Basel Accord II

RENAISSANCE IN RISK MANAGEMENT IN BANKING

The Basel Committee of Banking Supervision was constituted by the Central Bank Governors of Group – 10 - countries in the year 1975 primarily with the objective of undertaking eclectic analysis of the working of Banks in various countries and to offer hand-made remedies on an on going basis. To begin with its mammoth task Basel Committee came out with its first document on International Convergence of capital Measurement and Capital Standards in July 1988 as a harbinger to tone-up the safety and stability of Commercial Banking in particular world over.

Over time Basel Committee issued number of operational directives enabling Central Banking Authorities to consider and to implement the prescriptions as may be possible in their efforts of fine tuning its overall objectives mentioned above.

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Basel Accord – II was since after strenuous efforts of Basel Committee over five full years from June 1995, born in May 2004 and the revised document-containing framework on International Convergence of Capital Measurement and Capital Standards was released over the Internet in June 2004. The rationale behind this accord alongside the existence of earlier Accord (Accord-I) lies with the efforts of the committee to develop a revised framework for further strengthening the soundness and stability of International Banking System with provision for sufficient consistency and further to ensure that capital adequacy regulation does not impose any element of competitive inequality among Internationally active Banks.

Basel Accord – II: Three dimensional approach

One of the most distinguishing features of the current Accord is with respect to its three dimensional approach. Firstly Risk segments in Commercial Banking have been classified into three distinct categories Viz. Credit Risk, Market Risk and Operational Risk. Further another direction of the Accord is with respect of development of three Pillars (Viz. Minimum Capital, Supervisory Review Process and Market Discipline)

An initial analysis of the Accord will reflect that for professional management of all the three Risk Categories as above the element of capital requirements, regulatory review process, transparency and disclosures by way of market discipline form the basic super structure of a healthy, sound consistent and proactive Risk Management System in business entities.

Does it therefore mean that if the prescriptions of Basel Committee in the form of three pillar remedy if administered by the concerned authorities in respective

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countries would have the effect of eliminating/reducing the 'virus' of various Risks facing an organisation? It is a fact that as in human anatomical system the efficacy of a prescribed medicine is judged only when the disease is rightly diagnosed. The Risk doctor in the Central Banking Authorities of respective countries would, therefore, have to consider various tenets of Basel – II on case by case basis in their banking environment and not certainly as a plain pill in the three pillar usage. This is precisely the reason why Basel Committee in their wisdom has offered a lot of leeway to the implementing authorities so that a smooth transition from prevailing Risk System to the revised framework is possible, without dislocating or distorting existing functioning of the banking system.

Let us have a closer view of Risk Categories and Risk Pillars: -

3 categories of Risk

Risk in business environment may take any form and depth and it is difficult to foresee only a particular category of risk prevailing in any environment. While one may conceive a wide range of risks (Some international writers have jokingly identified "Phantom Risk"). For the sake administration of Risk Management System across business entities, Commercial Banking in particular, the committee has clubbed various risk situations in three categories: -

- Credit Risk
- Market Risk
- Operational Risk

In simple terms Credit Risk emanates owning to default of the counter party in respect of funded and non-funded exposure including treasury operations.

Market Risk arises on change of market variable in the form of liquidity constraints, prices, exchange rates etc.

Operational Risk, on the other hand, is an omnibus group and in the strict sense it contains the ingredients of Credit Risk and Market Risk in as much as human failure – intentional and unintentional, which is a part of Operational Risk, may exist both in credit transaction and market related transaction. However, Basel Committee has now come out with a consensus definition of Operational Risk stated here under in an attempt to avoid intermingling of Operational Risk with aforesaid two categories of Risk: -

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"The Risk of loss resulting from inadequate or failed internal process, people and systems or from external events". (This definition includes Legal Risk but excludes Strategic and Reputational Risk)

Internationally the significance of Credit Risk, Market Risk and Operational Risk in banking business is not uniform and varies considerably in view of size, complexity, Risk Philosophy and Risk Appetite of each organisation. Some experts consider as a very rough guide the intensity in between these risks to the extent as under in commercial banking: -

Credit Risk – 95%
Market Risk- 4%
Operational Risk- 1%

The above percentage is only indicative and as stated above may widely vary in different banking environment and again Bank to Bank position. However, what is important is that in Commercial Banking highest amount of focus is on Credit Risk Management followed by Market Risk and finally

by Operational Risk.

Notwithstanding this, Risk Management architecture and implementation process to manage the above Risk on a consistent basis is the crying need of the millennium in the Risk Management System. Here comes the sanctity and validity of the three-pillar approach enunciated by Basel -II Committee.

Three Pillar Approach

Pillar of a building / house - how strong - weak determines its safety and longevity. Same is the case with Risk Management System. Basel Committee has clearly identified three pillars as under so that they serve as positive strength of the Risk Management System in an organisation: -

Pillar I - Minimum Capital Requirements

Pillar-II - Supervisory Review Process

Pillar-III - Market Discipline

The prescription of minimum capital requirement is nothing new. Basel Accord- I since 1988 has been in operation requiring Banks to maintain minimum 8% Capital Adequacy Ratio (in India presently minimum prescribed is 1% more i.e. 9%)

This minimum capital otherwise known as regulatory capital acts as sort of insurance for the interest of the depositors. Basel Committee, while initially suggesting aforesaid regulatory capital towards Credit Risk, subsequently in 1996 covered Market Risk transactions. Now in the recent Accord (Accord-II) regulatory capital requirement for Operational Risk has also been prescribed. In other words now Banks will have to maintain separate regulatory capital for Credit Risk, Market Risk and Operational Risk.

The methodology of computation of capital under Basel Accord –II covers a simple system as well as a very advanced statistical based system. It is left to Regulatory Authorities of the respective countries to decide on the modalities they would like to adopt, subject to, the precondition that minimum - 8%- capital adequacy must be maintained for Credit Risk and Market Risk and in addition suitable capital ratio to be maintained

for Operational Risk segment.

Indian Banking System has, by now, matured itself sufficiently to face the global competition in the area of capital regulation of Basel Committee. The computation aspect of Capital adequacy for Credit Risk and Market Risk has been strengthened. RBI has recently issued a revised guideline for computation of capital for Market Risk in consonance with Basel Committee recommendations. The need for capital adequacy for Credit Risk and Market Risk is fairly understood by the existing system but the emerging requirement of capital regulation for Operational Risk will be altogether be a new cup of tea.

Second pillar of Basel Committee i.e. Supervisory review Process is definitely enlightened version of various regulatory systems and procedure across the countries. But the primary focus under Basel – II from supervisory angle will be towards sound capital assessment, assessment of risks, internal control as well as assessment of adequacy of Risk components and compliance standard of the various Banks. This therefore calls for necessary action by Central Banks of the respective countries in order that the identified risk categories are properly assessed and due safeguards initiated on an on going basis, thereby ensuing that any sudden hiccups do not cause serious impact in the system.

Third and Final pillar goes under the nomenclature " Market Discipline". In simple terms market discipline demands that operating units should continue its operations with transparency and disclosure to the Public Proprietary and confidential information which may affect Bank's business from the angle of competition or in terms of legal requirements of a particular country would not be required to be disclosed but where possible "general information" on such matters may be disclosed. This will mean that a Bank or an organisation is fully market discipline oriented.

The nitty-gritty of each Risk category and each pillar stated above is not intended to be covered in this endeavour since they demand an exhaustive treatment and analysis, which is not the focus here.

Basic Issues on implementation in Indian Context

- Basel II Accord is applicable for Internationally Active banks. No specific criteria of identification of such Banks has been laid down. It is

understood that USA has decided to identify their first –10- banks as Internationally Active Banks.

As per Press report in India one/ two Banks may at best qualify. Will it then mean that remaining about –100- banks would not be required to be covered under the revised framework?

- The guidelines as framed are quite extensive and presuppose a compact techno-savvy environment and sound MIS in Banks. At the prevailing pace of technological progress and data base creation, it may not be possible to implement a major portion of package under Basel II within the outer time limit of year 2006, looking to the varied size of Commercial Banking operations in India.
- Staff Skill Development in Banks to handle the various new issues / technicalities in Risk Management on an ongoing basis remains a focus area. With the exodus of large number of skilled personnel from Public Sector Banks under VRS, energetic steps need be taken to upgrade skill of existing personnel and also to bring in specialist personnel from open market on appropriate pay package.
- Risk culture on enterprise basis has to be developed with more active involvement of Top Executives. Business proposals of significant value must pass through Risk Management criteria.
- To take care of newly developed Operational Risk parameters Bank would to have to relook to their existing guidelines / instructions on operational areas. Their Manual of Instructions / Book of Instructions may have to be substantially updated.
- Clear-cut Credit Risk Policy, Market Risk Policy and Operational Risk Policy must be developed with necessary flexibility of their operations and provision of updation preferably on annual basis.
- Quarterly Risk Management meetings of Zonal / Regional Heads must take place with TOP Officials of Corporate Office so as to monitor Risk Management implications of the entire Bank.
- RBI also in turn should organise similar quarterly Risk Management meetings with each Bank's Top Officials so that their supervision Review Process role under Pillar III is discharged smoothly.

One of the most distinguishing features of the current Basel Accord is with respect to its three dimensional approach. Firstly Risk segments in Commercial Banking have been classified into three distinct categories — Credit Risk, Market Risk and Operational Risk.

Some Conflicting Areas

- Default of counterparties on payment of interest / instalment generates Credit Risk. Interest rate charged comes under Market Risk Category.

If arising out of upward revision of rate of interest in a borrowal account from time to time due to market volatility, there is any default – which risk category it will come under: Credit Risk or Market Risk?

- Failure of people taking usual precautions falls under Operational risk. Suppose if due to defective/inadequate documentation a Bank is not in a position to recover its loan – which category of Risk will apply – Credit Risk or Operational Risk?

Conclusion

New Basel II Accord guidelines cannot be implemented in Indian Banking in toto. Hence it is expected RBI will analyse each component of the guidelines as to its viability of implementation in Indian Banking environment while at the sametime taking care to ensure that improved Risk Management framework adds further vigour and strength to Indian Banking so as to face International banking Competition smoothly.

It may be appropriate if the Regulatory Authorities adopt simplified version to begin with e.g. Standardised Approach for Risk Rating and consequential computation of Regulatory Capital requirements for Credit Risk. Similarly for capital charge for Market Risk and Operational Risk, will it be a funny idea to say that in place of 8% minimum capital requirements under Basel Accord II for Credit Risk, Market Risk and Operational Risk why not RBI straightway without going into complexities for the time being increase Regulatory Capital requirements to 10% -11% (from 9% at present in India) w.e.f. 31.03.05 to take care of all the three risks viz Credit, Market and Operational Risk as a preparatory step to be fully Basel II compliant over a period of time. As most of the Banks are maintaining high level of Capital Adequacy Ratio, this may not be a handicap and at the same time International Authorities may view such an initiative favourably. ■