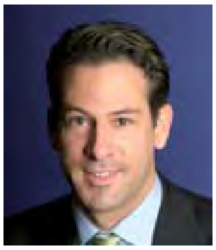
Act now

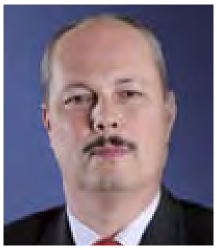
The implications of Basel II revisions

Public confidence in banks has been badly damaged by the financial crisis. In its wake regulators across the world are working intensively to fashion a new framework for the financial services industry. The Financial Stability Forum is emphasizing the need for better risk and capital management. The Basel Committee is pressing ahead with revisions to the current Accord. Details are still under discussion. But as Thilo Kasprowicz and Klaus Ott claim, banks do not necessarily have the luxury of being able to wait until all the details are finalized.

When the current version of the Basel II Accord on capital adequacy and supervisory arrangements for banks was finalized in 2006, it was clear that further updates would follow. Even though many banks would have preferred a 'regulatory break' for a few years, detailed work under the aegis of the Basel Committee for Banking Supervision has been proceeding since, at the same time as the financial crisis has taken hold. The crisis has given major new impetus to the Basel process. Much of the debate at the G20 London summit, and the principles captured in the final communiqué, are feeding directly into updating Basel II. Conversely, the Basel Committee had already formulated proposals which, in some respects anticipated the G20 recommendations.



Thilo Kasprowicz



Klaus Ott

Current proposals

In January 2009, the Basel Committee published three discussion documents addressing critical areas where they believe the current framework needs to be strengthened:

- Enhancements to the overall framework: these are aimed at strengthening risk capture in Pillar 1 (minimum capital requirements); improving corporate governance and risk management and their supervisory oversight (Pillar 2); and improving disclosure of financial exposures to enhance market discipline and allow third parties to develop better understanding of a bank's overall risk profile (Pillar 3)
- Revisions to the market risk framework: the current framework fails to capture some key aspects of market risk and will be extended; in addition, stressed value-at-risk requirements will be imposed
- Incremental risk in the trading book: since the crisis began, a number of banks have suffered large losses from trading exposures, and the committee now proposes a supplementary incremental risk capital charge, based on estimates of potential losses

Consultation on these proposals has now ended, and there are clear target dates for complete implementation of the final conclusions: December 2009 for the overall framework enhancements, December 2010 for the market risk and incremental trading risk proposals. Since the revised Accord can only take legal effect when it is implemented into individual national jurisdictions, it is clear that these implementation timetables are extremely challenging.

Similarly, many banks should wake up to the potential implications now. In view of the high political pressure to act on the lessons learned from the crisis, the European Union and others are already anticipating expected changes. They are issuing detailed directives and draft regulations to strengthen banking supervision and improve risk and capital management of banks even before December 2009 or 2010. The luxury of waiting until proposals are finalized and regulations drafted in detail before planning how to comply is simply not available. Most aspects of the revised framework are already clear in principle. Banks should be urgently working out how to respond.

Strategies, methodology

A number of the new proposals will involve banks in reconsidering strategic decisions. For example, certain trading book products will attract higher capital charges, and some banks may need to review whether or not to continue in a particular securitization markets, whether as originator or investor. Changes to capital definitions will mean banks will have to review the issuance of some capital instruments, for example hybrids. Proposals on concentration risk will mean that credit portfolios will need to be scrutinized critically. Credit risk management teams should re-think their approach to active portfolio management.

Basel II will also involve changes to methodologies and valuations. Stress testing will almost certainly be imposed more widely, and potentially even applied to integrated underlying portfolios of securitizations. Liquidity regulations will involve the thorough identification of cash-flow positions for a wide range of products and the need for adequate processes for liquidity risk management. Furthermore, the calculation of risk-weighted assets for some products will change. Changes to disclosure, in particular for securitizations, trading book activities and the use of special purpose vehicles, are likely to accelerate the move to bring internal management reporting, external statutory and financial reporting according to IFRS into closer alignment: banks should be looking at consistent disclosure strategies, capital market communications and reporting policies.

Organization and IT

These proposals will have implications for many aspects of a bank's systems, processes and infrastructure. Some risk management and disclosure processes will need to be redesigned. Management information systems may have to be reconfigured to support new reporting procedures and facilitate enhanced communication with supervisory authorities. Banks should prepare for a much closer interaction with regulators, who will increasingly use their intervention to monitor business and risk strategies.

Underpinning process changes will be requirements to reconfigure and enhance IT architectures and system functionality. Databases supporting cash flow information, portfolio composition, disclosure and risk management will almost certainly need to be upgraded. Issues of skills, resources, staffing and cooperation across departments are likely to arise, both as banks undertake the necessary change programs, and as they comply with the new regime on a continuing basis.

Basel II has been a significant challenge for many banks to date. Even before the current framework has been fully implemented, new challenges are now apparent. It may be tempting to think that the proposed revisions to the framework are simply slight enhancements or variations. But the changes will impact even on banks using the less demanding Basel II standardized approaches. There is a lot to do and, as we have seen, the timetable is tight. Given the present political momentum for change, it is more likely that deadlines will be brought forward rather than be delayed. Analyzing the strategic impact of the new regulations and planning for implementation should not be delayed for further clarification.

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