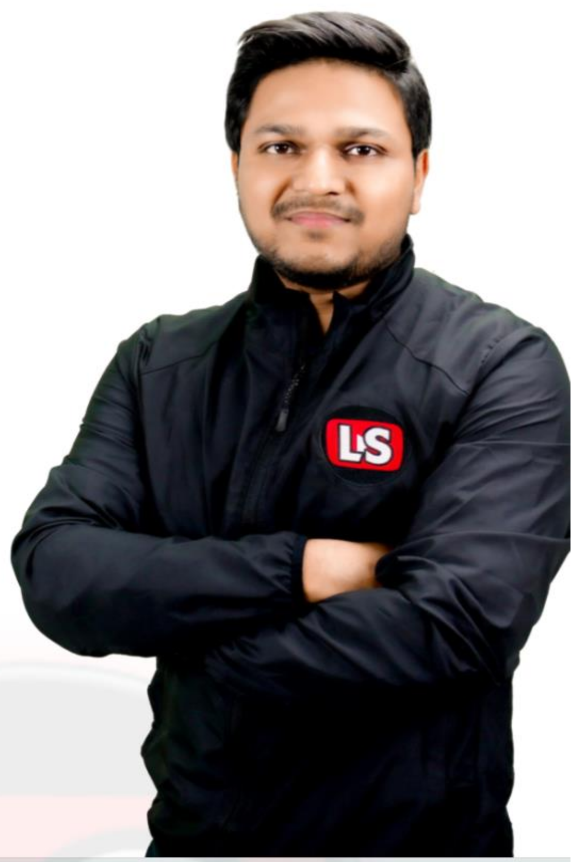
BASEL - I

RISK MANAGEMENT



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BASEL 1 – What is a Bank for the purpose of BASEL Accord?

- As on date the provisions of Basel Accord of 1988 have undergone a number of changes made year after year.
- Basel II accord has become operational, some of the covenants of Basel 1 (1988) are still relevant.
- Under the 1988 accord, Banks and security firms have been given different treatment.
- when Basel III became operational, capital part of the formula (nominator) went under lot of changes whereas the denominator part (risk weight portion) continued as per Basel II prescription.

What is a 'Bank' for the purpose of Basel accord: To understand the scope of the 1988 accord, we need to clarify what we mean by "bank".

This is because, some jurisdictions distinguished between banks and securities firms, and the Basel accord (Basel I) applied only to the former.

EXCLUSIVE FOCUS ON CREDIT RISK DURING 1988-1998

The 1988 Basel Accord-Basel I- primarily addressed banking in the sense of deposit taking and lending (commercial banking under US law), so its focus was credit risk.

MARKET RISK - RECOGNITION OF THE NEED FOR CAPITAL AMENDMENT OF BASEL I IN 1996

With banks increasingly taking market risks, in the early 1990s, the Basel Committee decided to update the 1988 accord to include bank capital requirements for market risk.

This would have implications for non-bank securities firms. Any capital requirements the Basel Committee adopted for banks' market risk were where to be incorporated into future updates of Europe's Capital Adequacy Directive (CAD) and thereby apply to Britain's non-bank securities firms.

If the same framework were extended to non-bank securities firms outside Europe, then market risk capital requirements for banks, and, securities firms could be harmonized globally. In 1991, the Basel Committee entered discussions with the International Organization of Securities Commissions (IOSCO) to jointly develop such a framework. The two organizations formed a technical committee, and work commenced in January 1992.

COMMERCIAL BANKS & SECURITIES FIRMS - UNIVERSAL BANKS

Banks

- Banks were primarily exposed to credit risk.
- **often held illiquid portfolios of loans** supported by deposits. Such loans could be liquidated rapidly only at 'fire sale' prices. This placed banks at risk of 'runs.

- **If depositors feared that a bank might fail**, they would withdraw their deposits. Forced to liquidate its loan portfolio, the bank would succumb to staggering losses on those distress sales of loan assets.
- Though Deposit insurance and lender-of-last-resort provisions implemented eliminated the risk of bank runs, they introduced a new problem.
- Depositors no longer had an incentive to consider a bank's financial viability (prior to Basel I guidelines) before depositing funds.
- Without such market place discipline, regulators were forced to intervene often at huge cost to the exchequer.
- One solution was to impose minimum capital requirements on banks.

Securities Firms

- The **primary objective** behind stipulation of capital requirements for securities firms was to protect clients who might have funds or securities on deposit with a firm.
- **Securities firms were primarily exposed to** market risk. They held liquid portfolios of marketable securities supported by secured financing such as repos.
- A troubled firm's portfolio could be unwound quickly at market prices.
- For this reason, capital requirements were based upon the liquidation value of a firm.

Capital for Banks & Securities Firms

- In a nutshell, banks entailed systemic risk, whereas the Securities firm are not largely exposed to this risk.
- Regulators would strive to keep a troubled bank afloat but would gladly unwind a troubled securities firm, since it may not have public deposits.
- Banks needed long-term capital in the form of equity or long- term subordinated debt.
- Securities firms could operate with more transient capital, including short-term subordinated debt.

SEGREGATION OF BANKING BOOK & TRADING BOOK FOR HOLDING CAPITAL

- In April 1993, the Basel Committee released a package of proposed amendments to the 1988 accord. This included a document proposing minimum capital requirements for banks' market risk.
- Banks would be **required to identify a trading book and hold capital for market risk** under trading book and organization-wide foreign exchange exposures.
- Capital charges for the trading book would be based upon a crude value-at-risk (VaR) measure broadly consistent with a 10-day 95 per cent VaR metric.
- Market risk capital requirements were set equal to the greater of either the previous day's VaR, or the average VaR over the previous six days, multiplied by 3.

BANKS TO HAVE INDEPENDENT RISK MANAGEMENT FUNCTION AND SATISFY THE REGULATOR REGARDING ITS RISK MANAGEMENT PRACTICES

The Basel Committee's new proposal was adopted in 1996 as an amendment to the 1988 accord. It is known as the 1996 amendment. ***It went into effect in 1998.***

In the similar way, subsequent to the global sub-prime crisis, BCBS released its Basel Ill guidelines under the name, "A global regulatory framework for more resilient banks and banking systems' in December, 2010. The Basel III capital regulation has been implemented by RBI from April 1, 2013 in phases and it will be fully implemented as on March 31, 2019.