# CAPITAL ADEQUACY

## 1988 BASLE ACCORD

For internationally active banks capital should equal at least 8% of risk weighted assets

**Capital:**

Tier 1 capital (equity and equity-like capital (perpetual non-cumulative preference shares and disclosed reserves (eg retained earnings)) - at least 4%

Tier 2 capital (hybrid (debt/equity) capital, loan loss reserves, subordinated debt) - maximum of 100% of Tier 1

**Risk Weightings**:

**0%** :(a) Cash; (b) Claims on central governments and central banks denominated in national currency and funded in that currency; (c) Other claims on OECD[1] central governments and central banks; (d) Claims collateralised by cash of OECD central-government securities or guaranteed by OECD central governments

**0, 10, 20 or 50%** (at national discretion): (a) Claims on domestic public-sector entities, excluding central government, and loans guaranteed by or collateralised by securities issued by such entities;

**20%** :(a) Claims on multilateral development banks and claims guaranteed by, or collateralised by securities issued by such banks; (b) Claims on banks incorporated in the OECD and claims guaranteed by OECD incorporated banks; (c) Claims on securities firms incorporated in the OECD subject to comparable supervisory and regulatory arrangements, including in particular risk-based capital requirements, and claims guaranteed by these securities firms; (d) Claims on banks incorporated in countries outside the OECD with a residual maturity of up to one year and claims with a residual maturity of up to one year guaranteed by banks incorporated in countries outside the OECD; (e) Claims on non-domestic OECD public-sector entities, excluding central government, and claims guaranteed by or collateralised by securities issued by such entities; (f) Cash items in process of collection

**50%** :(a) Loans fully secured by mortgage on residential property that is or will be occupied by the borrower or that is rented

**100%**: (a) Claims on the private sector (b) Claims on banks incorporated outside the OECD with a residual maturity of over one year; (c) Claims on central governments outside the OECD (unless denominated in national currency - and funded in that currency); (d) Claims on commercial companies owned by the public sector; (e) Premises, plant and equipment and other fixed assets; (f) Real estate and other investments (including non-consolidated investment participations in other companies); (g) Capital instruments issued by other banks (unless deducted from capital); (h) all other assets

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[1] Australia, Austria, Belgium, Canada, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Korea, Luxembourg, Mexico, Netherlands, New Zealand, Norway, Poland, Portugal, Slovak Republic, Spain, Sweden, Switzerland, Turkey, United Kingdom, United States.

**Contingent Liabilities**: credit conversion factors (which vary with the likelihood that the credit exposure will occur) are applied to determine credit equivalent amounts and these are then risk-weighted.

**Weaknesses of the Accord**:
● Risk weightings do not encourage banks to be careful about credit allocation, and are very rough
● The current rules favour OECD entities
● Valuation issues : "Minimum capital requirements for banks are of little use if the accounting conventions used to value banks' assets are flawed."[2]
● The rules may limit the amount of credit available, or at least affect who has access to credit
● The 1988 Accord only deals with credit risk (market risk has subsequently been addressed).
● Should financial innovation be driven by regulation rather than by customers' needs?
● There are doubts as to whether the Accord effectively harmonizes prudential rules because of the scope for interpretation of the requirements and possibilities of difference in application.

**Basel II**[3]
Basel II focuses on:
1. minimum capital requirements, which seek to refine the measurement framework set out in the 1988 Accord
2 supervisory review of an institution's capital adequacy and internal assessment process
3 market discipline through effective disclosure to encourage safe and sound banking practices

**1. Minimum Capital Requirements**

**Risk Weighting**
**A. Standardised Approach**
More flexible approach to risk weighting using credit ratings where available.
For example: Loans to corporates are risk weighted at 100% if unrated. If rated, the risk weighting varies from 20% to 150% depending on the rating . However: "At national discretion, supervisory authorities may permit banks to risk weight all corporate claims at 100% without regard to external ratings. Where this discretion is exercised by the supervisor, it must ensure that banks apply a single consistent approach, i.e. either to use ratings wherever available or not at all. To prevent "cherry-picking" of external ratings, banks should obtain supervisory approval before utilising this option to risk weight all corporate claims at 100%."

This might reduce credit for smaller businesses. The Accord provides for **regulatory retail**

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[2] Andrew Crockett

[3] http://www.bis.org/publ/bcbsca.htm .

**portfolios** which would be risk-weighted at 75% (except for past due loans). These portfolios would include loan exposures to individuals and small businesses where individual exposures are limited and where the regulator is satisfied that the diversification justifies the 75% risk weighting.

Loans secured on residential property are weighted at 35% (but supervisors can increase based on local conditions) and loans secured on commercial real estate are weighted at 100%.

National regulators are responsible for recognising credit rating agencies (in the Accord these are referred to as **external credit assessment institutions** (ECAI)) on the basis of criteria relating to: objectivity, independence, international access/transparency, disclosure, resources and credibility.

The New Accord encourages banks to use credit risk mitigation techniques (to a greater extent than the 1988 Accord did) provided that the techniques meet standards of legal certainty:

> All documentation used in collateralised transactions and for documenting on balance sheet netting, guarantees and credit derivatives must be binding on all parties and legally enforceable in all relevant jurisdictions. Banks must have conducted sufficient legal review to verify this and have a well founded legal basis to reach this conclusion, and undertake such further review as necessary to ensure continuing enforceability.

**B. Internal Ratings Based (IRB) Approach** (for the largest banks which supervisors allow to use this approach)
The New Accord says: "Subject to certain minimum conditions and disclosure requirements, banks that have received supervisory approval to use the IRB approach may rely on their own internal estimates of risk components in determining the capital requirement for a given exposure. The risk components include measures of the **probability of default (PD), loss given default (LGD), the exposure at default (EAD), and effective maturity (M)**. In some cases, banks may be required to use a supervisory value as opposed to an internal estimate for one or more of the risk components."

Banks are to identify their banking book exposures in a number of different categories of exposure with different risk characteristics (e.g. corporate exposures, sovereign exposures, bank exposures, retail exposures).

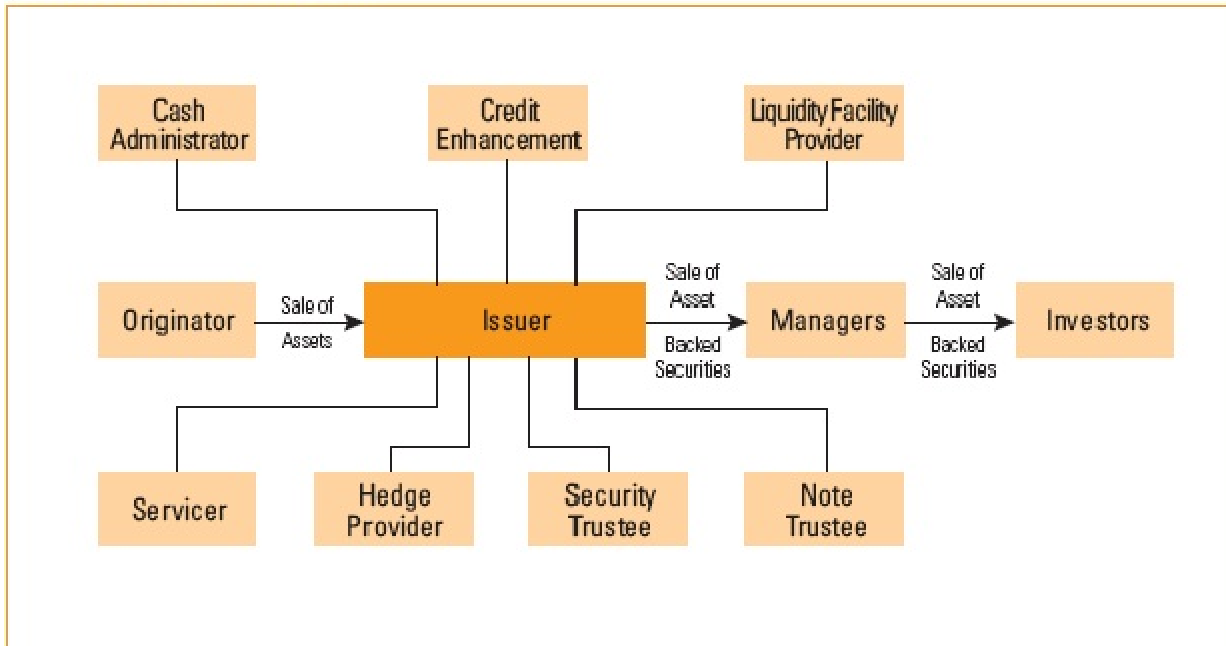
There are two versions of the IRB approach: the **Foundation** Approach and the **Advanced** Approach: "Under the foundation approach, as a general rule, banks provide their own estimates of PD and rely on supervisory estimates for other risk components. Under the advanced approach, banks provide more of their own estimates of PD, LGD and EAD, and their own calculation of M, subject to meeting minimum standards. For both the foundation and advanced approaches, banks must always use the risk-weight functions provided in this Framework for the purpose of deriving capital requirements."

**Operational Risk**
The New Accord requires banks to have capital in respect of **operational risk**: “Operational risk is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. This definition includes legal risk, but excludes strategic and reputational risk.”

**2 Supervisory Review**
This pillar emphasises that bank managements should develop internal capital assessment processes and that supervisors should assess how effectively they assess their capital needs. In addition, banks should think about risk management techniques other than capital. Under this pillar banks should particularly focus on aspects of risk that are not in fact or not entirely captured under the first pillar (eg credit concentration risk, business and strategic risk). Basle II says that supervisors should expect banks to operate with more than the minimum required amount of capital as a buffer.

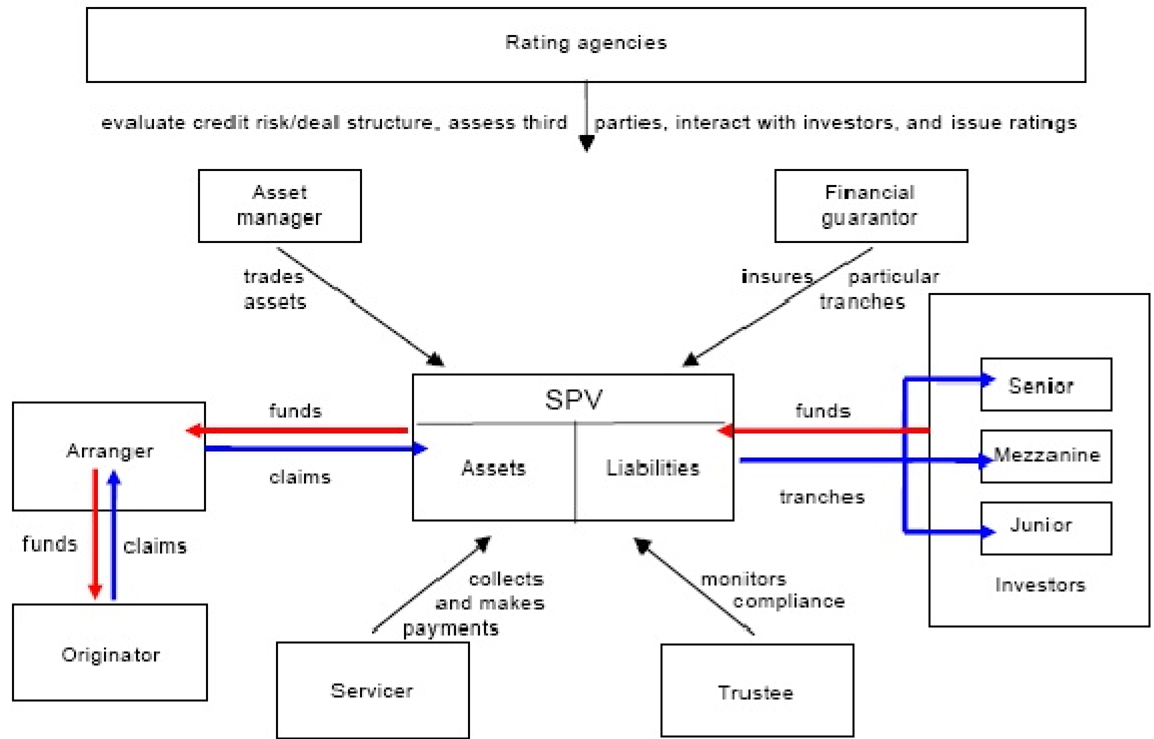
**3 Market Discipline**
The market discipline pillar will involve banks making detailed disclosures about the characteristics of their capital and how they assess capital adequacy in order to enable the market to assess the adequacy of their capital.

In January 2009 the Basel Committee proposed changes to address issues with respect to capital requirements and securitization, flaws in risk management practices and disclosure to enhance market discipline.




From: IFC, Securitization: Key Legal and Regulatory Issues, (2004)[4]

4 http://www.ifc.org/ifcext/eca.nsf/AttachmentsByTitle/Securitization1A%2B9-04/$FILE/Securitization1A%2B9-04.pdf




From: Ingo Fender, Janet Mitchell, Structured Finance: Complexity, Risk and the Use of Ratings, BIS Quarterly Review, June 2005[5]

[5] http://www.bis.org/publ/qtrpdf/r_qt0506f.pdf