regulatory Reporting
Basel II Modeler based on Basel II “Final Rule”

Pillar III - Market Discipline to Stabilize Financial System

START

Change Management

Present Change Management Controls and Procedures
Present Basel Team Controls and Procedures
Newly Developed Basel Team Controls and Procedures

Basel II Team

Basel II Modeler and Stress Testing
Modeler for Access and Backup
Basel II Risk Management System developed and implemented – based on Three Pillars

Pillar III – Market Discipline to promote Financial System Stability
Pillar II – Supervisory Review and Regulatory Response
Pillar I – Minimum Capital Requirements - Credit, Operational, and Market Risk

Review Process

White Paper reviews With Stakeholders
Internal Reviews and RMS Reports
Regulatory Milestones And Due Dates

Administration Process

Feedback Review And Assistance
Change Control Feedback and Control Procedures
Wells Fargo Corporation Paperwork and Feedback

END
Basel II Overview

Basel II Modeler and Dashboard concept

Basel II Modeler and Reporting Tool

- Credit Risk based on Advanced IRB Approach
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- Market Risk based on Value at Risk (VaR)

Pillar I – Minimum Capital Requirement

Pillar II - Supervisory Review and Regulatory Reporting

Basel II Modeler based on Basel II “Final Rule”

Pillar III - Market Discipline to Stabilize Financial System

Online Viewing, Maintenance, and Support to authorized personnel

Management Reports from Pillar I on Minimum Capital Requirements

Supervisor Review Reports from Pillar II

Market Discipline Reports from Pillar III

Basel II Dashboard

“Core Bank” Capital exposure

Domestic Balance ($250B)

Foreign Balance ($10B)

Credit Risk, as calculated by the Advanced Internal Rating-Based Approach

Operational Risk as calculated by the Advanced Measurement Approach (AMA)

Market Risk, as calculated by Value at Risk (VaR)

Regulatory Response to Pillar I, providing a framework for dealing with risks faced by banks, including: Systemic Risk, Pension Risk, Concentration Risk, Strategic Risk, Reputational Risk, Liquidity Risk, Legal Risk, and Residual Risk. It provides the framework for developing a Risk Management System.

Market Discipline requires banks to disclose their risk management activities, risk rating processes, and risk distributions. It provides the public disclosures that banks must make to lend greater insight into the adequacy of their capitalization.

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