The Basel II Accord was conceived as a global standard for capital adequacy. It is the result of a compendium of expertise from the banking sector’s stakeholders, including bank employees, central banks’ experts, academics and supervisors from across the world. More than seven years of research in various working groups and five quantitative impact studies were undertaken to produce the final paper in 2005: International Convergence of Capital Measures and Capital Standards.

The Basel II framework provided the basic elements, or ‘pillars’, for an improved prudential structure: risk-sensitive statutory capital requirements (Pillar 1), supervisory review of the capital adequacy assessment, risk procedures and internal control (Pillar 2) and appropriate disclosure by each bank to allow for market discipline (Pillar 3). The three pillars were intended to complement each other and be applied consistently by all internationally active banks. At

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A pillar of strength

Amid the policy-making storm following the global financial crisis, it is, writes Gonzalo Gasós, adviser at the European Banking Federation, imperative to remember some of the important merits of Basel II, especially within the scope of the framework’s second pillar.
present, the implementation of Basel II is still fragmented (many jurisdictions such as the US and developing countries have not implemented it) and partial (only the first pillar has been applied in its entirety).

Basel II focused on improving the risk-weighting methods but left the definition of capital and its minimum requirement as it was under the Basel I regime.

When the financial crisis struck the global economy in 2007, Basel II was only an upcoming change in the EU, and only a future plan in other countries around the world. It is unwarranted to put the blame of the financial crisis on Basel II, given that the fiasco of the sub-prime instruments had been developing underground during the reign of the former Basel I regime. However, it is broadly accepted that a revision of Basel II is necessary, in particular to the quantity and quality of capital, in order to strengthen the resilience of the banking sector.

As a result, the Basel III regulatory package is focused on Pillar I measures, notably large increases in the numerator of the solvency ratio – the capital. In contrast, the most effective measures in crisis prevention are sound risk management practices and effective supervision, which were envisaged within the scope of Pillar 2.

**The numerator**

The capital ratio is essentially a quotient between the eligible capital available (the numerator) and the risk-weighted assets (the denominator). By way of example, the regular risk weight of an asset would be 100%, which implies that the bank needs to hold capital equivalent to at least 8% of the exposure amount under the current Basel II regime. A better quality credit could have a risk weight of 50%, which requires a capital support of at least 4% of the exposure. A loan to a highly creditworthy corporation with a risk weight of 20% would only require 1.6% capital. On the other side, riskier exposures can have risk weights above 100%. For instance, a securitisation rated BB+ would be weighted at 250%, thus requiring 20% capital; an unrated securitisation would bear a weight of 1,250%, hence having to be fully backed by capital.

On 12 September 2010 the Basel Committee on Banking Supervision (BCBS) took the remit of the G20 to redefine the structure of the eligible capital. The lift in the minimum core equity ratio from 2% to 4.5%, together with the more stringent definition of eligible capital, so that only core equity and reserves qualified, will undoubtedly increase the likelihood of each and every banking institution to withstand future economic upheaval. Moreover, the new enhanced risk-weights of market risk and re-securitisation exposures will require banks to back them with higher amounts of capital if they are to maintain the same level of exposure in those asset classes.

In general, the banking industry has acknowledged the need for enhancing the quantity and the quality of capital. However, the BCBS proposals seem to have gone above and beyond by adding two layers of capital buffers, without mentioning other measures under discussion, such as capital surcharges for systemically important financial institutions. Yet the G20 declaration of April 2009 mandated that buffers above the regulatory minima should be increased, once recovery is assured, and that buffers should also be allowed to decline to facilitate lending in deteriorating economic conditions. It also foresaw a requirement for banks to build buffers in good times from which they can withdraw when conditions deteriorate.

Given the final BCBS proposals, it looks as if the remit of the G20 may have been read in an overly conservative way, in three aspects: firstly, the magnitude of the buffers (2.5% each); secondly, the intrusive intervention in the dividend policy of going concern banks, by curtailing the dividend pay-outs; thirdly, the imposition of a country-wide countercyclical buffer to all banks with no regard to their contribution to the excessive credit growth during the upswing of the economic cycle.

The magnitude of the buffer, the way it needs to be accrued and the contribution of banks’ behaviour to procyclicality are issues that would typically be assessed in the supervisory review and evaluation process. Otherwise, the new regulation could start putting forward the wrong incentives, such as:

- the incentive to move assets to more capital-efficient lending sectors (normally unregulated or barely regulated);
- the incentive to seek higher reward for the heightened level of capital, compelling banks to take on riskier assets;
- the incentive for investors to reduce their investments in the
banking sector due to the uncertain dividend expectation
■ the incentive for banks to lend more during the upside of the cycle.

The Basel II Accord provided an adequate framework for the assessment of the aspects mentioned above: it is called Pillar 2. Regulators should allow and encourage supervisors to make good use of it.

Risk sensitivity
The Basel II Accord was aimed at standardising a growing industry practice that came along with the development of more advanced risk methodologies during the 1990s. Financial firms became more able to rank and measure the risk involved in every transaction across different asset classes.

The fact that the risk weights of certain asset classes needed to be recalibrated does not invalidate the risk sensitivity principle of the Basel II framework. In fact, once the recalibration is in place, the overall risk assessment should be more robust.

A return to the blunter, risk-insensitive Basel I regime would be a step backwards and would represent a failure in terms of offering the right incentives to risk management. There are grounds for thinking Basel III could mark a subtle way to return to Basel I by burying the risk-sensitivity merit of Basel II with supplementary provisions that would lift and tend to equalise the risk weights of all exposures. What, then, is the incentive to run sophisticated risk measurement processes if the ranked and proportionate results are finally flattened by the imposition of a leverage ratio and the obligation to comply with stringent funding structures?

Hopefully, the observation periods set by the Basel Committee of 2013-16 for the leverage ratio, 2011-14 for the liquidity ratio and 2012-17 for the net stable funding ratio will end up in Pillar 2 guidance rather than in Pillar 1 rules. If the merits of Basel II risk-sensitivity are to be preserved, transactions should be assigned levels of capital commensurate to the risk involved as determined by Pillar 1 and be subject to the overall assessment of capital adequacy under Pillar 2.

Improved supervision
One lesson learnt during the financial crisis was that banks that had a stronger risk culture in place were more able to cope with one of the root problems of the crisis: the role that risk management plays in the institution. But what has this got to do with Basel II?
Perhaps the major contribution of Basel II to the safety of the banking sector is its framework of risk management and its principles of supervisory review, all within the scope of the second pillar. Indeed, Pillar 2 is intended to encourage banks to develop and use better risk management techniques in monitoring and managing their risks.

Had Pillar 2 been working in the run-up to the crisis, the story would have been quite different. Indeed, the key elements to counter the root problems that led to the crisis had already been thought through in Pillar 2:  
- a supervisory review process, emphasizing the quality of the bank's risk management and control.
- a supervisory review process with a focus on the risk profile and the business plan.
- an assessment of risks, including a comprehensive assessment of risks, covering not only credit risk, but also other sources of risk, notably concentration risk and liquidity risk.
- adequate capital levels; the board is also responsible for ensuring that the formality and sophistication of the risk management processes are appropriate in light of the risk profile and the business plan.

The solution to the crisis, therefore, had already been invented. Pillar 2 only needed to be fully put into operation.

The wide range of regulatory proposals underway needs a good deal of understanding and flexibility in its implementation. The supervisory review and evaluation process envisaged in the Pillar 2 scope is set up to gain momentum and should be used to a large extent in the adoption of the prudential framework. Supervisory resources and methods should be generously reinforced to achieve the new regulation goals. In Europe, the constitution of the new European Banking Authority should pave the way for a more Pillar 2-oriented implementation of the Basel III package.

Basel III should encourage the use of Pillar 2 in combination with a less rigid approach to Pillar 1 measures. It is not overly tight regulation that will prevent the next crisis, but rather sound risk management and reliable supervisory review.

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European banks welcome the crisis management framework

The European Banking Federation welcomes the European Commission communication, An EU Framework for Crisis Management in the Financial Sector. This document, published in October 2010, is a useful roadmap for the forthcoming European Commission legislative proposal on cross border crisis management, which is expected to be published by April 2011.

The European Banking Federation has been supportive of the call by the Financial Stability Board and the G20 for designs and systems that would help to restructure or resolve financial institutions in crisis, thus avoiding public support on the one hand and guaranteeing financial stability and continuity of vital economic functions on the other.

"We believe that exposed banks should be allowed to fail, if worst comes to worst," declares Guido Ravoet, secretary general of the federation. "Taxpayers should not have to step in and pay the bill."

As part of the framework, the European Banking Federation urges the European Commission to particularly give priority to prevention and preparation measures. Some details still require clarification, but, generally speaking, European banks fully agree with the need to establish as a first step a coordination framework based on resolution tools that would be available to supervisors in all EU jurisdictions. Clearly, the new supervisory framework will also play an important role here.

Impact assessment

With regard to the funding of the resolution tools, the European Banking Federation looks forward to the European Commission’s impact assessment to understand any desired fund size and functioning.

"It is important that the final calibration of the funding requirement takes into account the structure of the national banking systems,” says Ravoet. “It should also carefully consider other taxing and regulatory funding demands imposed on banks so far, be they on financial stability, capital and liquidity. They should all be subject to appropriate timing and phasing in.”

Finally, the European Banking Federation welcomes the formation of colleges to coordinate the preparation and prevention measures, as well as crisis management and resolution. It believes that colleges are an indispensable component in terms of facilitating cross-border crisis management.

“We note that the European Commission envisages the creation of a coordination framework by 2011 and an insolvency framework for 2012-13,” explains Ravoet. “It also wishes to reach an integrated system for resolution of cross-border groups by 2014; these are all welcome plans. We certainly look forward to seeing the consultation of technical details later in December 2010.”