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BASEL - II

RISK MANAGEMENT

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3 PILLARS of BASEL II and Capital for Operational Risk

The Basel Committee replaced the 1988 accord (amended in 1996 and adopted in 1998) in April 2006. Basel II also addressed 'Operational risk', among other things.

BASEL I WAS BASED ON UNIFORM ASSESSMENT METHODOLOGY FOR CAPITAL ADEQUACY

Basel II is based on 3 pillars as mentioned below:

Pillar - I Minimum Capital requirements

Pillar - II Supervisory Review Process

Pillar - III Market Discipline

PILLAR - I MINIMUM CAPITAL REQUIREMENTS

A bank will have to determine the proportion of its capital that it must keep in reserve based on this calculation:

- Credit risk capital is for Banking book'.
- Market risk Capital is for 'Trading book'
- Operational risk - new rules introduced for Basel II.

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PILLAR – 2 SUPERVISORY REVIEW PROCESS

- Banks to ensure that they have a **process in place to make sure that they hold adequate capital** consistent with their risk profile and strategy.
- The **Internal Capital Adequacy Assessment Process [ICAAP]** is the responsibility of the bank and banks under Pillar I should come out with a Board mandated ICAAP policy for managing the risks that could not be captured.

the Internal Capital Adequacy Assessment Process (ICAAP) should capture and include the following risks:

(a) the risks that are not fully captured by the minimum capital ratio prescribed under Pillar 1.
(b) the risks that are not at all taken into account by the Pillar 1.
(c) the factors/risks that are extraneous/external to the bank.

PILLAR - III MARKET DISCIPLINE [TRANSPARENCY & DISCLOSURES]

- Banks would come under this pillar only when their shares issued to the public at large and also listed in the exchanges.
- This pillar takes care of the interest of the investors and hence comes under the regulator / supervisor overseeing the capital markets.
- Security Exchange Board of India (SEBI) is the regulator for this pillar in India.
- This sets out the **minimum disclosure requirements** for external reporting

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- It should disclose various information relating to its financial aspects including its risks at periodical intervals.

COMPARISON BETWEEN BASEL I & BASEL II

Introduction: In the previous paragraphs we have given the highlights of Basel I and Basel I. In this chapter we compare the two for better understanding.

Comparison between Basel I and Basel II

Basel - I (1988 and amended in 1996) - Based on Methodology for Capital Adequacy	***Basel - II (to be in place by 2006 in G-10 countries and in India from 2008) - Basel I based on 3 pillars***
1. Capital adequacy based on Risk Weighted Assets	1. Capital adequacy based on Risk Weighted Assets
2. Not risk sensitive. Prescriptive.	2. Risk sensitive.
3. All credit exposures carried risk weight of 100 per cent - except for some sovereign exposures and mortgages.	3. Credit exposures carry risk weights based on credit quality/ rating.
4. Risk Capital = Credit exposure * Risk Weights * 8 per cent.	4. Risk Capital: Similar to Basel I. But efficient Banks can have lesser Capital than others.
5. No capital provision for Securitization exposures.	5. Captures Securitization exposures including capital provision.
6. Risk mitigants are not reckoned for reducing the credit exposures	6. Eligible financial collaterals would act as risk mitigants for reducing the credit exposure

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	leading to reduction in capital when compared the compared under Basel I.

Implications were	*Implications are*
Every bank had **to maintain same 8 per cent capital**. Thus, Banks with good quality assets had no incentives. As a result, credit quality had to be lowered to increase returns	Banks with good quality assets have incentives because they can manage with lower capital
Low rated exposures were subsidized by high rated exposures	Better quality assets require lesser capital
No provision for economic pricing by banks	Risk pricing can be done by banks based on credit risk perception
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