# What is... Basel II?

BANKTrack

**Basel II is an international agreement that sets minimum requirements for the capital reserves held by creditor banks.** It was drafted by the Basel Committee on Banking Supervision, which is comprised of central bankers from the 13 biggest industrialised economies.. With the official name "International Convergence of Capital Measurement and Capital Standards: a Revised Framework," "Basel 2" is a follow-up to the first Basel accord established in 1988.

## The Basel Committee

The Basel Committee on Banking Supervision (Basel Committee) was established in 1974, by the Bank of International Settlements (BIS), an international organisation founded in Basel (Switzerland) in 1930 to serve as a bank for central banks. The BIS currently has 55 member central banks, only 13 of which are represented on the Basel Committee. It started as a forum for regular cooperation between banking supervisors of 10 Western countries (G-10) and currently consists of supervisory authorities and central banks of 13 developed countries.

The Basel Committee has gradually developed common international standards of banking supervision that are supposed to be implemented through national legislation, although the Committee has no international means of enforcement. The main instruments developed by the Basel Committee are: The Basel Committee's Concordat, The Basel Committee's 25 Core Principles for Effective Banking Supervision, and most importantly, the Basel Capital Accords.

## Basel I: a major international standard of banking supervision

In 1988, the supervisors of the Basel Committee agreed on how much financial reserves banks must put aside when providing loans. For banks, it is costly to leave capital idle and they prefer to keep as little capital in reserve as possible. But this temptation could threaten financial stability if the loans are not (entirely) paid back, or when depositors suddenly collect their money. The use of reserve requirements is thus one of the most important tools of prudential supervision, since it helps to prevent excessive lending by banks and thus reduces the risk of bankruptcies.

The basic principles of the Basel Capital Accord of 1988 (Basel I) are:

- Banks must put aside 8% of the amount of a loan in reserve when there is a 100% risk associated with that loan, as defined by the Basel Accord framework's risk assessment. If assessed risk is lower, reserve requirements can be lowered accordingly.
- Banks must make assessments of the potential for loan default for government, bank and corporate borrowers. For instance, a bank that gives a loan to a government in an OECD-country does not have to put any money in reserve since according to the Basel principles, the risks of non-repayment are none. In contrast, Basel I stipulates banks have to put aside 8% of all loans provided to corporations.
- Banks that give loans to other banks have to distinguish between short-term (up to 12 months) and long term loans. According to Basel I, the risk of providing short term loans to banks is much less (only 20% risk) than providing long term loans (up to 100% risk for developing country borrowers).

By 1994, Basel I was being implemented in over 100 countries, and the Basel Committee established the Accord Implementation Group to share experiences and promote implementation.

## Basel II: a revision of the framework

By the late 1990s, the Basel Committee began discussions to update Basel I. A revision was needed to reflect current risk measurement techniques that were more sophisticated than the 1988 "one size fits all" approach. Big banks were already increasingly using their own more detailed risk assessment mechanisms, and the 1988 standard approach thus increasingly was regarded as a burden.

In addition, a new framework was needed to account for developments in financial markets, such as the common practice of "credit risk transfer". Credit risk transfer (or mitigation) refers to the use of instruments that pass credit risk onto other banks or individuals through the sale of credit derivatives or through the securitization of credit.

Finally, with the Asia financial crisis in the late 1990s, the need for better financial supervision became very clear, further spurring the revision of the Capital Accord. By May 2004, the Basel member countries reached a consensus on a new agreement, Basel II.

## Basel II, the new framework

The text of the new accord (Basel II) is a complex document of 250 pages. It is based on three pillars:

**Pillar 1**
**New risk assessment mechanisms and resulting capital requirements:**

**A.** New methods are introduced to measure credit risk, the risk of non-payment associated with bank lending. The new capital requirements depend on the approach used.

- a "standardised approach" measures the risks of a borrower by using private or public rating agencies that assess borrower solvency; for government borrowers, banks can rely on the assessment of Export Credit Agencies.
- an "internal rate based approach" (IRB) allows a bank to use its own risk estimation systems as long as they comply with certain criteria and information disclosure requirements, e.g. sufficient auditing.
- a "securitization framework" provided by Basel II also helps measure of credit risk. Although securitization aims to mitigate credit risk, there often still remains a 'securitization exposure' that could result in credit loss. For example, if a bank securitizes home loans, so that investors buy bonds based on homeowners' mortgage payments, it passes much of the risk onto these bondholders. However, the bank still would not want massive defaults on its home loans, so it would give implicit support to the these mortgage-backed securities. Therefore, the bank still faces a risk and should keep some capital aside. Also, banks themselves hold securities such as bonds and this presents a credit risk in and of itself. Again, in determining the risks associated with securities, the Accord offers a standardized approach, as well as the option of using a more sophisticated internal rate based approach. The capital reserve requirements depend on the approach used.

**B.** Capital requirements are introduced for operational risk, the risk associated with the internal processes of the bank. Basel II offers 3 different approaches, varying in complexity, to assess these risks.

**C.** A final paragraph introduces a new definition of the trading book. Banks keep both a banking book and a trading book. With banks' increased engagement in security trading, the importance of the trading book has increased, so more specific definitions and rules are introduced as to how the book-keeping should be done.

**Pillar 2**
**Changes in the supervisory processes:**

- Banking supervisors get more power and scope to intervene and monitor risk assessment systems of banks.
- Banking supervisors of the home and host countries of banks are required to make concrete plans to improve cooperation and information exchange, and decrease the burden of banks to implement supervisory requirements.

**Pillar 3**
**Market discipline through better disclosure of information by banks:**

Banks have to publicise more differentiated data. The assumption is that when data indicate bad banking behaviour, e.g. too many risky loans, the banks' clients and investors will react and put pressure on the bank to correct the situation.

## Status and Implementation

According to the Basel Committee, the new Accord should be implemented by the end of the year 2006 and like the Basel I Accord, it is to be introduced worldwide. It must be noted that the exact implementation process is unclear. Before the text of Basel II had even been agreed upon, the US and

China already announced that they would pursue other regulations for most of their (national) banks so that not all banks would apply Basel II as originally conceived. The US House Financial Services Committee feared that Basel II would disadvantage smaller US banks that have no capacity to apply it, and that it would increase the concentration in the banking industry. As for the European Union, the EC is planning to implement the entire accord into the third European 'Capital Adequacy Directive' (CAD3), which will make the Basel II principles applicable to all European credit institutions. As for less developed countries, the Basel Committee acknowledged that the adoption of Basel II might not be the first priority of supervisors and banks in those countries. Thus, developing countries should focus more on the implementation of pillar 2 and 3 of the Accord (supervisory process and market discipline), rather than on the complex reserve requirements of pillar 1.

## Some critical issues

In drafting the new accord, the Basel Committee had already requested, and received, comments on its three consultative papers. Numerous articles written by experts have criticised the Basel II proposals, but many have not analysedt final definitive version of the Accord. In the end, it seems that the major aim of Basel II is to prevent Western governments from having to bail out the large consolidated Western private banks in case they fail. Also, the Basel Committee, which negotiated and designed the Basel II Accord, did not have representatives of developing countries among its members. The Committee held regular consultations with a group of 13 non-member countries, including Russia and China, but Basel II ultimately failed to take into account the interests of developing countries, who have no decision-making power in the design.

- **International banks get competitive advantage in developing countries** Banks that use their own risk assessment system must apply it to all the loans they provide in all countries. The costs of introducing and operating one's own risk assessment systems are expensive and only feasible for the top international banks. Consequently, the banks that operate in a particular developing country might each use different risk assessment approaches with different capital reserve requirements. Those international banks that use their own risk assessment system ('Internal rate based' approach - IRB) which require less capital requirements would be given a competitive advantage over domestic banks that use a standardised approach requiring higher loan reserves.

- **Loans to developing countries more expensive?** Governments, banks and corporations in developing countries will probably face higher costs for loans due to Basel II. First of all, developing country entities generally receive low ratings by rating agencies, Export Credit Agencies, and by the banks' own risks assessment systems; many companies or governments from developing countries have no rating at all. These lower or non-existing ratings do not always reflect actual creditworthiness of the corporations or governments and can reflect some bias in capital markets. According to the "internal ratings based" (IRB) approach in Basel II, banks need to put more capital aside for such lowly or non-rated lenders, meaning banks will charge relatively higher interest rates for many loans to developing countries. Secondly, it is argued that interest rates charged to the developing world as a whole could be too high because Basel II has chosen not to include diversification in its risk assessment mechanism. For banks, the concept of diversification (among regions, sectors, etc.) is an important way to spread and manage risks throughout their credit portfolios. Loans to developing economies are relatively risky, but banks can partially offset these risks with high-quality loans to developed countries. Although tools exist to assess the impact of diversification on credit portfolio risks, Basel II does not take them into account. As a result, the estimated credit risk for developing country loans could be as much as 20% too high and, consequently, the interest rates charged to developing countries could be much too high as well.

- **Loans for project finance more expensive?** Basel II also assigns higher risk to project finance loans compared with similar corporate loans. For all but the most creditworthy projects, this would make project finance lending prohibitively expensive for banks from a capital adequacy perspective. The result could be a decrease of private bank lending in the project finance market, and an increase in the relative importance of export credit agencies.
- **What about sustainability?** In the Basel Accord, there is no attention at all to sustainability issues. Central Bankers could maintain that this is not within their domain since their core objective is financial stability. But one could equally argue that that credit risk assessment should include an analysis of sustainability risks (i.e. the environmental degradation, the social and societal impacts of the companies and projects that receive bank loans), and that capital reserve requirements should be higher for environmentally or socially harmful loans. Currently, the Basel II accord only requires banks to assess those environmental risks that undermine the value of the collateral of the borrowing company. Moreover, although reputational risk is a recognized and important type of risk in banking (especially in cases of fraud, such as banks helping companies to manipulate financial statements), Basel II similarly does not recognize this as an Operational Risk. Reputation management drives many banks to support sustainability/ corporate social responsibility, and to avoid irresponsible environmental or social behaviour. Arguably, those banks with superior environmental management systems or those that finance less controversial transactions, should have lower capital requirements on the basis that they are reducing their reputational and operational risk.
- **Danger of financial instability not resolved.** The first issue in this respect is whether supervisors will be able to duly supervise the implementation of the banks' own risks assessment mechanisms (IRB approach). During the drafting stage of Basel 2, there were indications that supervisors did not fully comprehend these private risk assessment systems. Supervising such banks will require supervisors to work closely together with them, and to invest heavily in their own expertise to ensure they can actually judge the banks' assessments. It is doubtful whether the regulatory regime is strong enough for this.

Another point of concern is that short term loans are still treated more favourably than long term loans because of the much lower reserve requirements attached to the former. Although the Asian financial crisis has shown that short term loans can be the source of major financial instability, the new Accord hasn't taken this into account.

A final potential danger to financial stability lies in the possible procyclical effects of using external rating agencies for the assessment of risks. If a country is facing adverse macroeconomic circumstances, and rating agencies suddenly lower credit ratings, this would only aggravate the situation, creating financial crisis rather than stability.

## Glossary:

**Bonds:** promissory notes that oblige the issuer to pay back a certain amount of money within a certain time (with or without regular payments, or 'coupons').

**Securitization:** aggregating mortgages, other types of loans or assets in a pool and issuing new securities backed by this pool. This distributes the of risk on these assets and debt instruments to the new owners of the securities.

**Credit derivative:** a contract between two parties that allows for the use of a derivative to transfer credit risk from one party to another. For example, the creditor that has a loan or bond outstanding has the right to sell the loan or bond, in case of a default. In return the creditor pays the other party a regular fee (like an insurance premium).

## Useful websites:

www.bis.org

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