Basel II (and III) – Key Regulatory Solvency-related Characteristics

1. The Basel Committee on Banking Supervision adopted in 2004 what is commonly referred to as Basel II, which focuses on risk weights for assets held by banks. Relatively broad categories of assets under prior guidance are replaced with greater granularity that allows for lower capital charges on the bulk of banking assets while increasing capital charges on other assets that constitute higher risk but represent only a small percentage of the total. Certain other assets and exposures could also be treated conservatively through an outright deduction from capital.
2. Banks are expected to maintain capital equal to 8% of total assets. What counts as capital, and how different assets are weighted to add up to the numerator and denominator is the key. Subject to some proposed changes under Basel III, bank capital is divided into Tier 1 and Tier 2. Tier 1 consists of permanent capital such as common stock and noncumulative perpetual preferred. Tier 2 has certain mandatory features, such as cumulative preferred, hybrids and subordinated debt.
3. There are three approaches for determining risk weights. The standardized approach assigns risk weights that are largely a function of external ratings. While capital requirements were expected to decline modestly under the standardized approach, a significantly larger decrease is expected to the extent that banks could qualify to use their own internal ratings. Risk weights under the standardized approach reflect broad market experience. Banks that qualify their internal ratings (IRB) models could benefit from lower risk weights based on their own experience. There are two levels for IRB, the foundation approach and the advanced approach. The advanced approach relies on the internal model for assessing all of the different components of credit risk, subject to some minimum standards. The foundation approach is a circumscribed version, which allows banks to use their own probability of default but must use supervisory estimates for the remaining components, such as loss given default. The requirements for qualifying for IRB are significant. The intent clearly is to divide the universe between those banks with what supervisors can agree to as highly sophisticated investment operations from those that are more basic. There are very detailed minimum operating requirements for qualification and very specific supervisory guidelines to be met before even being considered.
4. There is also an additional component addressing operational risk. Operation risk is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events.
5. At this time, U.S. banking regulators have decided to adopt Basel II requirements for large banks and those with significant international operations. The advanced internal ratings approach would be applicable for these entities. Smaller banks could make the decision to opt into Basel II, but only using the standardized approach.
6. Besides risk weights that are used in the calculation of capital requirements, Basel II also established guidelines for two other "pillars" – the supervisory review process and market discipline.
7. Basel III focuses on what counts as capital, deducting a number of items such as mortgage servicing rights and minority interests. Secondly, it applies simple universal language for a leverage ratio and includes undrawn lines of credit, etc. The full notional amount of CDS is counted, with no netting. Third, it applies a liquidity ratio, similar to an asset-liability management requirement. Preliminary indications are that the second point, which forces banks to include a significant amount of, previously off-balance obligations is problematic.