The Basel Games

As the 2012 summer Olympic Games descends upon London, England, national pride and attention grows around the world in anticipation of an elite few chasing international glory. Organization of such an international affair takes a great deal of leadership and planning. In 1894, Baron Pierre de Coubertin founded the International Olympic Committee. The IOC is the governing body of the Olympics and has since developed the Olympic Charter that defines its structure and actions. A similar comparison can be made in regards to the development of The Basel Accords. Established in 1974, The Basel Committee on Banking Supervision, comprised of central bankers from around the world, has taken a similar role as the IOC, but its objective "is to enhance understanding of key supervisory issues and improve the quality of banking supervision worldwide." The elite participants of "The Basel Games" include banks with international presence. The Basel Accords themselves would be considered the Olympic Charter and its purpose was to create a consistent set of minimum capital requirements for banks to meet obligations and absorb unexpected losses. Although the BCBS does not have the power to enforce the accords, many countries have adopted their recommendations on banking regulations into law. To date there have been three accords developed.

The Bronze Metal

Our second runner up is Basel I, also known as the 1988 Basel Accord, which culminated as the result of the liquidation of the Herstatt Bank in 1974. With the development of technology and risk management techniques Basel I is considered obsolete by today's standards. It did create a foundation for regulating systemic risk though. The primary objective was to curb credit risk for international banks. The Cooke-Ratio came to fruition at this time setting up the minimum required capital as a fixed percentage of assets weighted according to their nature. The Cooke-Ratio suggested that regulatory capital should be 8% of the risk weighted assets in order to handle unexpected losses. The nature of the assets is classified into five groups based on their liquidity and debtor's credit rating. The Cooke-Ratio was advantageous in its simplicity, but Basel I had quite a few drawbacks. For example, the inability to incorporate market risk and only approximate operational risk into the calculation of the risk weighted assets and the fact that the Cooke-Ratio applies to all credit risk portfolios no matter how diverse it is. Basel I proved to be a great starting point for evaluating risk, but in June 2004 The Basel Committee introduced Basel II.

The Silver Metal

Pillar I

The New Basel Accord or Basel II began implementation in 2007 and takes home second place. Like the ancient pillars in Greece, the New Basel Accord is comprised of three pillars. The first pillar's objective is to calculate the required 8% regulatory capital against their total risk weighted assets. What is important to note is that the Basel Committee incorporated market risk using value at risk and operational risk equal to a fixed percentage. Each major risk factor

(credit, market, and operational) has a standardized approach and one or more advanced approaches. The standardized approaches use risk weights provided by the Basel Committee. Simplicity draws the most appeal to this approach.

Advanced approaches allow international banks to internally calculate their risk weighted assets in an effort to be as precise as possible when holding the minimum capital charge. There are two advanced approaches when calculating credit risk, Foundation Internal Ratings Base (IRB) and Advanced IRB. Four elements are needed to calculate credit risk: probability of default, exposure at default, loss given default, and effective maturity. Under Foundation IRB, the bank can only calculate PD and the values for the other three are provided by the supervisor. Under the Advanced approach the bank has the freedom to calculate all four values. Market risk has only one advanced approach, the Internal Models Approach. In this approach, value at risk is calculated using a 10 day horizon, 99% confidence interval, and one year of data. Stress testing is then performed to determine the stability of the assets. The final risk, operational risk, has two advanced approaches: the Advanced Measurement Approach and Internal Measurement Approach. In these cases internal and external data and scenario analysis are used. Like credit risk, the second advanced approach to operational risk is allowed to be used only at the discretion of regulators.

Pillar II

The second pillar serves as the supervisory review process. The goal here is to ensure that banks are effectively maintaining the required capital needs based on the amount of risk they take on. The Basel Committee came up with four key principles for supervisory review. The first is to evaluate the bank's process for assessing their risk and capital charge, management oversight and internal control, and reporting. The second is to assess the bank's strategy for maintaining adequate capital levels. The third is the supervisor's response, giving them the ability to hold banks to over the minimum capital required. Finally, supervisors have the ability to intervene to prevent banks from falling below the minimum levels.

Pillar III

Pillar III is a compliment to Pillars I and II by ensuring market discipline. The way this is achieved is by deploying a set of disclosure requirements. For example, banks have to disclose their capital structure, strategies and processes, and the three areas of risk they are assessing. This creates a sense of transparency of the banks. By reporting on their exposures, investors will also use market discipline when investing.

The Gold Medal

The winner resulting from the deliberations of the Basel Committee is Basel III. Essentially, Basel III is a set of amendments to Basel II in response to the 2008 global financial crisis. The objective here is to

increase capital requirements and incorporate bank leverage and liquidity when calculating risk. Although, the 8% capital requirement has not changed, the structure of the capital Tiers has changed. Tier 1 capital, capital that is more liquid than Tier 2, needs to constitute 6% of the capital requirement and the remaining 2% can be Tier 2 capital. Tier 3 capital will be removed completely. Basel II only required that Tier 2 assets not exceed the amount of Tier 1. Capital buffers are also proposed in Basel III. In this case a 2.5% increase in the minimum capital charge will be attributed to conservatism and another 2.5% increase for countercyclical times. It has also been proposed that "systemically important" banks will be subject to even higher capital requirements. A leverage ratio, a liquidity coverage ratio, and net stable funding ratio will also be introduced in an effort to scrutinize a bank's ability to meet its financial obligations. Many other changes have been proposed. For a list of all the changes please refer to: Basel 3: higher capital requirements, liquidity rules, and transitional arrangements.

The Basel Accords, on top of the three-tiered rostrum in Basel, Switzerland, stand proud as the answers to global systemic risk for now. With an ever changing global economy it would be premature to announce the closing ceremonies, so onward the games continue. The bronze medalist, Basel I, needs to be recognized for contributions to the foundation of analyzing and regulating global risk. Where Basel I fell short, the New Accord took the lead and won the silver medal with its incorporation of market and operational risk. Finally, reigning above all is Basel III; which further builds upon Basel II and takes the gold medal by restructuring the capital charge and incorporating bank leverage and liquidity into risk assessment.