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Chapter 2 Overview of Basel II

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Chapter – 2 Overview of Basel II

Introduction

Basel committee came into existence in 1970 by the efforts of Bank of International Settlement (BIS) which was established in 1930 in Basel, Switzerland. The Basel Committee was established as the Committee on Banking Regulations and Supervisory Practices. The central-bank Governors of the Group of Ten countries were behind the formation of this committee. This chapter briefs about Basel Committee, Basel I Accord and Basel II.

Learning Objective

After reading this chapter you will:

- Get an overview of Basel Committee and history behind its formation.
- Get insights of Basel I and Basel II Accord in brief.

2.1 Basel Committee & BIS

The Bank for International Settlements (BIS) is an international organization which fosters international monetary and financial cooperation and serves as a bank for central banks.
The BIS fulfills this mandate by acting as:

- A forum to promote discussion and policy analysis among central banks and within the international financial community
- A centre for economic and monetary research
- A prime counterparty for central banks in their financial transactions
- Agent or trustee in connection with international financial operations

The head office is in Basel, Switzerland and there are two representative offices: in the Hong Kong Special Administrative Region of the People's Republic of China and in Mexico City. Established on 17 May 1930, the BIS are the world's oldest international financial organization.

As its customers are central banks and international organizations, the BIS do not accept deposits from, or provide financial services to, private individuals or corporate entities. The BIS strongly advises caution against fraudulent schemes.

Basel Committee on Banking Supervision is created by group of Central bank Governors of ten countries. The Committee usually meets at Bank for International Settlements (BIS) in Basel Switzerland where its 12 member permanent Secretariat is located. The Committee is often referred to as BIS committee after its meeting location.

However Bank for International Settlements and Basel Committee on Banking Supervision remains two distinct entities.

<u>Overview of Basel Committee on Banking Supervision</u>

Basel committee came into existence in 1970 by the efforts of Bank of International Settlement (BIS) which was established in 1930 in Basel, Switzerland. The Basel Committee was established as the Committee on Banking Regulations and Supervisory Practices. The central-bank Governors of the Group of Ten countries were behind the formation of this committee. The Basel Committee on Banking Supervision (BCBS) sets the guide-lines for worldwide regulation of banks.

The Basel Committee on Banking Supervision provides a forum for regular cooperation on banking supervisory matters. Its objective is to enhance understanding of key supervisory issues and improve the quality of banking supervision worldwide. The main role of the Committee in promoting sound supervisory standards worldwide has intensified.

The Committee uses this common understanding to develop guidelines and supervisory standards in areas where they are considered desirable. In this regard, the Committee is best known for its international standards on capital adequacy; the Core Principles for Effective Banking Supervision; and the agreement on cross-border banking supervision.

The Committee's members come from Australia, Belgium, Brazil, Canada, China, France, Germany, India, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, Russia, Spain, Sweden, Switzerland, the United Kingdom and the United States. The present Chairman of the Committee is Mr Nout Wellink, President of the Netherlands Bank.

The Committee encourages contacts and cooperation among its members and other banking supervisory authorities. It circulates to supervisors throughout the world both published and unpublished papers providing guidance on banking supervisory matters. Contacts have been further strengthened by an International Conference of Banking Supervisors (ICBS) which takes place every two years.

The Committee's Secretariat is located at the Bank for International Settlements in Basel, Switzerland, and is staffed mainly by professional supervisors on temporary secondment from member institutions. In addition to undertaking the secretarial work for the Committee and its many expert sub-committees, it stands ready to give advice to supervisory authorities in all countries. Mr. Stefan Walter is the Secretary General of the Basel Committee.

The Committee issued in July 2009 a package of documents to strengthen the Basel II Capital framework. The Committee has also undertaken work on a number of technical banking and accounting issues in conjunction with outside bodies. The Basel Committee maintains close relations with a number of fellow bank supervisory groupings. Committee has always worked to raise the level of supervisors' consciousness of their mutual interdependence where the international activities of banks within their jurisdictions are concerned.

Basel I

In 1988 central bankers from around the world (the Basel Committee (BCBS) in Basel, Switzerland) published a set of minimal capital requirements for banks called as Basel I. This is also known as the 1988 Basel Accord, and was enforced by law in the Group of Ten (G-10) countries in 1992, with Japanese banks permitted an extended transition period. However, Basel I is now widely viewed as outdated, as a more comprehensive set of guidelines, known as Basel II are in the process of implementation by several countries. It became effective at the end of 1992.

This incident prompted the G-10 nations to form towards the end of 1974, the Basel Committee on Banking Supervision, under the auspices of the Bank of International Settlements (BIS) located in Basel, Switzerland.

- The objective of Basel I was to prevent international banks from building business volume without adequate capital backing.
- Basel I, that is, the 1988 Basel Accord, primarily focused on credit risk.
- The focus was on the credit risk and appropriate risk weighting of assets.
- Set minimum capital standards for banks
- Capital was set at 8% and was adjusted by a loan's credit risk weight
- Assets of banks are divided into five categories according to credit risk , carrying risk weights of 0% (for example cash, bullion, home country debt like Treasuries), 20% (securitizations such as MBS rated AAA) 50%, 100% (for example, most corporate debt), and some assets given No Rating
- Core Capital (Tier I Capital) and Supplementary Capital (Tier II Capital).

Since 1988, this framework has been progressively introduced in member countries of G-10, currently comprising 13 countries, namely, Belgium, Canada, France, Germany, Italy, Japan, Luxemburg, Netherlands, Spain, Sweden, Switzerland, United Kingdom and the United States of America.

Most other countries, currently numbering over 100, have also adopted, at least in name, the principles prescribed under Basel I. However the efficiency with which they are enforced varies even within nations of the Group of Ten.

2.2 Basel II

After consultations with supervisory bodies worldwide, the framework developed by Basel Committee for addressing the relevant issues of banking in present context was released as 'International Convergence of Capital Measurement and Capital Standards : A Revised Framework' and was released in June 2004. Some fundamental changes and modifications have been incorporated in Basel II capital accord to eliminate the shortcomings of Basel I accord. Basel II is revised capital accord of Basel I.

Basel II accord is more risk sensitive and takes into account those factors which are very important but were left unattended in Basel I. The best example of such an overcoming is the incorporation of operational risk for the calculation of capital requirement. Basel II defines the minimum capital which is to be allocated by each bank based on its risk profile of assets.

The Basel II Accord necessitates fundamental changes in how banks classify and manage their risks. This has had repercussions in terms of minimum capital requirements, new supervisory guidelines and disclosure norms. At the core of Basel II are its three pillars, the components of the three pillars are as follows

- **First Pillar - Minimum capital requirements**
    - Capital for Credit Risk
    - Standardized approach
    - Internal rating based (IRB) approaches
    - Foundation approach;
    - Advanced approach;
    - Capital for Market Risk
    - Standardized method

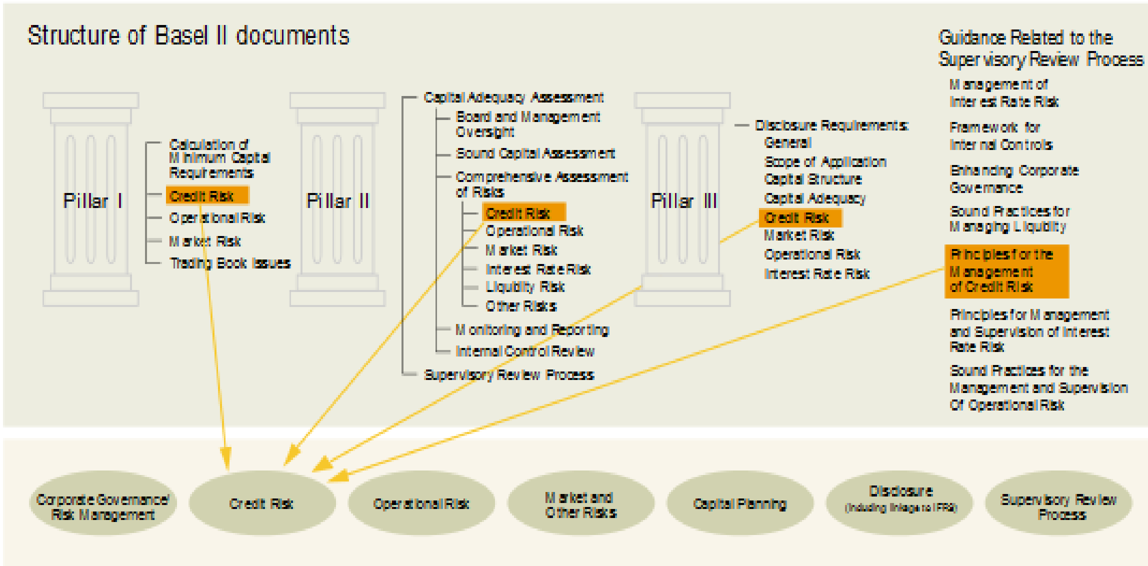
- Maturity method;
- Duration method;
- Internal models method
- Capital for Operational Risk
- Basic Indicator Approach (BIA)
- Standardized Approach
- Advanced Measurement Approach

- **Second Pillar - Supervisory review process**
  - Evaluate risk assessment
  - Ensure soundness and integrity of banks' internal processes to asses the adequacy of capital
  - Ensure maintenance of minimum capital
  - Prescribe differential capital, where necessary i.e. where the internal processes are slack.

- **Third Pillar - Market discipline requirement**
  - Enhance disclosures
  - Core disclosures and supplementary disclosures
  - Timely at least semi-annual disclosures

Thus, the Basel II accord does not merely prescribe minimum capital requirement but also envisages processes of supervisory review and market discipline. The revised framework is more risk sensitive than the 1988 accord. These are incentives for banks which have better risk management capabilities.

Basel II: Looking Beyond the Pillars



In Basel II, three types of Basic Risk are addressed –

- Credit Risk: Default by the borrower to repay the borrowings.
- Market Risk: Volatility in the bank's portfolio due to change in market factors.
- Operational Risk: Rising arising out of banks inefficient internal process, systems, people or external events.

Implementation of Basel II

Major Banks and financial institutions all over the world have already started incorporating Basel II as part of their systems. There will be further regulations of banks, insurance and investment agencies resulting in the implementation of this framework.

The new accord will significantly affect a wide range of organizations and different spheres of financial activities. It will impact the different kinds of operations conducted by the organizations including:

- **Rating Agencies** - All rating agencies will be required to incorporate the new accord in their operational systems to evaluate banks globally. Incorporation of Basel II will result in the establishment of a more competitive and safer banking system.

- **Financial Industry** - Many financial institutions that provide services such as credit cards and equities will also be impacted by the incorporation of Basel II in their workings.

- **Insurance Sector**- Basel II will also have a major impact on the insurance sector, as it will allocate and account for risk capital and enterprise-wide risk management.

The transparency achieved by Basel II for risk management and capital reserves will fundamentally change the reinsurance business. It will also affect the securitization of risk.

2.3 The First pillar- Minimum capital requirement

The first pillar would replace the existing 'one-size-fits-all' framework for the assessment of capital with several options for the banks. Pillar I is trying to achieve if banks own internal calculations show that they have extremely risky , loss-prone loans that generate high internal capital charges , their formal risk-based capital charges should also be high.

Basel II has specified the minimum capital requirement called capital adequacy for the banks and other similar financial institutions. It presents the calculation of the total minimum capital requirements for credit, market and operational risk. The capital ratio is calculated using the definition of regulatory capital and risk-weighted assets. The total capital ratio must be no lower than 8%. Tier 2 capital is limited to 100% of Tier 1 capital.

Banks have three types of capital as defined below:

i. **Core Capital (Basic Equity or Tier 1**)- paid up capital, statutory reserves, capital reserve, other disclosed free reserve

ii. **Supplementary Capital (Tier 2)-** undisclosed reserves, cumulative perpetual preference shares, revaluation reserve, general provision and loss, Hybrid Debt Capital Instruments (These combine characteristics of both equity and debt), Subordinated Debts

iii. **Short term subordinated debt (Tier 3)** - short-term subordinated debt covering market risk, non-perpetual preferred stock.

The formula for calculating minimal capital requirement is:

MCR = Capital / (credit risk+ market risk+ operational risk)

The result of this computation must be greater than or equal to 8%. The formula has three components:

- Credit Risk
- Market Risk
- Operations Risk

The details about theses risks are covered in the subsequent chapters.

- Minimum Capital Allocation for credit risk –

To allocate the capital for any of the above risk, it should be quantitatively measured. Currently banks follow two methods to measure credit risk and allocate the capital for credit risk

i. **Standardized Approach**: External credit rating agencies like CARE, Icra will assign the ratings for the assets of the banks and then capital is allocated for each of the assets. Credit rating and capital allocation is inversely proportional.

ii. **Internal Rating (IR) Approach**: This method has been further classified to

- Foundation IR approach
- Advanced IR approach

In both methods, capital is allocated based on the following 3 factors:

- Exposure at default (EAD) –amount of facility that is likely to be drawn in default.
- Loss given at default (LGD) – Measures the proportion of lost exposure in default.
- Probability of default (PD) - chances of default in terms of percentage (Default – fails to repay borrowings.

Credit Risk Approaches based on different criteria's

Figure 8: Credit Risk Approaches

Criteria	Standardized Approach	Internal Ratings Based (IRB) Approach	
		Foundation Approach	Advanced Approach
Rating	External	Internal	Internal
Risk Weight	Calibrated on the basis of external ratings by the Basel Committee	Function provided by the Basel Committee	Function provided by the Basel Committee
Probability of Default (PD): the likelihood that a borrower will default over a given time period	Implicitly provided by the Basel Committee; tied to risk weights based on external ratings	Provided by bank based on own estimates	Provided by bank based on own estimates
Exposure of Default (EAD): for loans, the amount of the facility that is likely to be drawn if a default occurs	Supervisory values set by the Basel Committee	Supervisory values set by the Basel Committee	Provided by bank based on own estimates
Loss Given Default (LGD): the proportion of the exposure that will be lost if a default occurs	Implicitly provided by the Basel Committee; tied to risk weights based on external ratings	Supervisory values set by the Basel Committee	Provided by bank based on own estimates; extensive process and internal control requirements
Maturity: the remaining economic maturity of the exposure	Implicit recognition	Supervisory values set by the Basel Committee or At national discretion, provided by bank based on own estimates (with an allowance to exclude certain exposures)	Provided by bank based on own estimates (with an allowance to exclude certain exposures)
Data Requirements	Provision dates Default events Exposure data Customer segmentation Data collateral segmentation External ratings Collateral data	Rating data Default events Historical data to estimate PDs (5 years) Collateral data	Same as IRB Foundation, plus: Historical loss data to estimate LGD (7 years) Historical exposure data to estimate EAD (7 years)
Credit Risk Mitigation Techniques (CRMT)	Defined by the supervisory regulator; including financial collateral, guarantees, credit derivatives, "netting" (on and off balance sheet), and real estate	All collaterals from Standardized Approach; receivables from goods and services; other physical securities if certain criteria are met	All types of collaterals if bank can prove a CRMT by internal estimation

Source: KPMG

Minimum Capital Allocation for Market risk

Value at risk (Var) is used to measure the market risk .Var summarizes the likely loss in value of a portfolio over a given time period with specified probability. Historical simulation, Model building approach, Monte Carlo simulation – are some of the Var techniques.

Minimum Capital Allocation for Operational risk

Three methods are followed to measure and allocate the capital for operational risk.

i. **Basic Indicator approach:** Capital charge should be 15% of banks' average annual positive Gross income over the previous three years.

ii. **Standardized indicator approach**: In this approach banks activities are classified into 8-business line. Each business line is having an exposure indicator (broadly it is a Gross income) which is multiplied by the factor (β) will give the capital charge for operational risk.

iii. **Advanced Measurement Approach (AMA)**: Loss distribution approach is one of the advanced versions in this approach, in which the impact of significant operational events on the various business lines of banks and the frequency of occurrences of these events are captured in the form of normal distribution.

Figure 9: Operational Risk Approaches

Approach	Basic Indicator Approach	Standardized Approach*	Advanced Measurement Approach (AMA)
Calculation of Capital Charge	Average of gross income over three years as indicator Capital charge equals 15% of that indicator	Gross income per regulatory business line as indicator Depending on business line, 12%, 15%, or 18% of that indicator as capital charge Total capital charge equals sum of charge per business line	Capital charge equals internally generated measure based on: - Internal loss data - External loss data - Scenario analysis - Business environment and internal control factors Recognition of risk mitigation (up to 20% possible)
Qualifying Criteria	No specific criteria Compliance with the Basel Committee's "Sound Practices for the Management and Supervision of Operational Risk" recommended	Active involvement of board of directors and senior management Existence of OpRisk management function Sound OpRisk management system Systematic tracking of loss data	Same as Standardized, plus: Measurement integrated in day-to-day risk management Review of management and measurement processes by internal/external audit Numerous quantitative standards—in particular, 3–5 years of historic data

Source: KPMG

Trading Book Issues

A trading book consists of positions in financial instruments and commodities held either with trading intent or in order to hedge other elements of the trading book. To be eligible for trading book capital treatment, financial instruments must either be free of any restrictive covenants on their tradability or able to be hedged completely. In addition, positions should be frequently and accurately valued, and the portfolio should be actively managed.

- Clearly documented trading strategy for the position/instrument, approved by senior management (which would include expected holding horizon).
- Clearly defined policies and procedures for the active management of the position.
- Clearly defined policy and procedures to monitor the position against the bank trading strategy including the monitoring of turnover and stale positions in the bank trading book.

2.4 The Second pillar- Supervisory Review Process

The supervisory review process of the Framework is intended not only to ensure that banks have adequate capital to support all the risks in their business, but also to encourage banks to develop and use better risk management techniques in monitoring and managing their risks.

The Committee recognizes the relationship that exists between the amounts of capital held by the bank against its risks and the strength and effectiveness of the bank's risk management and internal control processes. However, increased capital should not be viewed as the only option for addressing increased risks confronting the bank. Other means for addressing risk, such as strengthening risk management, applying internal limits, strengthening the level of provisions and reserves, and improving internal controls, must also be considered. Furthermore, capital should not be regarded as a substitute for addressing fundamentally inadequate control or risk management processes.

A further important aspect of Pillar 2 is the assessment of compliance with the minimum standards and disclosure requirements of the more advanced methods in Pillar 1, in particular the IRB framework for credit risk and the Advanced Measurement Approaches for operational risk. Supervisors must ensure that these requirements are being met, both as qualifying criteria and on a continuing basis.

Pillar II is based on series of four key principles of supervisory review. These principles address two central issues:

a. The need for banks to assess capital adequacy relative to risks overall.

b. The need for supervisors to review banks' assessments and consequently to determine whether to require banks to hold additional capital beyond that required under Pillar I.

The Committee has identified four key principles of supervisory review, which complement those outlined in the extensive supervisory guidance that has been developed by the Committee, the keystone of which is the Core Principles for Effective Banking Supervision and the Core Principles Methodology. A list of the specific guidance relating to the management of banking risks is provided at the end of this Part of the Framework.

Principle 1:

"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".

The five main features of a rigorous process are as follows:

- Board and senior management oversight;
- Sound capital assessment;
- Comprehensive assessment of risks;
- Monitoring and reporting; and
- Internal control review.

a) Board and senior management oversight

A sound risk management process is the foundation for an effective assessment of the adequacy of a bank's capital position. Bank management is responsible for understanding the nature and level of risk being taken by the bank and how this risk relates to adequate capital levels. It is also responsible for ensuring that the formality and sophistication of the risk management processes are appropriate in light of the risk profile and business plan. The bank's board of directors has responsibility for setting the bank's tolerance for risks.

b) Sound capital assessment

Fundamental elements of sound capital assessment include:

- Policies and procedures designed to ensure that the bank identifies, measures, and reports all material risks.
- A process that relates capital to the level of risk;
- A process that states capital adequacy goals with respect to risk, taking account of the bank's strategic focus and business plan; and
- A process of internal controls reviews and audits to ensure the integrity of the overall management process.

c) Comprehensive assessment of risks

All material risks faced by the bank should be addressed in the capital assessment process. While the Committee recognizes that not all risks can be measured precisely, a process should be developed to estimate risks. Therefore, the following risk exposures, which by no means constitute a comprehensive list of all risks, should be considered.

Credit risk: Banks should have methodologies that enable them to assess the credit risk involved in exposures to individual borrowers or counterparties as well as at the portfolio level

Market risk: This assessment is based largely on the bank's own measure of value-at-risk. Emphasis should also be on the institution performing stress testing in evaluating the adequacy of capital to support the trading function.

Interest rate risk in the banking book: The measurement process should include all material interest rate positions of the bank and consider all relevant repricing and maturity data. Such information will generally include: current balance and contractual rate of interest associated with the instruments and portfolios, principal payments.

Liquidity Risk: Liquidity is crucial to the ongoing viability of any banking organization. Banks capital positions can have an effect on their ability to obtain liquidity, especially in a crisis.

Other Risk: The Committee recognizes that within the other risk category, operational risk tends to be more measurable than risks such as strategic and reputational.

d) MONITORING AND REPORTING

The bank should establish an adequate system for monitoring and reporting risk exposures and how the bank's changing risk profile affects the need for capital. The bank's senior management or board of directors should, on a regular basis, receive reports on the bank's risk profile and capital needs. These reports should allow senior management to:

- Evaluate the level and trend of material risks and their effect on capital levels.
- Evaluate the sensitivity and reasonableness of key assumptions used in the capital.
- Assessment measurement system.
- Determine that the bank holds sufficient capital against the various risks and that
- They are in compliance with established capital adequacy goals and assess its future capital requirements based on the bank's reported risk profile.
- Make necessary adjustments to the bank's strategic plan accordingly.

e) INTERNAL CONTROL REVIEW

The bank's internal control structure is essential to the capital assessment process. Effective control of the capital assessment process includes an independent review and where appropriate, the involvement of internal or external audits. The bank's board of directors has a responsibility to ensure that management establishes a measurement system for assessing the various risks, develops a system to relate risk to the bank's capital level and establishes a method for monitoring compliance with internal policies.

The bank should conduct periodic reviews of its risk management process to ensure its integrity, accuracy, and reasonableness. Areas that should be reviewed include:

- The appropriateness of the bank's capital assessment process given the nature.
- Scope and complexity of its activities.
- The identification of large exposures and risk concentrations.
- The accuracy and completeness of data inputs into the bank's assessment process.

- The reasonableness and validity of scenarios used in the assessment process, and stress testing and analysis of assumptions and input.

Principle 2:

"Supervisors should review and evaluate banks' 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 supervisory action if they are not satisfied with the result of this process".

The periodic review can involve some combination of:

- On-site examinations or inspections;
- Off-site review;
- Discussions with bank management;
- Review of work done by external auditors (provided it is adequately focused on the necessary capital issues); and
- Periodic reporting.

a) Review of adequacy of risk assessment

Supervisors should assess the degree to which internal targets and processes incorporate the full range of material risks faced by the bank. Supervisors should also review the adequacy of risk measures used in assessing internal capital adequacy and the extent to which these risk measures are also used operationally in setting limits, evaluating business line performance, and evaluating and controlling risks more generally.

b) Assessment of capital adequacy

Supervisors should review the bank's processes to determine that:

- Target levels of capital chosen are comprehensive and relevant to the current operating environment;

- These levels are properly monitored and reviewed by senior management; and
- The composition of capital is appropriate for the nature and scale of the bank's business.

c) Assessment of the control environment

Supervisors should consider the quality of the bank's management information reporting and systems, the manner in which business risks and activities are aggregated and management's record in responding to emerging or changing risks.

In all instances, the economic capital levels at individual banks should be determined according to the bank's risk profile and adequacy of its risk management process and internal controls. External factors such as business cycle effects and the macroeconomic environment should also be considered.

d) Supervisory review of compliance with minimum standards

In order for certain internal methodologies, credit risk mitigation techniques and asset securitizations to be recognized for regulatory capital purposes, banks will need to meet a number of requirements, including risk management standards and disclosure .In particular, banks will be required to disclose features of their internal methodologies used in calculating minimum capital requirements. As part of the supervisory review process, supervisors must ensure that these conditions are being met on an ongoing basis.

The Committee regards this review of minimum standards and qualifying criteria as an integral part of the supervisory review process under Principle 2. In setting the minimum criteria the Committee has considered current industry practice and so anticipates that these minimum standards will provide supervisors with a useful set of benchmarks which are aligned with bank management expectations for effective risk management and capital allocation.

e) Supervisory response

Having carried out the review process described above, supervisors should take appropriate action if they are not satisfied with the results of the bank's own risk assessment and capital allocation.

Principle 3:

"Supervisors should expect banks to operate above the minimum regulatory capital ratios and should have the ability to require banks to hold capital in excess of the minimum".

Pillar 1 capital requirements will include a buffer for uncertainties surrounding the Pillar 1 regime that affect the banking population as a whole. Bank-specific uncertainties will be treated under Pillar 2. It is anticipated that such buffers under Pillar 1 will be set to provide reasonable assurance that a bank with good internal systems and controls, a well-diversified risk profile and a business profile well covered by the Pillar 1 regime, and which operates with capital equal to Pillar 1 requirements, will meet the minimum goals for soundness embodied in Pillar 1.

There are several means available to supervisors for ensuring that individual banks are operating with adequate levels of capital. Among other methods, the supervisor may set trigger and target capital ratios or define categories above minimum ratios (e.g. well capitalized and adequately capitalized) for identifying the capitalization level of the bank.

Principle 4:

"Supervisors should seek to intervene at an early stage to prevent capital from falling below the minimum levels required to support the risk characteristics of a particular bank and should require rapid remedial action if capital is not maintained or restored".

Supervisors should consider a range of options if they become concerned that a bank is not meeting the requirements embodied in the supervisory principles outlined above.

These actions may include intensifying the monitoring of the bank, restricting the payment of dividends, requiring the bank to prepare and implement a satisfactory capital adequacy restoration plan, and requiring the bank to raise additional capital immediately. Supervisors should have the discretion to use the tools best suited to the circumstances of the bank and its operating environment.

2.5 Third pillar- Market Discipline

Basel II committee has sought to encourage market discipline by developing a set of disclosure requirements so that market participants can assess key information about a bank's risk profile and level of capitalization. The Committee emphasizes the potential for market discipline to reinforce capital regulation and other supervisory efforts in promoting safety and soundness in banks and financial systems. Meaningful disclosures by banks inform market participants, facilitating effective market discipline. Pillar 3 contains disclosure recommendations and requirements for banks. Other parts of the framework set disclosure requirements and recommendations for ECAIs and supervisors.

The purpose of pillar three is to complement the minimum capital requirements of pillar one and the supervisory review process addressed in pillar two.

By bringing greater market discipline to bear through enhanced disclosures, pillar three of the new capital framework can produce significant benefits in helping banks and supervisors to manage risk and improve stability.

Banks operating under Basel II should have formal disclosure policy duly approved by the board of directors. Following disclosures are required:

A. **General Considerations**: Generally, the Committee is introducing disclosure recommendations. In some instances, however, disclosure requirements are attached to the use of a particular methodology or instrument, and as such form pre-conditions for the use of that methodology or instrument for regulatory capital purposes.

   i. Core and Supplementary disclosure recommendations

   ii. Materiality

   iii. Frequency

   iv. Templates

B. **Disclosures - scope of application of the new accord:** It is important that banking group's disclosure of the scope of application of capital requirements be extensive and explicit. This should ensure that market participants can understand (i) which corporate entities are within a banking group, and hence that the risks within those entities, are captured, and (ii) the approach used to capture those entities.

   i. Core Disclosures

   ii. Supplementary Disclosures

C. **Disclosure–structure of Capital**: Disclosure about the nature, component and features of capital provides market participants with important information about bank's abilities to absorb financial losses.

i. Core Disclosures (Quantitative)

ii. Core Disclosures (Qualitative)

iii. Supplementary Disclosures

D. **Disclosures- Risk Exposure and Assessment:** The following sets out disclosure requirements and recommendations for four key banking risks: credit, market, operational and interest rate risk in the banking book. For each risk type, the disclosures that all banks should make regarding their exposures.

i. Credit risk Disclosure

ii. Market risk Disclosure

iii. Operation risk Disclosure

iv. Interest rate risk in the Banking book

E. **Disclosures: Capital Adequacy**

Requirement Specifications for Basel II

1) IT Systems in Place

Banks and Financial institutions will be required to track the information of various organizations with which they have business relationships. Using knowledge management and customer relationship management systems, they will have to track this information and help calibrate risks at various levels within those organizations.

BIS II Required Credit Risk Technology

As per Basel II recommendations for credit risk will need the following technology elements:

- Data aggregation tools;

- Database for ratings and all inputs;
- Analytical tool for selecting factors and effectiveness testing;
- Capital allocation tools; and
- Regulatory reporting and disclosure documentation.

2) Integration of multiple functions in an Organization

Banks and Financial institutions will be required to collaborate and integrate their various functions within the organization. This result in multi-channel service experience and improved distribution strategies.

3) Out-Sourcing of specific functional areas

Keeping the core competency in their field of work, financial services providers can outsource their specific functional areas to third parties.

4) Information Availability

Basel II demands high quality and easily accessible information, dependent upon such factors as the scale and complexity of the data. Since Basel II requires raw and enriched data from multiple systems, the scale and complexity of data becomes enormous.

5) Audit

For a successful audit of the risks associated with finance systems, credit risk systems are expected to support the overall credit risk framework across the organization. Data such as 'Probability of Default' and 'Loss of Default' are required under Basel II. Since operational risk is a new element in Basel II, the systems will have to design and develop their approaches to measure it in their organizations.

Summary

- Basel committee came into existence in 1970 by the efforts of Bank of International Settlement (BIS) which was established in 1930 in Basel, Switzerland. The Basel Committee was established as the Committee on Banking Regulations and Supervisory Practices.

- In 1988 central bankers from around the world (the Basel Committee (BCBS) in Basel, Switzerland) published a set of minimal capital requirements for banks called as Basel I. Banks with international presence are required to hold capital equal to 8 % of the risk-weighted assets.

- The new accord provides a number of approaches from simple to advanced methodologies for the measurement of both credit risk and operational risk in determining capital levels. This provides sufficient flexibility for the banks to choose an approach that would best fit their risk profile.

- After consultations with supervisory bodies worldwide, the framework developed by Basel Committee for addressing the relevant issues of banking in present context was released as 'International Convergence of Capital Measurement and Capital Standards : A Revised Framework' and was released in June 2004.

- Under Basel II, the "outputs" of better management of credit and operational risk will be the "inputs" of an economic capital model by which banks can allocate capital to various functions and transactions depending on risk.

- At the core of Basel II are its three pillars, the pillars are as follows:

- First Pillar - Minimum capital requirements

- Second Pillar - Supervisory review process

- Third Pillar - Market discipline requirement

References

This document is prepared from the material available at www.bis.org.

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