1.0 The Origins of Basel II

The Basel Accord, also known as Basel I is a very basic model used for calculating a bank's capital requirement given the types of risks faced and the variations in the riskiness of the bank's assets (Hunt & Terry, 2008). Basel was an attempt to reduce the number of bank failures by tying a bank's Capital Adequacy Ratio to the risk of the loans it makes (Nath, 2006). Basel I refers to round deliberations by central bankers from around the world, and in the year 1988, a set of minimal capital requirements for banks were published by the Basel Committee (BCBS) in Basel, Switzerland. The 1998 Basel Accord was first enforced by law in the Group of Ten (G-10) countries in 1992 (Cornford, 2004).

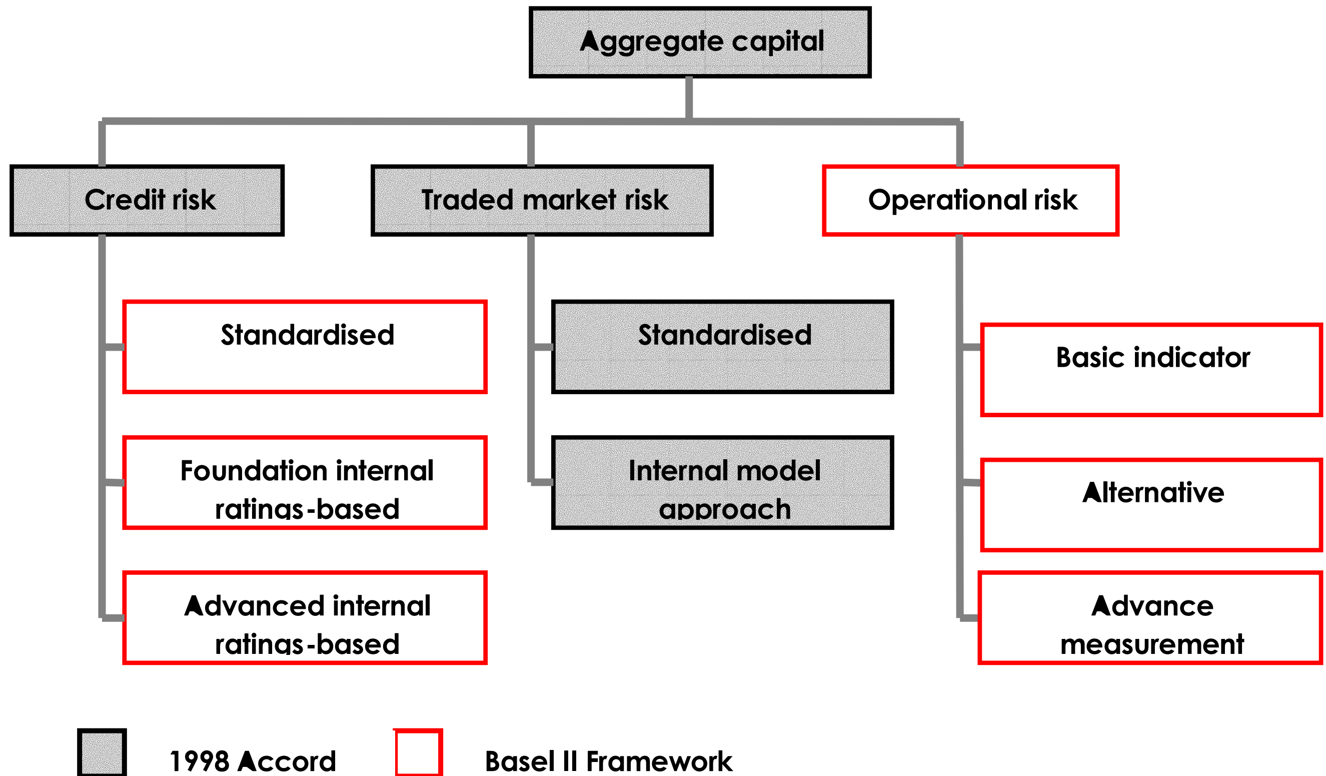
The Basel Accord was widely accepted and in response to this, BCBS came up with the initiation of work on Basel II As part of the regulatory consensus on the direction of work on Basel II, the BCBS decided to pick up the major banks' gauntlet and to include in the new agreement rules which would challenge banks to upgrade their rating systems to the point at which they could be accepted as an integral part of setting the weights for credit risk (Cornford, 2004). In the year 1998, a more comprehensive set of guidelines, known as Basel II was proposed, which uses much more sophisticated risk classifications (Nath, 2006). Therefore, Basel I is now widely viewed as outmoded, while the Basel II is currently still in the process of implementation by several countries.

2.0 The Original Intentions of Basel II

According to Cornford (2004), the initial purpose of Basel II, which was published in June 2004, was to create an international standard that banking regulators can use when creating regulations on how much capital banks need to put aside to guard against the types of financial and operational risks banks face. Advocates of Basel II believe that such an international standard can help protect the international financial system from the types of problems that might arise should a major bank or a series of banks collapse (Cornford, 2004). In practice, Basel II attempts to accomplish this by setting up rigorous risk and capital management requirements designed to ensure that a bank holds capital reserves appropriate to the risk the bank exposes itself to through its lending and investment practices. Generally speaking, these rules mean that the greater risk to which the bank is exposed, the greater the amount of capital the bank needs to hold to safeguard its solvency and overall economic stability (Basel Committee on Bank Supervision, 2003).

However, according to Nath (2006), in the latest and final version of Basel II, the intentions are to ensure that the capital allocation is more risk sensitive. Besides, it also aims at separating operational risks from credit risk, but at the same time quantifying both. The Basel II is also attempting to align economic and regulatory capital more closely in order to reduce the scope for regulatory arbitrage.

Pillar one of Basel II compared with the Basel Accord



Source: APRA (2004), 'The Basel II Capital Framework in Australia', [illegible], 4th Quarter,

The difference between Basel I and Basel II is that Basel I only involved parts from each of these pillars. For example, as seen in the figure above, the first pillar of Basel I only contained credit risk and traded market risk which were dealt with in a simpler manner compared to Basel II, wherelse, operational risk was not dealt with at all.

Basel II uses a "three pillars" concept. The first pillar represents minimum capital requirements and addressing risks. It deals with maintenance of regulatory capital calculated for three major components of risk that a bank faces, which are credit risk, operational risk and market risk. While the second pillar is based on supervisory review, it deals with the regulatory response to the first pillar, provides a framework that deals with residual risks a bank may face, which gives banks the power to review their risk management system. The third is on market discipline, and it increrases the disclosures that banks have to make. According to Lopez (2003), it is designed to allow the market to have a better picture of the overall risk position of a bank and to allow counterparties of the bank to price and deal appropriately. The three pillars intention is to promote greater stability in the financial system.

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The Advantages of the Implementation of Basel II and its Suitability in Different Banking Systems

According to the European Commission, instead of the Basel I 'one-size-fits-all' approach of fixing all banks' total capital so as it would never decline to a level of less than 8% of risk-weighted assets, the Basel II framework has the option of three different approaches. This allows financial institutions to select the approach of capital adequacy that is most suited to their banking systems. The three different approaches include simple, intermediate or advanced (Out-Law News, 2004). By allowing financial institutions to choose the most appropriate approach of fixing their capital adequacy requirements (CARs), Basel II provides them with a more efficient, safe and competitive advantage, which in turn benefits users of financial information, investors, corporations and the economy. In other words, the option of three different approaches will enable the setting of a more precise CAR for the financing of small and medium-sized enterprises as well as provide preferential treatment for some types of risk capital (EU, 2005). Approaches that are specifically designed for capital requirements for financing small and medium-sized institutions would mean lower capital requirements for lending to such institutions and preferential treatment for certain types of venture capital. Additionally, Basel II recognises the lower risks associated with retail lending (for general purposes and house purchasing) to individuals by introducing lower capital requirements for such lending (Out-Law News, 2004).

Under Pillar 1 of Basel II, there are three approaches in handling credit risk. They are the Standardized Approach, the Foundation Internal Rating Based Approach (IRB) and the Advanced Internal Rating Based Approach (A-IRB). Both the intermediate and advanced approaches require a minimum of two years' prior history of credit risks and defaults before they can be applied. These two approaches also require the ongoing collection of risk and default data to validate the risk weighting used (Unisys, 2005). Large international/ sophisticated banks will be at an advantage in using the intermediary and advanced approaches as they already have a wide history of credit risks and defaults. In addition, once a bank applies the IRB approach in a country or business line, the approach must also be implemented across all significant portfolios and business lines as quickly as possible. This can be done much easier by large international banks relative to smaller banks as they have a greater incentive to apply the IRB approach for core markets (Unisys, 2005). Compared to commercial or local banks, large international banks (such as the Reserve Bank of Australia,

RBA) are more acquainted with the use of sophisticated mathematic models in representing their market and credit risks, the pricing of credits as a function of risks associated to their individual corporate clients, as well as operational risk modelling.

Furthermore, banks in emerging markets can take advantage of Basel II's principle-based guideline for sound risk management, extracted from the best banking practice, to improve their operations of risk management (Nijathaworn, 2007). Also, from the viewpoint of financial information, the application of the International Financial Reporting Standards (IFRS) and International Accounting Standard (IAS) 39 required with the implementation of Basel II differs amongst commercial banks and foreign banks. Foreign bank branches, especially, European banks, are better equipped in implementing the IFRS and IAS 39 as they are more familiar with the new accounting principles. This is because they obtain supporting systems and knowledge from their head offices (Nijathaworn, 2007).

In addition, Basel II's menu approach provides supervisors and banking systems in emerging markets with options that make its basic standards more readily accessible to various kinds of financial organizations and their specific activities. Basel II's three-pillar approach supplies an efficient frontier of policy objectives relevant to banks in any country by emphasizing the need for banks to assess their risks, the need for supervisors to evaluate those assessments and the need for transparency to promote greater market discipline (Kania, 2006)

(635 words)

Challenges in the Implementation of Basel II

Although there are praises for Basel II, it is not without its detractors. Basel II has come under fire for being unfair to smaller banks and banks in developing countries. Small banks are to adopt the standardised approach while larger banks will adopt the advanced internal-ratings based approach. Under the advanced approach, larger banks can have lower capital requirements, casting smaller banks such as community banks and smaller retail banks at a disadvantage (Adler, 2004). Critics have denounced Basel II for not encouraging healthy competition by having an uneven playing field for banks. In order to meet larger capital requirements, banks that adopt the standardised approach will have to reduce lending or raise more securities (Coy, 2008). Reduced lending will have a disastrous effect on the competitiveness of smaller banks and also on emerging markets where most banks are under the standardized approach. Higher capital requirements will have detrimental effects on emerging economies where financial activity is heavily dependent on commercial banks as there will be a risk of a credit crunch should banks cut down on loans. (Aziz, 2008)

Banks in developing countries have been reluctant to implement Basel II for fears of losing out to more established and larger international banks. Basel II has been criticized for being more geared towards the needs of banks in developed countries (Gimbel, 2005). Most Asian banks will find it more challenging to adopt the advanced approach than their international counterparts due to high cost of implementing advanced data collection systems and the lack of human capital with the necessary expertise and experience to manage new risk assessment methods. (Gimbel, 2005). Moreover, most banks do not have enough reliable and historical data needed to put the new risk management system in place ("Asia's Erratic Approach to Basel II", 2007). Therefore, most banks will have to rely on the standardized approach for now, which makes it harder to compete with large international rivals who are at ease with the advanced approach.

The lack of regulatory harmony among different countries also poses problems for financial institutions with subsidiaries in different countries. Different countries may have different versions of banking supervision and are allowed to set their own timetable in implementing Basel II (Imeson, 2006). Problems arise for banks that operate across borders when the home and host country have different Basel II versions and are at different stages of implementing it (Imeson, 2006). Banks will be subjected to different sets of regulations, with the main bank being under the home country's regulator while their subsidiaries will be

subjected to the host country regulators. Inconsistencies in regulation and the timing of implementing Basel II will render Basel II less effective as banks struggle with administrative headaches to deal with discrepancies such as different capital allocations in different jurisdictions (Imeson, 2006).

Under the advanced internal ratings approach, banks are allowed to use their own credit-risk models to assess risk and determine the amount of capital reserves (Hunt & Terry, 2008). Some parties have raised concerns that this will encourage banks to underestimate their credit risk in order to have lower capital reserves and to increase their return on equity (Benink & Kaufmann, 2008). Furthermore, banks can manipulate capital levels to improve their performance (Lafalce, 2005). Such approaches will mislead investors and may worsen the ongoing financial crisis as banks strive to have lower reserves when they should be increasing their capital requirements to prepare against further crisis.

(541 words).