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Chapter 1 : The Fed - Basel Regulatory Framework

The New Basel Capital Accord (the New Accord) will be applied on a consolidated basis to internationally active banks. This is the best means to preserve the integrity of.

Many banks were not ready for the increasing international competition and reacted by an enlargement of their credit volumes and more aggressive credit pricing. Credit granting also increased outside the OECD countries where especially developing countries profited from new sources for debt rising. However, the debt situation worsened rapidly and reached a high with the Mexico crisis. Outside the USA similar measures had to be taken. In the Bank of England had to prevent over 20 institutions from defaulting. As a consequence the Basel Capital Accord[2] was issued forming an universal ground for the capital adequacy of credit risk. Since then minimum capital requirements became one of the primary instruments of the bank supervision even if high equity rations cannot prevent banks from failing. The standard had to be adopted by the central banks of the G10 countries into national law by the end of Even though there was no legal enforcement the adoption was morally binding. The Basel Capital Accord of was thought to guarantee the stability of the international banking system on a harmonized equity basis and to reduce the global systematic risk same risk, same rules. Despite all critics the Accord marked the beginning of the risk sensitive treatment of risk and differentiated between the major balance and off-balance sheet positions. The risk weighting was and is transaction based depending of the nature of the counterparty: Four risk weights risk buckets were defined. The first bucket consists of claims on OECD governments and has a zero weight. However, over time several important limitations of the current framework have become apparent, particularly that the regulatory measure of bank risk risk-weighted assets can differ substantially from actual bank risk. One example of such a difference stems from the growth in loan securitisation. By selling loans to a third party while retaining some exposure via credit enhancements, a bank can effectively remove loans from its portfolio and decrease its required capital without a commensurate reduction in its overall credit risk. A bank would generally prefer the riskier claims to generate greater returns on investment. They primarily complain about the one-size-fits-all approach to capital adequacy. It is argued that as an unintended consequence of this approach banks have been given an incentive to shift up their risk exposures without being required to hold an adequate amount of capital against these risks. In addition, a particular focus was given to the financial innovations that have developed since the introduction of the original Basel Accord. During the formal comment period on the proposal, which ended on March 31, , the Basel Committee received more than comments from industry members and supervisors around the world. The result is a comprehensive proposal that goes beyond simply setting rules for credit risk in the banking book. Comments on the proposal were due by May 31, , and the Committee expects to issue the definitive version of the new accord by year-end Implementation by participating supervisory jurisdictions is targeted for In addition, the Basel Committee will extend the new Basel Accord on a consolidated basis to holding companies of banking groups, with the avowed purpose of ensuring that the risks of the entire banking group are considered. Minimum Capital Requirement 1. Under the accord, uniform risk-weights are assigned according to the institution type and country of the borrower. This includes a distinction between corporates, sovereigns and banks. Under the new framework, the treatment of credit risk is more sophisticated. While the measurement of market risk remains unchanged the New Accord will require capital for operational risk. The Basel Committee expects that in the beginning a majority of banks will operate under the standardised approach while only the most sophisticated of international banks will qualify the internal ratings based approach IRB. Over time it is assumed that an increasing number of financial institutions will change to the IRB approach. In order to bring this process forward, the Committee has created explicit and implicit incentives in the more sophisticated approaches, especially a potential reduction of required capital. Indeed, following recent consultations, the Basel Committee has concluded that a greater number of major banks will be in a position to adopt the IRB approach when the Accord is implemented. Weights will still be depending upon the category of borrower sovereign, bank or corporate. However, to create the new standard approach more risk sensitive there are some major changes from the Accord: In this way, banks and corporates may be assigned a higher rating than their sovereign. Table 11 shows the weights for claims against sovereigns. As a major changes the distinction between OECD members and other countries is replaced by an external credit assessment of the sovereign. It was widely argued that the membership criterion is insufficient since the creditworthiness within the OECD is not homogenous. Basel Committee on Banking Supervision [d] 3. As far as risk weights for banks are concerned supervisors will have to choose between two options. In addition to the higher differentiated risk buckets, there is a special treatment for short-term debt. This distinction has created an incentive for financial institutions to prefer short-term debt. In opposite to the proposal, the Committee decided to lower the maturity bound to three months. However, negative incentives are not totally removed for banks with an external rating between A1 and B-. Table 12 shows the proposed weights for banks under the two options. Basel Committee on Banking Supervision [d] 6. In the corporate sector risk weights are applied in a similar way. Table 13 describes the weighting scheme for corporates and the private sector. Basel Committee on Banking Supervision [d] 7. However, this will have negative effects on low rated OECD countries. In addition, by the removal of the sovereign floor highly rated debtors in less highly rated countries will benefit. It is expected that the new Capital Accord will in sum create more risk sensitivity. One crucial aspect, however, could be the introduction of external credit assessment by private sector agencies. In this context external ratings are said to be inherently pro-cyclical. The ECAs need to be recognized by national supervisors and therefore fulfill certain criteria. Basel Committee on Banking Supervision [d] 4. Depending on its methods used to evaluate credit quality, banks may choose between two proposed IRB approaches. If a bank chooses the second approach, called advanced IRB, it needs to determine the input data. In addition, the required standards regarding assessment competency and process control are more strict. In both cases the following input figures are needed for risk assessment and capital determination:

Chapter 2 : The New Basel Capital Accord : The Devil Is in the (Calibration) Details

*The New Basel Capital Accord [Benton E. Gup] on calendrierdelascience.com *FREE* shipping on qualifying offers. Becoming operational in , the Basel Capital Accord initiative is an effort to bring order to international capital markets and level the playing field for banks.*

The final version aims at: Ensuring that capital allocation is more risk sensitive; Enhance disclosure requirements which would allow market participants to assess the capital adequacy of an institution; Ensuring that credit risk , operational risk and market risk are quantified based on data and formal techniques; Attempting to align economic and regulatory capital more closely to reduce the scope for regulatory arbitrage. While the final accord has at large addressed the regulatory arbitrage issue, there are still areas where regulatory capital requirements will diverge from the economic capital. The accord in operation: Three pillars[edit] Basel II uses a "three pillars" concept â€” 1 minimum capital requirements addressing risk , 2 supervisory review and 3 market discipline. The Basel I accord dealt with only parts of each of these pillars. Minimum capital requirements[edit] The first pillar deals with maintenance of regulatory capital calculated for three major components of risk that a bank faces: Other risks are not considered fully quantifiable at this stage. For operational risk , there are three different approaches â€” basic indicator approach or BIA, standardized approach or TSA, and the internal measurement approach an advanced form of which is the advanced measurement approach or AMA. For market risk the preferred approach is VaR value at risk. As the Basel II recommendations are phased in by the banking industry it will move from standardised 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 bespoke risk measurement systems is that they will be rewarded with potentially lower risk capital requirements. In the future there will be closer links between the concepts of economic and regulatory capital. It also provides a framework for dealing with 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. Banks can review their risk management system. Market discipline[edit] This pillar aims to complement the minimum capital requirements and supervisory review process by developing a set of disclosure requirements which will allow the market participants to gauge the capital adequacy of an institution. Market discipline supplements regulation as sharing of information facilitates assessment of the bank by others, including investors, analysts, customers, other banks, and rating agencies, which leads to good corporate governance. The aim of Pillar 3 is to allow market discipline to operate by requiring institutions to disclose details on the scope of application, capital, risk exposures, risk assessment processes, and the capital adequacy of the institution. It must be consistent with how the senior management, including the board, assess and manage the risks of the institution. These disclosures are required to be made at least twice a year, except qualitative disclosures providing a summary of the general risk management objectives and policies which can be made annually. Institutions are also required to create a formal policy on what will be disclosed and controls around them along with the validation and frequency of these disclosures. In general, the disclosures under Pillar 3 apply to the top consolidated level of the banking group to which the Basel II framework applies. This delays implementation of the accord for US banks by 12 months. These changes had been flagged well in advance, as part of a paper released in July No new elements have been introduced in this compilation. This version is now the current version. This rule establishes regulatory and supervisory expectations for credit risk, through the Internal Ratings Based Approach IRB , and operational risk, through the Advanced Measurement Approach AMA , and articulates enhanced standards for the supervisory review of capital adequacy and public disclosures for the largest U. The final guidance, relating to the supervisory review, is aimed at helping banking institutions meet certain qualification requirements in the advanced approaches rule, which took effect on April 1, It releases a consultative package that includes: 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. Federal Deposit Insurance Corporation Chair Sheila Bair explained in June the purpose of capital adequacy requirements for banks, such as the accord: There are strong reasons for believing that banks left to their own devices would maintain less capitalâ€”not moreâ€”than would be prudent. The fact is, banks do benefit from implicit and explicit government safety nets. Investing in a bank is perceived as a safe bet. Without proper capital regulation, banks can operate in the marketplace with little or no capital. And governments and deposit insurers end up holding the bag, bearing much of the risk and cost of failure. History shows this problem is very real â€¦ as we saw with the U. The final bill for inadequate capital regulation can be very heavy. Common equity incl of buffer: According to the draft guidelines published by RBI the capital ratios are set to become: Thus the actual capital requirement is between 11 and All the credit institutions adopted it by â€" While some argue that the crisis demonstrated weaknesses in the framework, [3] others have criticized it for actually increasing the effect of the crisis. Nout Wellink , former Chairman of the BCBS , wrote an article in September outlining some of the strategic responses which the Committee should take as response to the crisis. Given one of the major factors which drove the crisis was the evaporation of liquidity in the financial markets, [19] the BCBS also published principles for better liquidity management and supervision in September Tighter capital requirements based on risk-weighted assets, introduced in the Basel III, may further contribute to these skewed incentives. New liquidity regulation, notwithstanding its good intentions, is another likely candidate to increase bank incentives to exploit regulation. In essence, they forced private banks, central banks, and bank regulators to rely more on assessments of credit risk by private rating agencies. Thus, part of the regulatory authority was abdicated in favor of private rating agencies. Stroke and Martin H. Wiggers pointed out, that a global financial and economic crisis will come, because of its systemic dependencies on a few rating agencies.

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Chapter 3 : Basel II: The New Basel Capital Accord

The Basel Committee on Banking Supervision has issued a third consultative paper on the New Basel Capital Accord. Comments are due by 31 July , and will be helpful to the Committee as it makes the final modifications to its proposal for a new capital adequacy framework.

The New Basel Capital Accord: Katchova and Peter J. Barry The first Basel Capital Accord, the current system used for evaluating capital adequacy, was implemented in by the Basel Committee on Banking Supervision. The guidelines proposed in Basel I were accepted by more than countries. Basel I, however, turned out to be too simplistic to address the needs of the banking system in a changing environment of new technology and increased globalization and competition. The Basel Committee on Banking Supervision has been developing a new accord, Basel II, to address the shortcomings of the current accord and to reflect the new developments in the assessment and management of risk. Basel II is expected to be implemented by the end of Pillar 1 outlines the calculation procedures of the capital requirements for banking organizations. The difference under Basel II will be that the risk exposure will be evaluated as the total of the credit risk, market risk, and operational risk exposure of the bank, where more refined measures will be incorporated to calculate credit and operational risk. Pillar 2 addresses the supervisory review process in ensuring sound capital management and comprehensive assessment of the risks and the capital adequacy of the banking institutions. This pillar seeks to increase the transparency and accountability of the banking system and to a large extent has already been incorporated in the United States. Pillar 3 aims at improving market discipline by requiring banks to publicly disclose key information regarding their risk exposures and capital positions. Because Basel II gives banking institutions greater discretion in calculating their own capital requirements, it is anticipated that the disclosure statements will allow market participants to better assess the safety and soundness of the banking environment and thus exert stronger market discipline. Basel II will include three options for measuring credit risk and another three options for measuring operational risk. The options for calculating credit risk are the standardized approach and two internal ratings-based approachesâ€”the foundation approach and the advanced approach. The standardized approach is similar to the approach currently used for categorizing bank assets according to their risk and then weighing them using fixed weights. Under the internal ratings-based approaches, banks will evaluate key elements of credit risk: Under the foundation approach, banks will estimate the probability of default of their loans, but the regulators will provide the other measures. Finally, under the advanced approach, banks will calculate all key elements of their credit risk exposures. Likewise, there are three options for calculating operational risk: As incentives for adopting the more advanced approaches for credit and operational risks, banks are anticipated to experience lower capital requirements. Currently, ten banks meet these size requirements, and another ten banks have chosen to adopt the advanced approaches of Basel II. It is expected that over time other large banking and nonbank institutions will also choose to adopt advanced capital calculations. The banking agencies have identified several areas of concern regarding the implementation of Basel II in the United States Federal Reserve Board, The first concern is the equitability of a bifurcated scheme whereby large banks will be required to adopt Basel II while small banks will continue to operate under the existing Basel I. Small banks that remain under the current capital regime would generally have higher capital requirements, which would also be less sensitive to risk. Thus, these small banks would be at a competitive disadvantage. However, the banking agencies predict that Basel II may not have a large impact on capital holdings, because many small banks currently choose to hold capital in excess of the required minimum. The second concern is that the adoption of advanced approaches for measuring credit and operational risk may be too expensive, especially for smaller banks. The adoption of these approaches, of course, will not reduce losses but rather will better align capital requirements and losses. However, even if not required by Basel II, these approaches may be needed in order to compete effectively in the existing banking environment. The third concern is the way operational risk is treated, either as an explicit capital charge under pillar 1 or on a case-by-case basis under pillar 2. Basel II implies that large agricultural loans would be treated as corporate loans and small agricultural loans as retail loans. The regulators, however, need to take into account the particular characteristics of farm loans when setting capital charges for organizations involved in agricultural lending Barry, Farm businesses are characterized by cyclical performance, seasonal production patterns, high capital intensity, leasing of farmland, participation in government programs, and annual payments of real estate loans. Because of these characteristics, losses in agricultural lending may not be frequent, but could be large due to high correlations among farm performances. At the same time, high capital intensity, especially involving farmland, offers relatively strong collateral positions, thus mitigating the severity of default when default problems do arise. Katchova and Barry developed models for quantifying credit risk in agricultural lending. They calculated probabilities of default, loss given default, portfolio risk, and correlations using data from farm businesses. The authors showed that the calculated expected and unexpected losses under Basel II critically depend on the credit quality of the loan portfolio and the correlations among farm performances. These analyses of portfolio credit risk could be further enhanced if segmented by primary commodity and geographical location. Agricultural lenders could adopt similar models to quantify credit risk, a key component in the calibration of minimum capital requirements. Farm Lending Institutions Among agricultural lending institutions, commercial banks and the Farm Credit System are the largest providers of credit. Commercial banking in the United States has long been characterized by a large number of smaller community banks, many of which are heavily dependent on agriculture. Such larger banks likely have the capabilities to move toward the adoption of the internal ratings-based approaches to risk assessment and capital management, whereas smaller banks serving different market niches will probably remain under the current standardized approach. The Farm Credit System FCS is a federated organization of five mostly wholesale banks lending to farmer-owned lending associations, which in turn provide credit and related services to agricultural borrowers. Autonomy of individual units of the FCS has been high, although recent consolidations, business practices, product and service offerings, risk assessment, and capital management have become more uniform over time. Uniformity helps the FCS to present a more understandable, coherent structure to the national and international financial markets. Investors in these markets, in turn, purchase securities issued by the FCS banks, thus providing the loan funds for agricultural borrowers. In general, the FCS has sufficient size, specialization, and expertise to move toward adopting the internal ratings-based approaches to capital management. Initial steps have involved the design of data systems needed to compile and store loan-level loss data over time and the development of dual rating systems for categorizing the frequency and severity of default by borrowers. The goals are to achieve greater precision and granularity in risk classifications. These steps will lead to the formulation of economic capital models that combine measures of credit, market, and operational risks to determine capital adequacy, risk-adjusted returns on capital, and risk-adjusted pricing of loans and services. Essential to the adoption of more advanced internal ratings-based approaches is the acceptance by federal regulatory agenciesâ€”the Farm Credit Administration in the case of the FCS and the Fed, Comptroller of the Currency, and the FDIC for commercial banks. Basel II requires a formal approval process for the measurement, modeling, and management of risk-based capital. Thorough documentation, rigorous testing, complete validation, and ongoing use are key elements of gaining and maintaining approval. In Conclusion As occurred under Basel I, the new spectrum of choices for capital management under Basel II will be widely reflected throughout the financial system. The scope and depth of Basel II have followed the "best practices" of the top tier of banks worldwide. Such successful practices typically permeate a financial system with modifications to fit institutional size and resource base. Vendors offering fee-based capital services, further consolidations among financial institutions, data sharing arrangements, and experience gained by the industry and its regulators will hasten the permeation process and enable community banksâ€”as well as the internationally active onesâ€”to utilize internal ratings-based approaches and economic capital concepts in their risk management. For More Information Barry, P. Modern capital management by financial institutions: Implications for agricultural lenders. Agricultural Finance Review, 61, Basel Committee on Banking Supervision. The new Basel Capital Accord. Bank for International Settlements. Available on the World Wide Web: Credit risk models and agricultural lending. American Journal of Agricultural Economics, 87, The Federal Reserve Board. Capital standards for banks: The evolving Basel Accord. Other articles in this theme:

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Chapter 4 : Basel II - Wikipedia

The New Basel Capital Accord: A Status Report It's been an extraordinary year since I last spoke to the Institute in this forum -- a year that saw both unspeakable tragedy and awe-inspiring heroism.

Chapter 5 : About the Basel Accord

The first Basel Accord, known as Basel I, was issued in and focuses on the capital adequacy of financial institutions. The capital adequacy risk (the risk that a financial institution will be.

Chapter 6 : Future Banking Supervision Under the New Basel Capital Accord (Basel II)- DocsBay

Basel III is an extension of the existing Basel II Framework, and introduces new capital and liquidity standards to strengthen the regulation, supervision, and risk management of the whole of the banking and finance sector.

Chapter 7 : Choices Article - The New Basel Capital Accord: Implications for US Agricultural Lenders

Implementation of the New Basel Capital Accord in the U.S. The Board of Directors of the Federal Deposit Insurance Corporation has approved publication of the final rules regarding Risk-Based Capital Guidelines; Implementation of New Basel Capital Accord.

Chapter 8 : Basel Accords - Wikipedia

The Basel Committee on Banking Supervision has been developing a new accord, Basel II, to address the shortcomings of the current accord and to reflect the new developments in the assessment and management of risk.