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

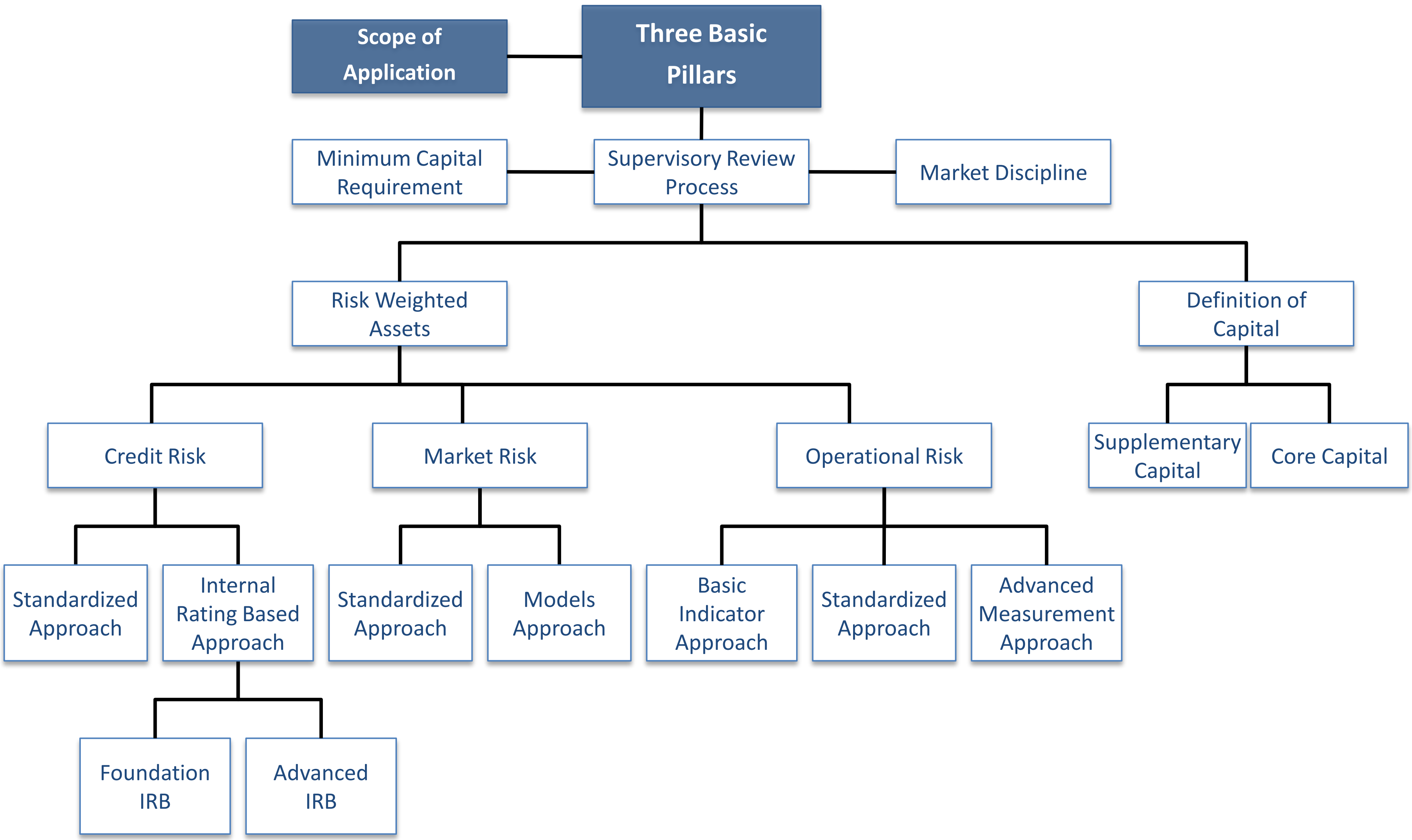
- Moral hazard issue related with deposit insurance:
  - Provides incentives to banks increase risks. To avoid it insurance premium should be linked to a bank's risk profile
  - Leads to a lax deposit monitoring of banking risks since their deposit is anyways insured
- 'Too-Big-To-Fail' doctrine:
  -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

Structure of Basel II

Pillar I	Minimum Capital Refined Credit and new Operational Risk capital requirements	Internal view
Pillar II	Supervisory Review Supervisor's assessment of bank and any additional capital requirement	Supervisor's view
Pillar III	Market Discipline Disclosure to allow the markets to decide	External view

The three pillars are intended to be mutually-reinforcing and interlinked

Organization of Basel II



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

Component	Conditions for Inclusion	Limits
Tier I: Common Equity & Disclosed Reserves (equity includes common stock outstanding and any preferred stock that is non redeemable and non cumulative)		▪ At least 50% of bank's capital to comprise of core elements of Tier 1
Tier II: Hybrid Capital Instruments	▪ 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.	▪ Restricted to 100% of Tier I capital
Tier II: Subordinated Term Debt		
Tier III: Short Term Subordinated Loans	▪ Original term to maturity of at least 2 years. For support of Market Risks after at least 28.5% of such risks are supported through Tier 1	▪ Tier 2 and 3 capital together should not be more than Tier 1 capital

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

	RWA	Capital
Credit	34344	2748
Market	75654	6052
Operational	33543	2683

Capital	Actual Capital	Appropriated by Credit	Actual After Credit	Appropriated by Operational	Left After Operational	Appropriate By Market	Left After Operational
Tier 1	5334	2748	2586	2586	0		0
Tier 2	4222		4222	97	4125	4125	0
Tier 3	2564		2564		2564	1927	637
		2748		2683		6052	