Abstract

Basel II (The New Capital Reasonability Agreement) refers to a revision of the original Capital Agreement (Basel I) that was made as a response to permanently developing complicated bank processes. Basel II is aimed to change calculation of capital requirements towards more risk sensitive approaches and increased requirement to risk managements in the banks. The new concept Basel II is base on three fundamental pillars: determination of capital reasonability, regular supervision and market discipline. A part of European Directives was transposed to Slovak legislation in the form of amendment of the Bank Act.

Keywords: Basel II; implementation; three fundamental pillars; capital allocation

JEL codes: G21, G32

1. Introduction

Risk has represented an innate part of business in financial institutions that refers to the business model basis. However, last year have been characterized with turbulent capital market changes, bankrupting companies as a result of financial frauds or both terrorist attacks and ecological catastrophes. Such dangers and hazards have even more and more emerged together with consequences that can result from incorrect and insufficient risk management. A climate has been created that supported development of new regulation principles of control, risk management; making members of Top Management and the Executive directly responsible for implementation of such principles.

Basel II is a standard that brings new requirements laid on financial institutions and opens road to new sources and effective utilization of those existing. Basel II, sometimes called the New Accord refers to abbreviation of the original name - International Convergence of Capital Measurement and Capital Standard – A Revised Framework. It is summary of rules and recommendations on bank supervision over central banks in 13 countries grouped in the Basel Committee on Banking Supervision (BCBS). The Agreement
is aimed to determine international rules of capital reasonability of the banks in order to unify
bank finalized in year 2004 and its implementation is expected in year 2008. The objective
priority refers to reduction of risk associated with allocation of capital, separation of operation
and credit risks including their unbiased description.

Agreement Basel II id based on three fundamental pillars: determination of capital
reasonability, regular supervision and market discipline. These pillars are aimed to bring more
stability to the financial sector. The third pillar largely depends on many factors associated
with security and overview of all systems operation, since it significantly increases amount of
data available to financial institutions.

2. New concept Basel II

Basel II refers to revision of the original Capital Agreement (Basel I) concluded in
year 1988. Growing complicatedness of banking industry showed that the simple frame
agreement Basel I is not sufficient for the bank praxis needs. In year 2004, the Basel’s
Committee approved the final version of new bank business rules and those applicable to
bank supervision (Basel II: International Convergence of Capital measurement and Capital
Standards). In the same time, EU presented its final draft amendment of existing directives
dealing with capital reasonability.

Development of a document similar to Basel II is never easy. Therefore, the document
had passed a few amendments. The actual version is made as the consultative paper (C3) and
among other things, it has brought relevant reinforcement of regulation authorities position.
One of the reasons of CP3 amendments referred to requirement for making Basel II
implementation accessible by smaller banks and financial institutions showed that
implementation of measures and goals contained in Basel II was beneficial, giving a chance to
the companies to change and increase effectiveness of both processes and risk management.

Basel II has introduced changed calculation of capital requirements towards more risk-
sensitive approaches and increased demand on risk management in the banks or banking
mechanisms and processes. The new rules are much more complex and detail, expanding the
extent of risks that must be taken into account by banks at determination of capital
reasonability. They include alternative calculation methods, since the banks can apply their
own advanced methods of risk measurement and assessment. Procedure of assets evaluation
through risk weight determined in advance will remain an alternative. The new rules increase
sensitivity to credit risk related loss through higher demands laid on debtors’ capital with higher credit risk and vice versa.

2.1 Fundamental Basel II pillars

The new concept is based on three pillars and relates to three areas. The 1st pillar represents significant reinforcement of minimum capital requirements determines in the Agreement dates 1988, trying to set up the minimum capital requirements to actual risk of economical loss of any bank; while the 2nd and 3rd pillar represents innovative addenda to the supervision over capital.

2.1.1 Pillar I

Pillar I determines minimum capital requirements of a bank with regard to undergone risk. Compared to current situation when capital reasonability calculation takes into account credit risk (risk of contract party failure during fulfillment of liabilities, the state risk, business settlement risk) and market risk (foreign currency risk, interest risk, share risk, commodity risk), Basel II has introduced the operation risk that is defined as a risk of direct or indirect loss caused by not suitable or unsuccessful internal process, employees or systems or external events (natural disasters, operation system failure, human factor failure).

2.1.2 Pillar II

Within Pillar II, the supervision authority focuses on assessment of activities and risk profile of a bank in order to evaluate the bank capital sufficiency as well as reliability and quality of bank management and control mechanisms. A bank should implement corresponding internal processes enabling risk measurement and management as well as assessment of the bank internal capital adequacy with regard to undergoing risk (so called Internal Capital Adequacy Assessment Process – ICAAP). Supervision authority is to evaluate ICAAP and has right to determine additional capital requirement, should the one determined by the bank be considered insufficient in relation to complex bank risk profile.

2.1.3 Pillar III

Pillar III stipulates requirements on bank information publishing, affecting strengthening of market discipline through increase transparency degree. Through published bank information, market participants will get overview of the bank risk profile, its activities and capital sufficiency. Pillar III determines requirements for publishing in various areas including
3. Implementation of Basel II

Agreement Basel II is proposed to internationally active banks on all levels. However, a decision was made in Europe to apply the Agreement to all banks and investment companies. In July 2004, EC adopted the draft frame for bank and investment companies capital requirements. Basel II was implemented in the form of Directives called Capital Reasonability Directives (CRD; 2006/48/EC and 2006/49/EC) that were enacted with more than half-year delay. Deadline of the Directives implementation in national legislations was reduced to 6 months. Since the Fall 2004, The Slovak Association of the Banks had conducted intensive dialogue with the National Bank of Slovakia on the form of legislation modifications of prepared directives. The most important part of the Directives was transposed to the Slovak legislation in the form of amendment of the Bank Act No. 644/2006 Coll., enacted by the Parliament in December 2006. The amended Act became effective on Jan 01, 2007.

Implementation of Basel II can help an organization to determine its goals in more exact manner, to implement respective policies, to utilize sources in a more effective manner and mainly to build all risk management systems. It is vital to know that Basel II should be implemented within entire organizational structure across all business units, eventually within all branches in particular countries. If a bank decides to implement the rules Internal Ratings (IRB), it is expected that it will be done within entire holding structure. Goals determined by the bank within Basel II implementation in order to reduce operating risk depend both on bank activity extent and possible resulting risks, being concurrently subject to approval by supervisory authority (bank supervision).

3.1 Basel II implementation process

A few year experiences with implementation of Basel II have showed that very high attention should be paid to planning and gradual implementation of Basel II. Incorrect project management can cause excessive and gradual implementation cost. Thus, it is vital to precisely define the starting position and objectives to be reaches by a company. Mapping the current situation and comparison to requirements stipulated by CP3 should refer to an initial point. Effect of Basel II implementation on another standardization processes should be assessed on basis of differential analysis as well as extent in what other standardizations could reduce Basel II implementation cost.
Following evaluation of the results, it is important to prepare detail implementation plan including exact description of tasks for particular organizational units. Role to be played by the organization headquarters in the entire process must be exactly specified. Implementation experiences showed that sufficient attention paid to precise implementation plan could save from many potential issues. Thus, the implementation plan must be prepared in such way that the company can respond to changed situation during the implementation. It should be taken into account that particular company organizational units tend to work independently but implementation of Basel II always affects many units that have nothing in common and can even affect job practices and employees’ tasks across many countries, affecting also external partners and suppliers. Therefore, the project management should be paid with principal attention.

Fundamental benefit of Basel II implementation is a chance to newly define the company processes and risk management. Implementation within entire company structure opens way to unification of the processes that is otherwise not easy. According to experiences, most frequent failure during implementation refers to underestimated process demands with regard to time and human resources.

In relation to implementation of Basel II, capital requirements that can be released by the banks should be considered. Of course, particular bank capital needs will differ. The banks that understand allocation of their capital will become better regulating with lower likelihood of sources leakage because of insufficient data or incorrect data approach. As a result of properly created and implemented program Basel II, the company Top Management and its shareholders will be able to monitor the capital optimizing. Biggest mistake that can be made by a bank refers to consideration of Basel II just another IT project.

4. Conclusion

In general, financial institutions worldwide have appreciated the new banking era introduced by measures Basel II. These measures will significantly change competitive environment in the banking sector. Organizations with better risk management system will reach better position on account of those who will fail to implement the changes as fast as required. Processes, systems and risk management methods will change dramatically as a part of the new era and changed dynamics of global market with financial services. Measures Basel II are perceived as something more than just common regulation requirements. Survey showed that head bank representatives have began to appreciate long-term effect of measures
Basel II on their own companies and banking sector as such. It is expected that new requirements laid on risk-related information publishing based on Basel II rules will change product pricing and portfolio management – higher emphasize will be placed on credit transactions and utilization of derivates. Bigger and more sophisticated banks will get huge advantage because of being able to use new risk-related information. Risk portfolio management will be more active, depending on accessibility of better and earlier risk-related information, following requirements of capital allocation according to new principles. Profitability of certain banks compared to the other ones could improve and trend towards particular sector consolidation could be reinforced. Organizations should make intensive efforts in incorporation and correct understanding of new credit processes. However, survey results indicate that work associated with pillars II and III is running late. Most banks in the region don’t presume immediate benefits and higher competition following implementation of Basel measures. Nevertheless, they shall bring competitive advantage to local banks in medium to long-term time horizon.

References