Basel II: From Vision to Reality

"Basel I" as an international standard for capital adequacy

In the 1980's it was possible to observe among banks internationally a trend towards a steady reduction in capital resources. As the banks' lending was underlaid with a decreasing amount of capital, the danger also increased that if their loan portfolio deteriorated they no longer had a sufficient reserve of capital available as a cushion against major losses, and so were themselves facing difficulties. Such disturbances or crises within the financial system can, however, entail enormous costs to the national economy, especially since these turbulences in the financial system can have an effect on the real economy. The Capital Accord adopted by the Basel Committee for Banking Supervision in 1988 put an end to this worrying development. The minimum requirements, the same for all banks and relatively simple to apply, harmonized the regulation of credit risks at international level, thereby increasing the stability of the financial system. Although Basel I is not a binding agreement under international law and was originally intended for implementation in the G-10 countries and the EU, to date – probably precisely because of its simplicity – it is applied in over a hundred countries and has developed into an internationally recognized standard for capital adequacy.

Change in the banking world

Since then the banking business has changed greatly. It has become more diverse and complex. In addition, the volume of financial contracts traded has hugely increased. Also, many institutions have merged across national borders. Major progress has also been made in information technology and, based on this, in the banks' risk management. As a result it has also become possible to assess the economic risks of financial contracts more accurately and to specify an appropriate economic capital as a cushion for losses. The minimum regulatory capital requirements on the other hand are still aligned to the admittedly coarse but in compensation simple rules of Basel I. This situation creates the danger that banks may be tempted to boost their returns by granting those loans which carry a higher financial risk in relation to their regulatory ranking. Using securitisation or credit derivatives, all other loans can be passed on to other parties with less stringent supervisory standards. This "regulatory arbitrage" noticeably undermined the original objective of reinforcing the stability of the financial system.

"Basel II" as a reflection of modern banking

In order to ensure that this objective is still achieved and to provide a level playing field between banks, the Basel Committee decided in 1998 to revise the existing Capital Accord and to start the work leading to a new, more differentiated regulatory framework ("Basel II"). Basel II is intended to bring banking regulation closer to present-day banking practice. Its first pillar lays down minimum capital requirements for credit and market risks, and also for operational risks. In contrast to Basel I, in which capital requirements for operational risks is considered implicitly under credit risks, under Basel II the two types of risks are considered separately. The intention here is that the capital in the financial system should

At one time the existing Capital Accord agreement ("Basel I") harmonized capital regulation very successfully. Now, however, it is no longer in tune with current banking practice. The proposed new version ("Basel II") seeks to regulate the complex banking business using generally applicable rules in a completely heterogeneous banking world. Here once again the aim is to reinforce the stability of the financial system. The importance of a stable financial system to the national economy justifies the major expense.

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remain the same in aggregate. In place of a single rigid straitjacket, for each of the three risk categories mentioned, Basel II offers a choice from a menu of different methods of calculating capital requirements. In this way the different size or organization of the bank, and also the complexity of its business activity, is taken into account. The simple, less elaborate methods – as compensation for their lack of precision – lead to higher capital requirements than the sophisticated approaches, which are closer to the true risks, and are tied to strict examination and approval by the responsible supervisory authorities. The advanced approaches are in line with the risk management procedures as developed and used internally by the major banks operating internationally. As a supplement to the first pillar, a second pillar is now concerned with procedures for examining the risk profile of individual banks by the responsible authorities under supervisory law. Finally, a third pillar, also a new one, with enhanced duties of publication, is intended to increase market transparency – as a sort of disciplinary competitive element. It is forecast that Basle II will be adopted in mid-2004, and come into force at the end of 2006. From the start of the revision of Basel I an intensive dialogue and exchange of ideas between the supervisory and regulatory bodies responsible and representatives of the financial industry has taken place. Anyone interested in the details of the three pillars, and the different menus, can find these on the internet page of the Bank for International Settlements (*www.bis.org*).

Wide consensus (and a few dissenting voices)

There is a broad consensus among all those involved and affected by the question of the need for Basel II and its correctness. None the less, there are also controversies concerning Basel II. The apparent complexity of the new agreement at first sight is explained in particular by the large number of possible choices offered, and by Basel II's claim to regulate the complex business of banking by means of generally applicable rules in a completely heterogeneous banking world. The allegedly immense costs and necessary capital investment caused by Basel II also immediately appear in another light when one considers that Basel II is seeking to reflect only "best practice" in current banking business, and that maintaining the competitiveness of an organization necessarily demands investment in information technology and in the further development of risk management. The costs of the new regulatory system mentioned must be set against the major benefit to the national economy: in addition to protection of investors against bank failures, and the banks against "black sheep" among their competitors, the stability of the financial system should in particular be mentioned. This public good constitutes an important condition for efficient allocation of capital.

Implementation of "Basel II" in Switzerland

In Switzerland the EBK (www.ebk.admin.ch) is entrusted with implementation. Under its leadership a mixed national working group, made up of representatives of all relevant interest groups in the Swiss financial industry, is working out the appropriate Swiss legal regulatory standards. In Switzerland all the menu approaches offered by Basel II are being implemented, and are therefore in principle available to every institute. Nevertheless the EBK expects that under the new regulations most Swiss banks will not use the advanced approaches requiring approval for calculating capital requirements, but will be guided by these in order to improve their risk management. The problem of "adverse selection", that is to say the danger that good credit risks will gather at banks applying advanced methods, because there the loan conditions take accurate account of risks and are therefore comparatively favorable, while bad risks concentrate at banks with simpler approaches, will be countered by the EBK using instruments from the second pillar. As seen today, it seems unlikely that Basel II could in Switzerland lead to a rationing of loans to small and medium-size companies.

Summary

The stability of the financial system is of outstanding importance throughout the whole economy. Banking regulation, as an important guarantor of this, must therefore constantly adapt to the current circumstances and developments of the institutes subject to supervision, and keep up with them. In doing so it must always set the costs of regulation against the corresponding benefits. This guarantees that a healthy sense of proportion is maintained in implementing the rules. In this spirit Basel II is not a final state, but a logical and above all important next step on the road. ○

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