

BASEL II ACCORD



EXECUTIVE SUMMARY

THE BASEL II ACCORD AND REGULATORY IMPACT ON THE U.S. FINANCIAL INDUSTRY

The Basel Committee was founded in 1974 by the Central Bank Governors from the Group of Ten Nations (G10). The underpinning of the Basel Committee is to develop international banking regulations and industry methodologies to mitigate risk from the global banking system. As an intergovernmental organization, the Basel Committee possesses no formal legislative authority and its conclusions have no legal and/or judicial proclamation. Nonetheless, the Basel Committee's recommendations and guidelines carry a global regulatory consensus, which are constantly adopted by the countries comprised of the G10 nations.

The collapse of United States banking markets in the 1980s, coupled by recent bank failures both in the United States and internationally, led the Basel Committee to conclude that financial institutions needed to reduce market risks, operational risks and increase capital reserves, and that the implementation of international banking regulations were necessary to accomplish these objectives. Additionally, another key factor for this rationale was directly due to the capital reserve requirements for many nations not being sensitive enough to abet unadvisable market risks, while fostering regulatory differences that put some banks at a competitive disadvantage than less-regulated financial institutions.

In January 2001, the Basel Committee issued the consultative Basel II proposal whereby establishing quantitative risk-guidelines and methodologies for financial institution's internal controls, regulatory audits, and market risk considerations. At present, the Basel II proposal will go into effect in 2005. The cornerstone of the Basel II proposal is the following accords and/or principles ("Pillars"), which relocates capital reserve requirements and risk mitigation methodologies for financial institutions:

- New reserve rules for maintaining adequate capital levels for ongoing market and operational risk ("Pillar I").
- The establishment of regulations for competitive equality for international financial institutions.
- The implementation of new regulatory audits and supervisory reviews ("Pillar II").
- The development of comprehensive disclosures for addressing various risks and market disciplines ("Pillar III").

The most prominent component in "Pillar I" is the establishment of new capital reserve requirements. This is directly due to risks varying greatly within each financial institution for computer failures, fraud, bond ratings, credit worthiness, market segment and so on... Under "Pillar I", financial institution assets will be segmented into six categories: corporate, project finance, sovereign, bank, retail and equity. In addition, risk assessments will now consider an entire banking organization and consolidated reporting for holding companies. The evaluation and risk measurement for these categories will be based on the following two principle options and mathematical formula:

The first principle option is a standardized method and the second principle option is an internal rating based (IRB) method that is comprised of two sub-methodologies (foundation & advanced). Under the first principle, banks will allocate a riskweight to each of its assets and off-balance-sheet items, and produce a sum of risk-weighted asset values for the appropriate six categories. A risk weight of 100% means that an exposure is included in the calculation of risk weighted assets at its full value, which translates into a capital charge equal to 8% of that value.

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Similarly, a risk weight of 20% results in a capital charge of 1.6% (i.e. one-fifth of 8%). Additionally, under the new standardized rules, the risk portfolio weights are to be refined by referencing a risk-rating table that will be provided by regulators.

Subject to strict methodological disclosure standards and the establishment of analytical procedures that account for characteristic differences for loan exposure risk types, the IRB principle permits financial institutions to use their internal estimates for determining creditworthiness of loan portfolios. Under the IRB method, a bank estimates each borrower's creditworthiness, and the results are translated into estimates of a potential future loss amount, which then forms the basis of a minimum capital reserve requirement. As stated previously, the IRB principle allows for two sub-methodologies, a foundation method and the advanced method for corporate, sovereign and bank exposures.

In the IRB foundation method, banks estimate the probability of a default associated with each borrower and implement regulatory risk standards. In the IRB advanced method, a bank with a sufficiently developed internal capital allocation process will be permitted to integrate other risk factors in their risk/capital evaluation process. The theory behind the IRB methods is to take advantage of regulators' and financial institutions' expertise in the determination of capital reserve requirements and risk mitigation. Under both IRB methods, the range of risk weights will be far more diverse than those in the standardized method, which should result in greater risk sensitivity.

"Pillar II" requires regulators to ensure and audit that each financial institution has sound internal methodologies and controls to assess and implement the adequacy of capital reserve requirements set forth under the guidelines of "Pillar I". The new oversight framework stresses that senior banking management develop internal capital assessment procedures and targets for capital that is commensurated with a bank's particular risk profile and/or environment.

Accordingly, "Pillar II" requires each financial institution to begin assessing their internal capital reserve requirements and directs regulators to review these internal assessments and certify that internal risk targets are based on realistic and quantitative data. Currently, regulators expect banks to operate above the minimum regulatory capital ratios and, when necessary, will intervene to require additional capital reserves.

The intent of Pillar III is to utilize the regulatory power of the marketplace by improving transparencies whereby making more information publicly available. Effectively, new disclosure requirements will be the essential tools for ensuring that market participants have an opportunity to understand a financial institution's risks and capital adequacy. The new disclosure requirements would include both quantitative and qualitative data. The amount of information required to be disclosed will vary from financial institution to financial institution. However, the Basel II Accord set forth the general disclosure standard proportional to the IRB method implemented in "Pillar I".

As a concrete proposal, the Basel II Accord will for the first time recognize economic capital risk exposure disparities between financial institutions. As a result, financial institutions that have a higher risk exposure will be required to set aside greater capital reserves and will likely find the new proposal difficult to implement. In addition, the Basel II Accord will also change the landscape and fundamental principles banks utilize in capturing and reporting basic financial information