Basel II
International Convergence of Capital Measurement and Capital Standards
Banking Regulation

- Setting of Basel Committee on Banking Supervision in 1974 with the following objective:
  - Broad supervisory standards and guidelines and recommends statements of best practice in the expectation that individual authorities will take steps to implement them through detailed arrangements that are best suited to their jurisdiction

- Main motivations that justify the existence of banking regulation are as follows:
  - Protection of banks' depositors in the event of bank default
  - Provide stability for transactions
  - Avoid contagion effects in banking industry
  - To maintain stability in the economy
Banking Regulation

- Moral hazard issue related with deposit insurance:
  - Provides incentives to banks increase risks. To avoid it insurance premium should be linked to a bank's risk profile
  - Leads to a lax deposit monitoring of banking risks since their deposit is anyways insured

- 'Too-Big-To-Fail' doctrine:
  - Belief that large institutions always would be rescued unconditionally by the regulators as the risk of a 'contagion-effect' would be very large and no government can afford it
  - Leads to inter-bank market players take a lax stance at risk-profile of large banks
  - TARP (USA) – Troubled Asset Relief Program is an example of this doctrine. All large FIs are its beneficiaries to date e.g. Citigroup, BoA (incl ML), AIG, Morgan Stanley, and JPMC
The three pillars are intended to be mutually-reinforcing and interlinked.
Organization of Basel II

Scope of Application

Three Basic Pillars

Minimum Capital Requirement

Supervisory Review Process

Market Discipline

Risk Weighted Assets

Definition of Capital

Credit Risk

Supplementary Capital

Market Risk

Core Capital

Operational Risk

Standardized Approach

Standardized Approach

Advanced Measurement Approach

Core Capital

Supplementary Capital

Internal Rating Based Approach

Models Approach

Basic Indicator Approach

Minimum Capital Requirement

Supervisory Review Process

Market Discipline

Advanced IRB

Standardized Approach

Internal Rating Based Approach

Models Approach

Basic Indicator Approach

Core Capital

Supplementary Capital

Foundation IRB

Advanced IRB
Objectives of Basel II Accord

- Promote safety and soundness of the financial system.
- Enhance competitive equality.
- Create capital adequacy assessments.
- Focus on internationally active banks while following the principles to be flexible enough to have applications to a wide variety of banking operations.
- Encourage continuous improvement in a bank's internal risk assessment capabilities.
- Ensure that risk is primary emphasis in supervisory practices.
Scope of Application: Basel II

- The new Capital Accord will be applicable to the Internationally Active Banks.
- The scope of the analysis should include on a fully consolidated basis to entities where control exists (including securities and other financial subsidiaries but not insurance) of a banking group at every tier of the group structure (consolidated at a holding company level)
- Significant minority investments where control does not exist will be excluded from banking group capital by deduction of equity and other regulatory investments
- Investments in an insurance entity also has to be deducted
## Regulatory Capital and Constraints

<table>
<thead>
<tr>
<th>Component</th>
<th>Conditions for Inclusion</th>
<th>Limits</th>
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</thead>
</table>
| Tier I: Common Equity & Disclosed Reserves | - Unsecured, subordinated and fully subscribed; not redeemable at the holder's initiative or without consent of the supervisory authorities; can be used to cover losses without the need to liquidate the bank; can be deferred if the bank's profits do not allow payment.  
- Original term to maturity of at least 5 years. Amortized at 20% per year if maturing in less than 5 years. | - At least 50% of bank's capital to comprise of core elements of Tier 1 |
Consumption of Regulatory Capital

- Basel requires banks to exhaust Credit and Operational Risk Capital with Tier 1 and Tier 2 capital categories before moving to exhaust Market Risk Capital.

<table>
<thead>
<tr>
<th>Capital</th>
<th>Actual Capital</th>
<th>Appropriated by Credit</th>
<th>Actual After Credit</th>
<th>Appropriated by Operational</th>
<th>Left After Operational</th>
<th>Appropriate By Market</th>
<th>Left After Operational</th>
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