Basel II

some consequences

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Regulatory commandments now set

- The Basel Committee on Banking Supervision has reviewed its capital framework for banking organisations and decided to maintain the current calibration
- The review was based on the results of the fifth Quantitative Impact Study (QIS 5), and also QIS 4 carried out in some jurisdictions.
- Outcome of the review will be the basis for national rulemaking processes (further implementation of Basel II)

Objectives of the New Basel Capital Accord

- **The Accord should continue to promote safety and soundness in the financial system and, as such, the new framework should at least maintain the current overall level of capital in the system***

- **The Accord should continue to enhance competitive equality (”level playing field”)**

*2nd consultative document, 2001

Objectives of the New Basel Capital Accord

- The Accord should constitute a more comprehensive approach to addressing risks
- The Accord should contain approaches to capital adequacy that are appropriately sensitive to the degree of risk involved in a bank´s positions and activities*
- The Accord should focus on internationally active banks, although its underlying principles should be suitable for application to banks of varying levels of complexity and sophistication

*2nd consultative document, 2001

The Revised Framework

Three pillar approach

Minimum capital requirement

Supervisory review process

Market discipline

Pillar 1

Risk is quantified by internal or external models and capital is explicitly assigned. Credit, market, and operational risk will fall into this category

Pillar 2

Each bank should assess its internal capital adequacy in light of its risk profile and Supervisors should review these internal assessments

Pillar 3

Capital adequacy is the subject of *market discipline*, with the trading of a bank´s debt and equity expected to reveal shifts in an institution´s risk profile. High disclosure standards are encouraged

Costs of implementation

- Forrester Research:

  European banks will spend approx 0.05%-0.10% of assets p.a. between 2002 - 2006

- Mercer Oliver Wyman:

  Banks will invest on average 0.05% (i.e. 0.01% p.a.) of loan assets over five years

Estimated costs of implementation across the EU

20-30 bn EUR between 2002 and 2006*

- IT systems
- Data collection costs
- Design or enhancement of rating systems
- Training and change management
- Regulatory reporting systems

*

Basel II is strengthening risk management across the industry

- Pressure to develop
  - Risk classification and risk quantification
  - Risk management – processes and organisation
- Creating a common ”risk language”
- Risk management is the quality control of finance
- Opportunity to catch up with best practice
  - Lower risk of crisis for individual banks
  - Prudent Risk Management practices first defense line
  - Promote financial stability

Impact on Capital Levels

- QIS 5 initiated in early 2005 by BCBS
- Evaluate the effects of the Basel II Framework on capital levels before the final calibration
- Banks split into two groups:
  - Group 1: large (Tier 1>EUR 3 billion), diversified and internationally active
  - Group 2: smaller, specialised
- Coverage in 31 countries
- Participation of 55 G10 Group 1 banks, 148 G10 Group 2 banks, and 155 banks from other countries.

Quantitative Impact Study 5 – Aggregated results

Percentage change in capital requirements relative to current Accord

	Standardised approach	FIRB approach	AIRB approach	Most likely approach
G10[1] Group 1	**1.7**	**-1.3**	**-7.1**	**-6.8**
G10 Group 2	**-1.3**	**-12.3**	**-26.7**	**-11.3**
CEBS[2] Group 1	**-0.9**	**-3.2**	**-8.3**	**-7.7**
CEBS Group 2	**-3.0**	**-16.6**	**-26.6**	**-15.4**
Other non-G10[3] Group 1	**1.8**	**-16.2**	**-29.0**	**-20.7**
Other non-G10 Group 2	**38.2**	**11.4**	**-1.0**	**19.5**

Sources: BCBS www.bis.org & CEBS www.c-ebs.org June 2006

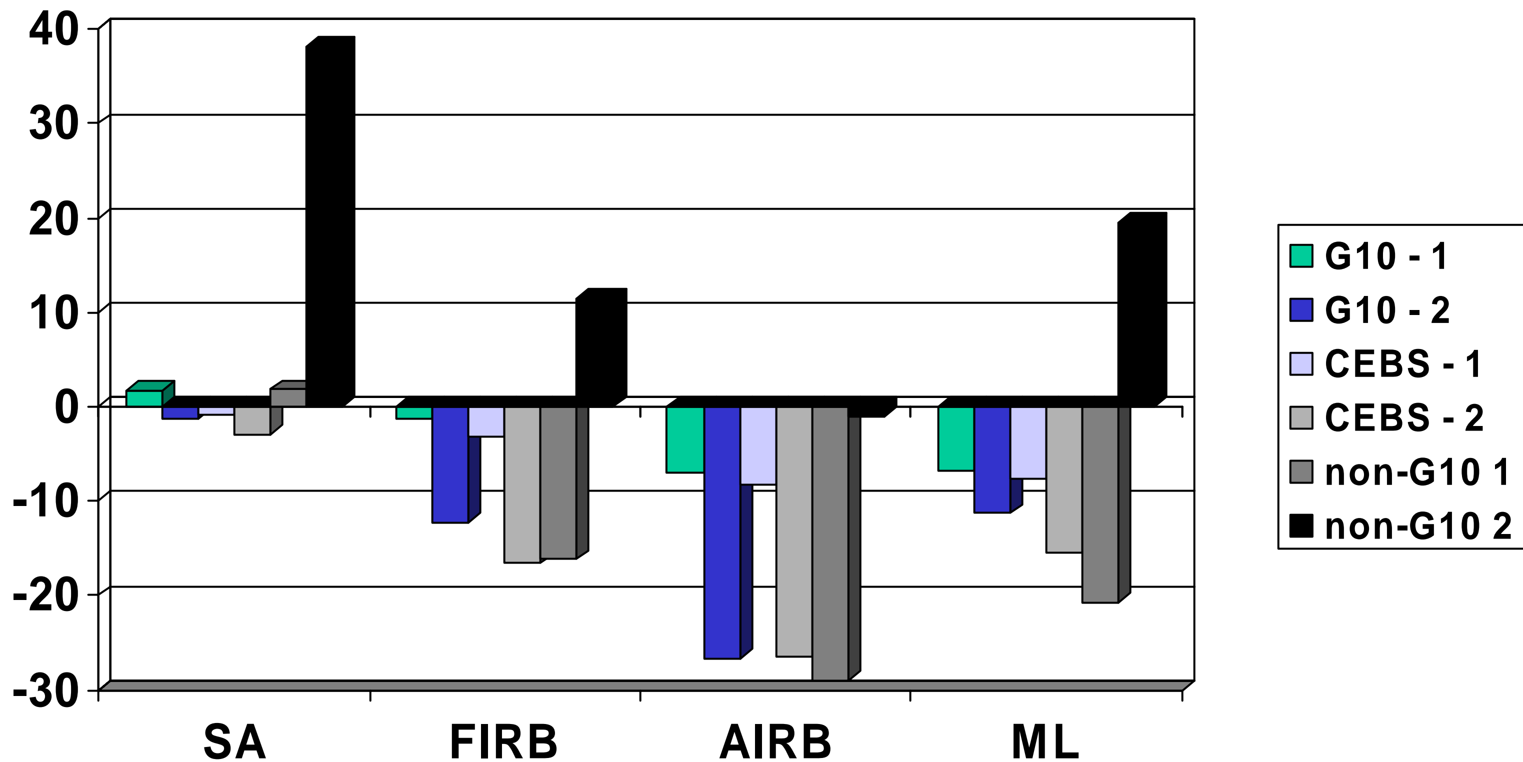
[1]Members of the Committee are Belgium, Canada, France,Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom, and the United States

[2]Non G10 members of this group are Bulgaria, Cyprus, the Czech Republic, Finland, Greece, Hungary, Ireland, Malta, Norway, Poland, and Portugal

[3]Other non-G10 countries are Australia, Bahrain, Brazil, Chile, India, Indonesia, Peru, and Singapore

Quantitative Impact Study 5 – Aggregated results

Percentage change in capital requirements relative to current Accord



Quantitative Impact Study 5 – Aggregated results

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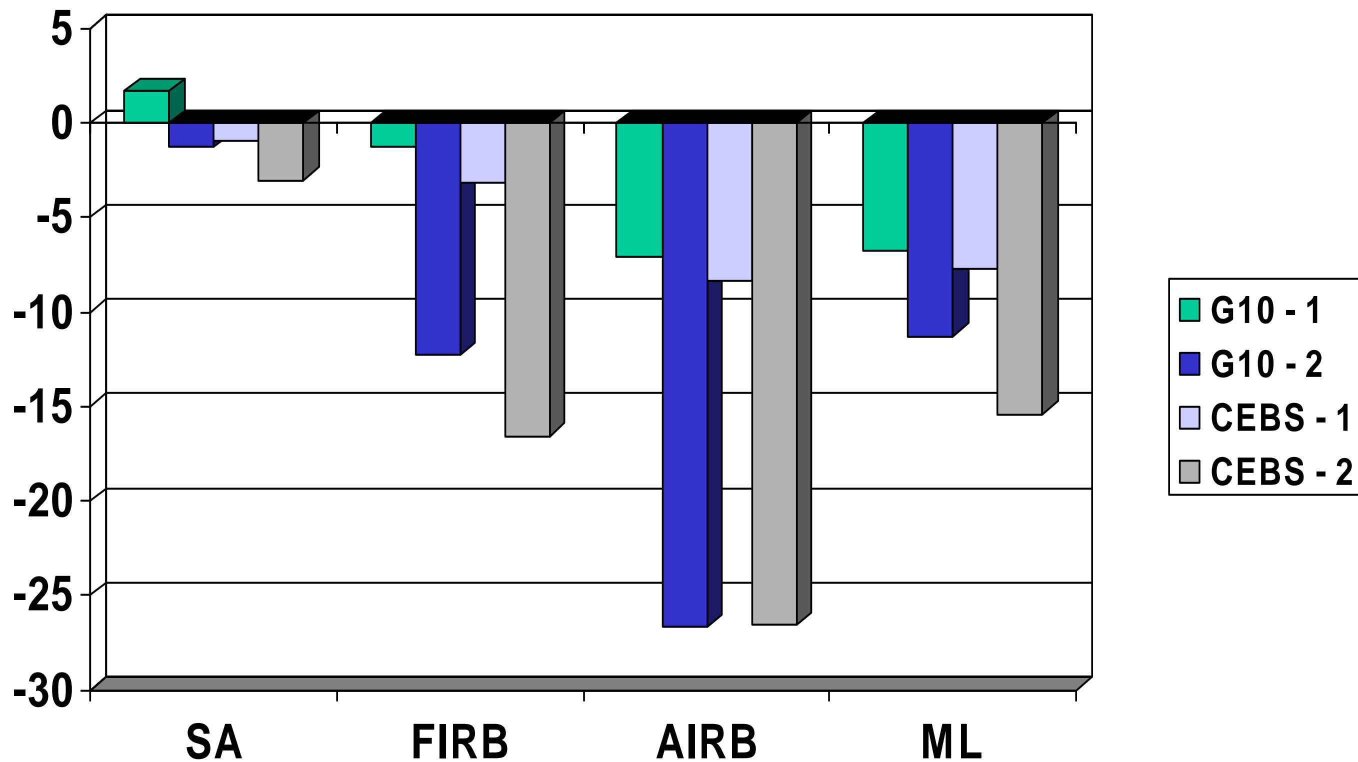
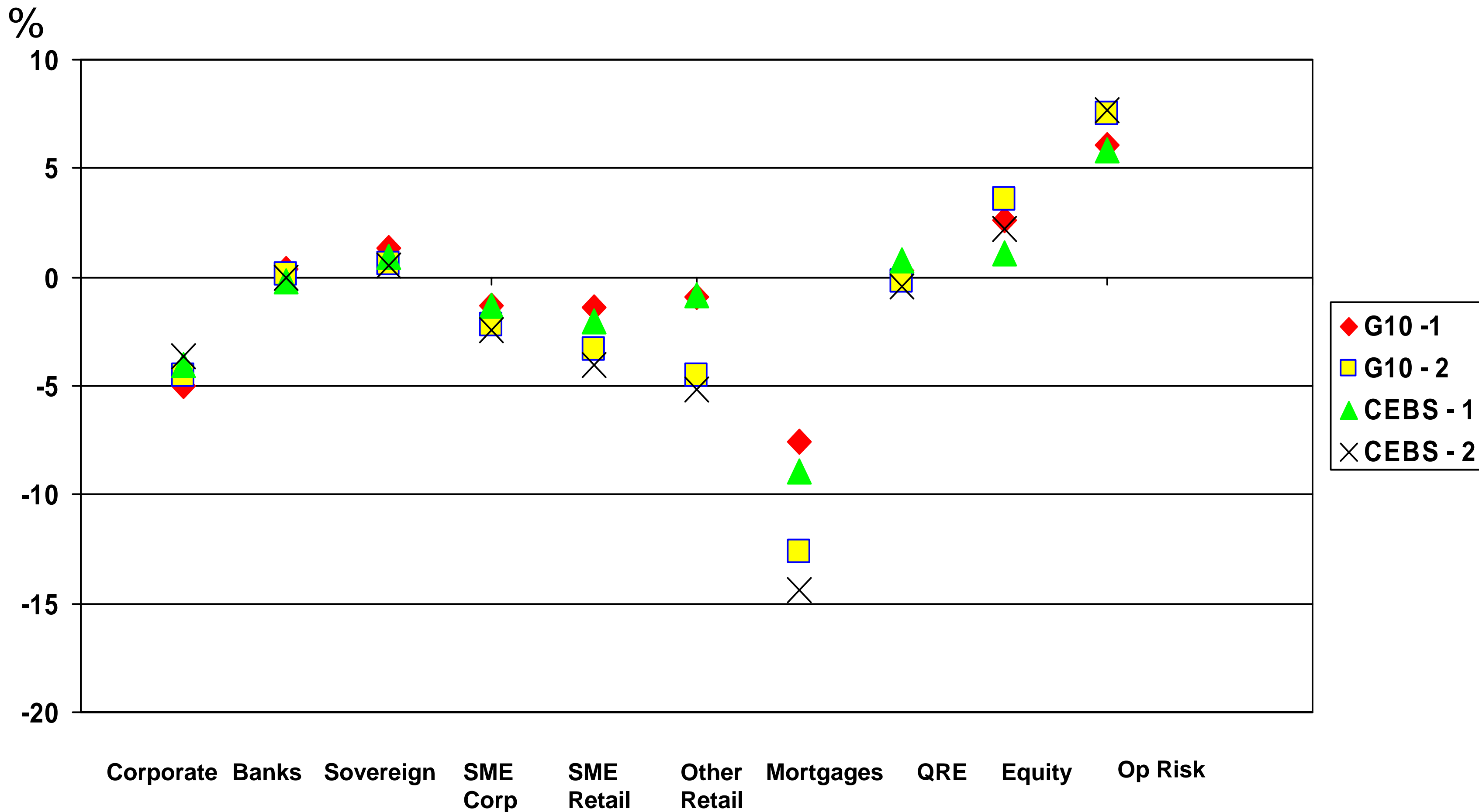


Results of the Quantitative Impact Study

Broadly in line with overall objectives with regard to calibration of Pillar 1:

- To leave the minimum required capital broadly unchanged relative to the Current Accord for Group 1 banks
- Make sure that the risk parameters and the incentive structure of Basel II are set appropriately

Contributions to change in MRC
- Most Likely IRB approach core portfolios



Remarks on QIS 5

- QIS 5 delivered quantitative information (a snapshot) on Basel II capital requirements of banks around the world based on the current proposals and on the economic environment in Sept/June 2005
- QIS 5 conducted on a best-efforts basis
  - Various stages of implementation
  - Flexibility within the framework
- Benign overall economic conditions

Dynamic effects of the New Framework

Boom

↑

Business cycle

↓

Recession

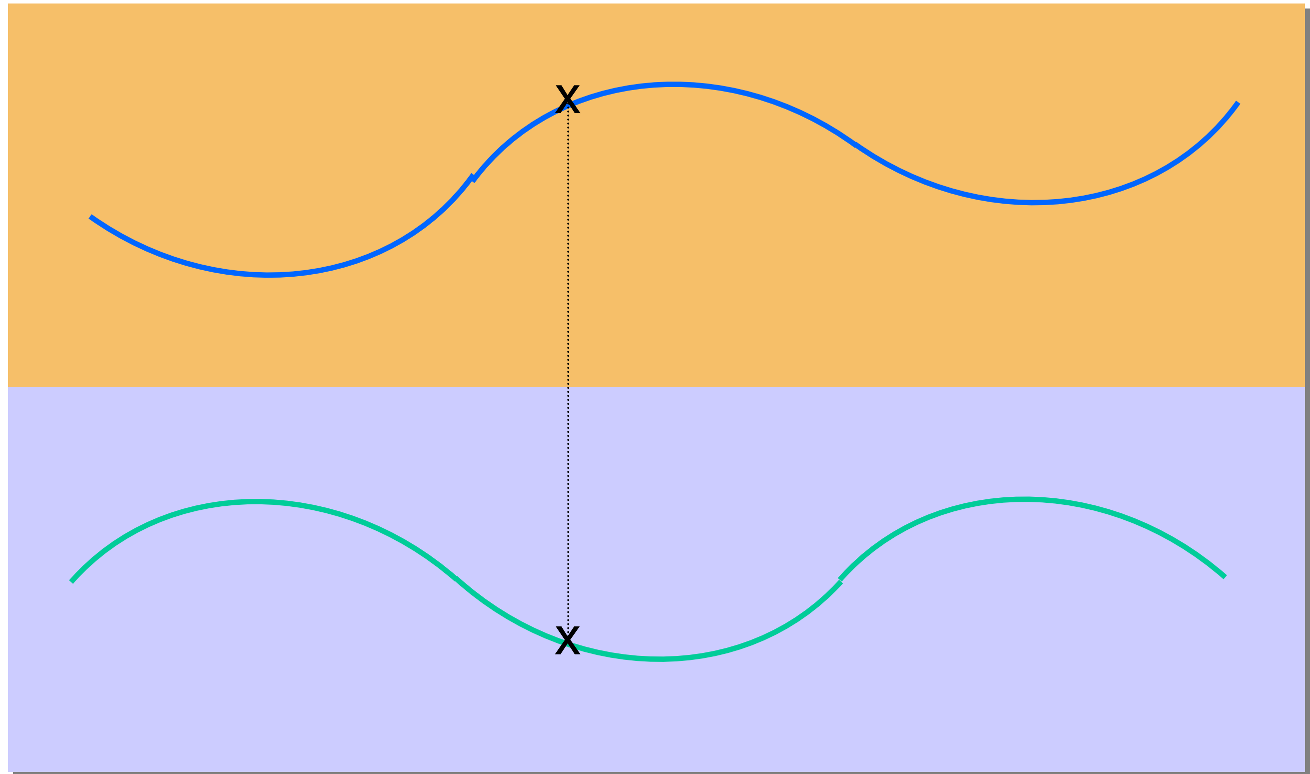
Recession

↑

PD-values

↓

Boom



No re-calibration of Pillar I

- Benign economic conditions result in decrease in capital requirements
- Economic downturn will push MRC upwards (mean reversion)
- Sound risk management first line of defense
- And then there is Pillar 2………

- **Objectives of Pillar 2 are to**:
  - Ensure institutions have adequate capital to support all risks in their business
  - Encourage institutions to manage risk
  - Foster an active dialogue between institutions and supervisors
- **Covers the relationship between:**
  - *Supervisor's SREP* (the Supervisory Review and Evaluation Process); and
  - *Institution' ICAAP* (the Internal Capital Adequacy Assessment Process).

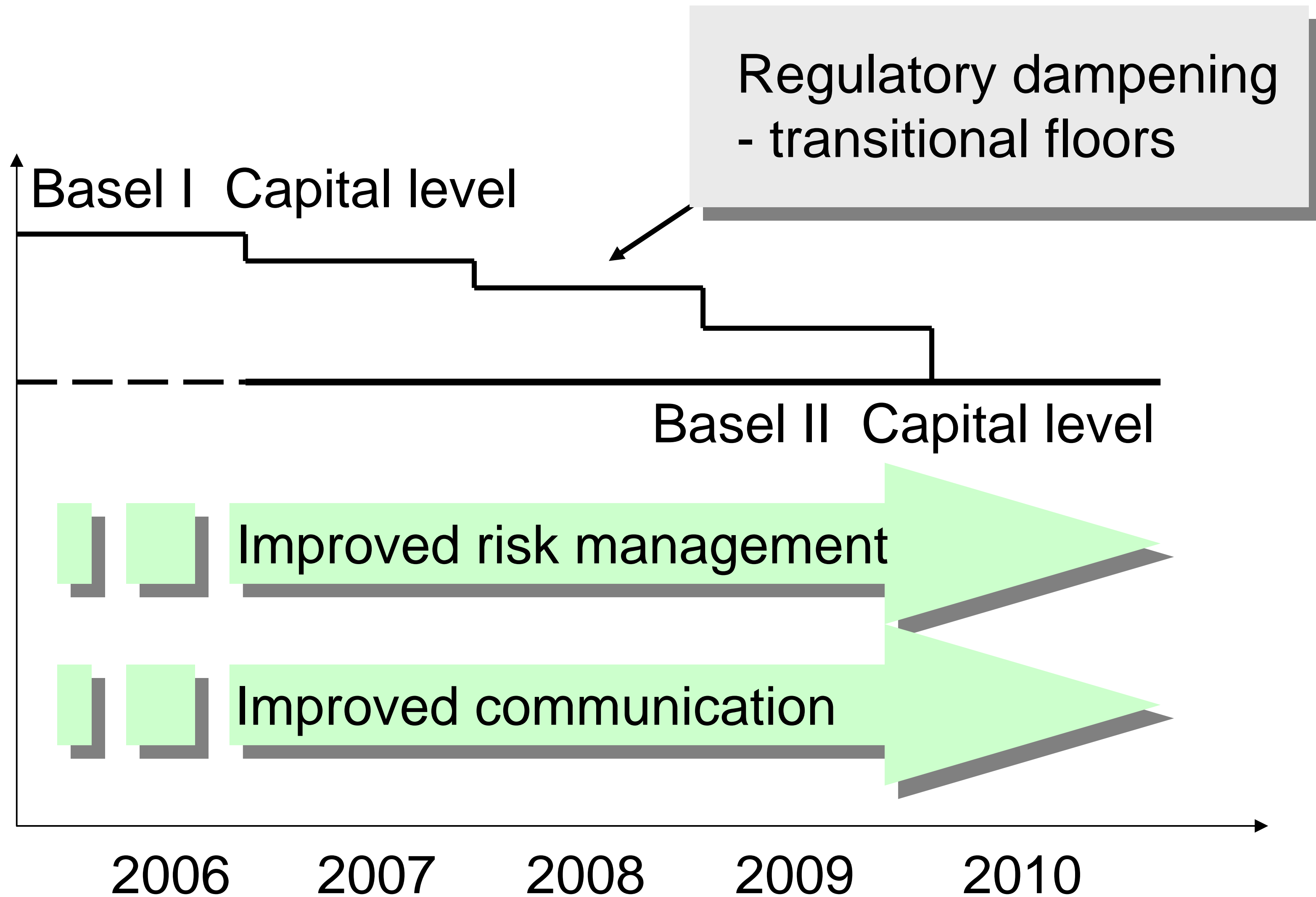
The Supervisory Review Process
- The four key principles of Pillar 2

Principle 1: ICAAP	**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**	**•Board and senior management oversight** **•Sound capital assessment** **•Comprehensive assessment of risks** **•Monitoring and reporting** **•Internal control review**
Principle 2: SREP	**Supervisors should review and evaluate banks´ internal capital adequacy assessments**	***•On-site examinations*** ***•Off-site review*** ***•Discussions with bank management*** ***•Review of work done by external auditors*** ***•Periodic reporting***
Principle 3: SREP	**Supervisors should expect banks to operate above regulatory minimum capital**	***•Capital above 8%***
Principle 4: SREP	**Supervisors should intervene and take action**	***•Intensified monitoring of the bank*** ***•Requiring system and process improvements*** ***•Requiring the bank to change risk profile*** ***•Restricting the payment of dividends*** ***•Requiring the bank to raise additional capital***

No re-calibration of Pillar 1

- Benign economic conditions result in decrease in capital requirements
- Economic downturn will push MRC upwards (mean reversion)
- Additional capital cushion required in Pillar 2 (ICAAP and Stress testing)
- Transitional floors

Time profile



No re-calibration of Pillar 1

- Benign economic conditions result in decrease in capital requirements
- Economic downturn will push MRC upwards because of increased risk sensitivity in the New Framework
- Additional capital cushion required in Pillar 2 (ICAAP and Stress testing)
- Transitional floors 2007-2009
- Rating agencies (Pillar 3)

Re-calibration of Pillar 1

If decrease in capital requirements is sustained will BCBS ‘recalibrate’ new framework?

Options

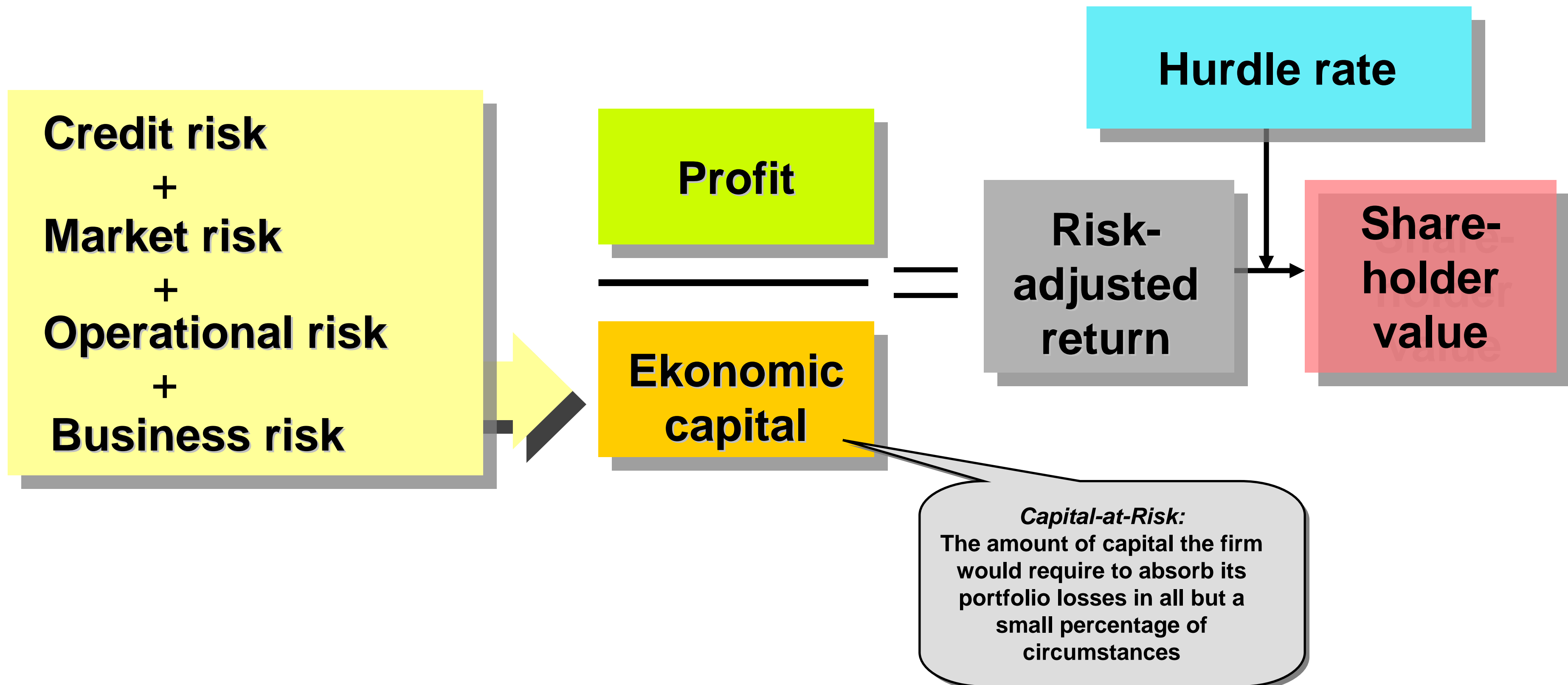
- Increase the confidence level
- Modify curves by changing correlations
- Portfolio-specific multiplier
- Overall multiplier
- Extension of transitional floors

Pillar 2 - the Supervisory approach (work in progress)

- Supervisory guidance will be kept to a minimum
  - ICAAP is used by institution for its own purposes
  - ICAAP should be a core management tool
- Supervisory assessment will include determining required buffer above Pillar 1 minimum
  - ICAAP will be a key input
- Economic capital is not required but expected

A Risk Based Control Model

Return on risk based capital should be the basis for evaluation of performance of a bank and its business units, internal capital allocation and pricing of transactions



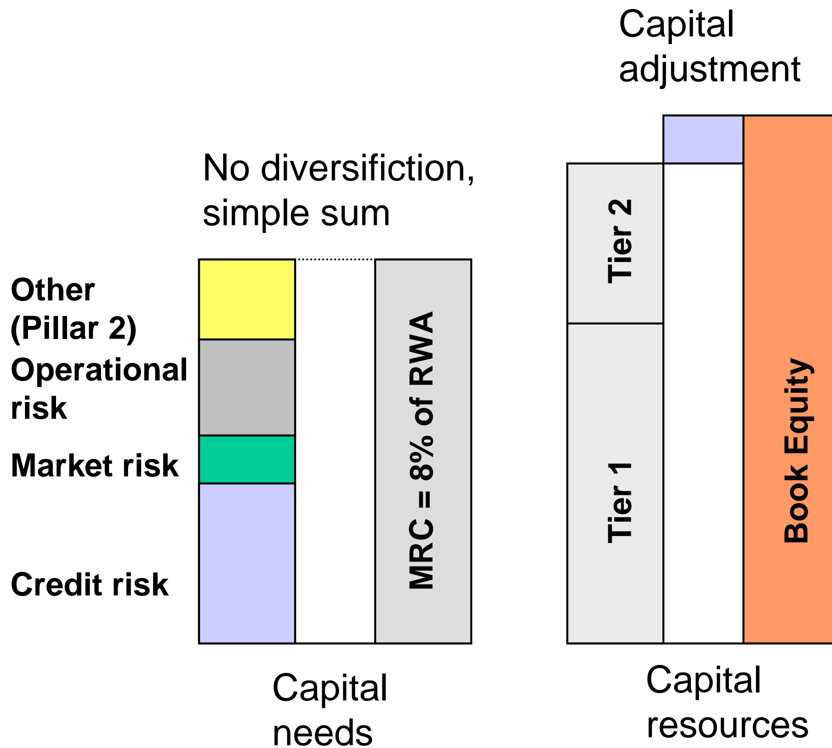
Regulatory capital more in line with economic capital

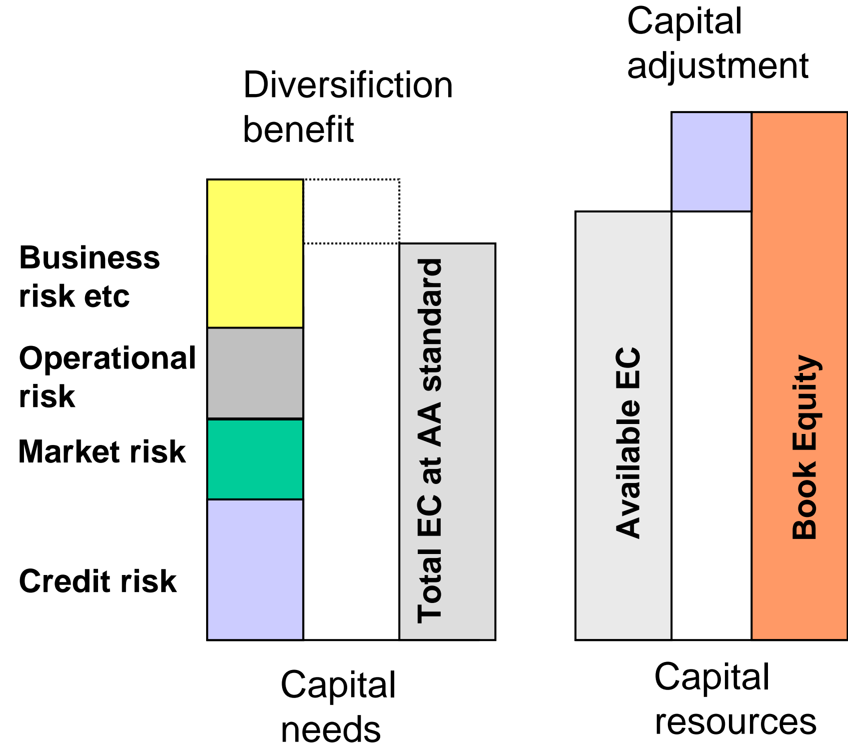
- Recognizes the advances in risk measurement technology and internal economic capital frameworks
- Operational Risk: the new kid on the block
- No capital charge for interest rate risk in the banking book

Economic and regulatory capital have distinct purposes

- *Regulatory Capital* is intended to set a minimum solvency standard to protect depositors and help maintain the stability of the banking system
  - Transparent
  - Easily measurable for a subset of all risks
- *Economic Capital* is a tool for bank management
  - Range of risks and complexity of approach based on business needs
  - Solvency standard based on target debt rating

Solvency Analysis





- **Two key constraints: Total capital, and Tier 1 Ratio**
- **Total Capital: (T1+T2) > MRC**
    - **Strict regulatory requirement**
- **Tier 1 Ratio: (T1/RWA) > T1 Target Ratio**

Source: CSFB

To add value whilst meeting regulatory challenges

- It is important to focus on what you need to run your business
- Any regulatory structure which you impose separately to your risk management structure will prove inefficient
- Improve staff awareness
- Implement software solutions to provide further assistance
- THOSE WHO DELAY TOO LONG MAY NEVER CATCH UP!

Summary

- Not just number crunching – qualitative issues matters
- Continuing dialogue essential
- Implementation is challenging – for institutions and supervisors

THE END