Basel II – Achievements and Challenges

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1 The Goals: Risk Sensitivity and Qualitative Supervision

In late June 2004, the Basel Committee on Banking Supervision approved and published a document entitled "International Convergence of Capital Measurement and Capital Standards: A revised Framework", better known as the "Basel II framework". The publication of this document marked the final milestone of a process that was over five years in the making. The fundamental improvements over the Basel I Accord of 1988 help explain this relatively long time span. The main objectives of the new framework, stated by the Basel Committee in its June 1999 Consultative Paper, were the following:

- To promote safety and soundness in the financial system.
- To enhance competitive equality.
- To adopt a more comprehensive approach to addressing risks.
- To continue to focus on internationally active banks, although the new framework's principles should also be applicable to banks of varying levels of complexity and sophistication.

Whereas the first two goals pick up where the Basel I Accord left off, the last two represent important advancements. The desire to develop a more comprehensive approach was a direct consequence of recognizing that the current regime lacks risk sensitivity in its minimum capital requirements and encourages market participants to exploit mechanisms of regulatory capital arbitrage. Capital arbitrage occurs if regulatory capital requirements do not reflect the true risk of a certain business transaction and set an incentive to pursue this transaction instead of another which is less risky but more costly in terms of regulatory capital. Mounting concerns about insufficient risk sensitivity were spurred by the creation of new instruments, an example being the triumphant success of the market for securitizations. Furthermore, advances in risk management, in particular for credit risk, which occurred in the 1990s drove a widening wedge between regulatory capital, still based on the rigid risk weight scheme of Basel I, and the bank's own internal economic capital.

* The views expressed herein are my own and do not necessarily reflect those of the Deutsche Bundesbank.

The new framework, however, goes beyond improving the risk sensitivity of the regulatory capital calculation. It was planned from the beginning to rest on three pillars of which the minimum capital requirements are only the first.

The second pillar comprises the supervisory review process and has at its core four principles:

1. Banks should have an adequate internal capital assessment process.
2. This process should be reviewed by supervisors, who should take appropriate action if necessary.
3. Banks should be expected to operate above the minimum capital ratios.
4. Supervisors should intervene at an early stage to prevent capital from falling below the minimum levels.

The third pillar aims at strengthening market discipline through requiring the disclosure of important information about banks' capital and their riskiness.

In spite of the fundamental advancements in pillar 1, it has been argued that pillar 2 actually constitutes the most important innovation of Basel II. The reason is that it marks the turning point in the process of moving away from calculating regulatory capital as a mechanical exercise toward a qualitatively oriented supervisory regime that does more justice to the complexity and sophistication of a bank's operations.

Pillar 1 offers banks a choice between three different approaches. The revised standardized approach inherits many elements of the static risk weight scheme of Basel I, but also brings important innovations, for example, in the recognition of credit risk mitigation techniques and a previously not existing capital charge for operational risk. The Internal Ratings Based (IRB) approach is more risk sensitive and comes in two flavors, the Foundation IRB (FIRB) and the Advanced IRB (AIRB) approach. Both approaches mainly differ in the set of risk components which need to be estimated by the bank instead of being defined in the Basel II framework. In the following we focus only on the two IRB approaches.

The differentiation between the three approaches in pillar 1 reflects the idea of an evolutionary framework. Banks should select their approach in accordance with the complexity of their business operations and the sophistication of their internal risk assessment processes and, when appropriate, move to a more risk sensitive approach. Therefore, Basel II is less prescriptive and much more flexible than the previous regime.

In the following, the focus is on the first pillar, in which the capital requirements for banks' credit portfolios serve as an example of the advancements due to the Basel II framework as well as the challenges that remain.

2 The Achievements: Model-Based Risk Weight Functions

Model-based risk weight functions for a bank's credit portfolio which are a key characteristic of both IRB approaches are a fundamental change from Basel I. In the current regulatory regime, differences in credit risk are captured by risk weights dependent on a broad categorization of borrowers, e.g. OECD banks or residential mortgages. More specifically, the risk weight functions for credit risk in the new