The recommendations

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In the recent past, there have been calls for stricter regulations in terms of supervision and capital adequacy of the banking sector as a result of increased risks faced by banks trading internationally. A committee was therefore formed; Basel Committee on Banking Supervision, to come up with recommendations that would be adopted by banks to mitigate themselves against the risks they face in their operations.

The original proposals by the committee were done in 2001 and 2003 although due to changing financialenvironment, revisions have had to be made that has led to the current financial proposals which were expected to be adopted by member countries after being endorsed by the central bank Governors of G10 countries (BIS, 2009). The Recommendations The framework is set out in 3 pillars; the first one being the minimum capital requirements which touch on the calculation of the minimum capital requirements, capital risk (using standardized approach, internal ratings approach as well as securitization framework), operational risk and market risk.

The second pillar touches on the supervisory review process while the third pillar on market discipline (BIS, 2009). 1st Pillar This pillar gives recommendations on the minimum capital requirements and how it is calculated for purposes of credit, market and operational risks. The capital ratio should be lower than 8% with Tier 2 capital being limited to 100% of Tier 1 capital. The capital ratio is calculated using the regulatory capital and risk weighted assets.

Regulatory capital framework includes Tier 1 (paid up capital , disclosed reserves), Tier 2 (undisclosed reserves, asset revaluation reserves, general

provisions, hybrid capital instruments, subordinated debt and Tier 3 (subordinated short term debts). All these Tiers will be included in the capital base provided total of Tier 2 is subject to maximum of 100% of Tier 1, subordinated debt limited to 50% of Tier 1, Tier 3 capital limited to 250% of Tier 1 capital, general provisions on unidentified losses limited to 1.

25 percentage points and unrealized gains being subject to a discount of 55% (BIS, 2009). The internal ratings approach of calculating credit risk is based on unexpected losses and expected losses. Under this method there is categorization of exposures into asset classes with different underlying risk characteristics. These classes are corporate, sovereign, bank, retail and equity. The internal ratings approach should be adopted in the banking group in a phased manner.

Standardized approach measures credit risk in a standard manner, with the help of external assessments (BIS, 2009). The other method of determining credit risk is through the use of securitization approach where exposure is determined on the basis of the economic substance rather than the legal form. Traditional securitization is where cash flow from an underlying collection of exposures is used to service a minimum of two different stratified positions showing different levels of credit risk.

Synthetic securitization on the other hand is where at least two different stratified risks reflecting different levels of credit risk where credit risk of an underlying collection of exposures is transferred, partly or wholly through use of funded or unfunded derivatives that mitigate against the credit risk of the portfolio. Operational risk results from insufficient or inadequate internal processes, people and systems or from external events. Operational risk

includes legal risk but not strategic or reputational. This risk is measured using standardized and advanced measurement approaches.

Market risk is risk of losses in on and off balance sheet positions as a result of changes in the market prices. The risks include risks associated with interest related instruments, forex and commodities. 2nd pillar This pillar of the Basel II provisions touches on supervisory review, risk management as well as supervisoryaccountabilityin relation to risks facing the banks. Supervisory review ensures that banks have enough capital to manage risks develop internal capital assessment , how well banks are assessing their capital requirements as regarding risks as well as amount of capital held against risks.

The second pillar also has 4 provisions on banks i. e. banks should have processes of assessing their overall capital adequacy in relation to risk and maintaining capital levels, banks internal capacity and strategies and compliance with capital ratios. , banks operate above regulatory capital ratios and capital requirements, and intervention by supervisors to avoid capital falling bellow minimum capital requirements. Other issues to be addressed under this pillar include interest rate risks, credit risks, operational risks, and market risk (BIS, 2009) 3rd pillar

This touches on the disclosure requirements under Basel II. The disclosure requirements is to complement pillar 1 and 2 thus encouraging market discipline in terms of information access on risk, capital, risk assessment process. The disclosures should be in line with the management of these risks thus effectively informing the market on the banks exposure to risks hence enable consistency, understandability and comparability. The

information could be made publicly available and in case of non disclosure, penalties may be enforced. These, though, varies across different countries.

The disclosure requirements under the framework should not conflict with the accounting standards which are overall and if conflicts arise, they should be explained. Accounting disclosures should also be complemented with the frameworks disclosure requirements to clarify the disclosures (BIS, 2009). Materiality of the disclosures should also be considered. Materiality is determined by the effect of omission or inclusion of an item. The disclosures can also be done on a semi annually, quarterly, or annual basis depending on the nature of information to be disclosed.

Confidential and proprietary information should also be considered in disclosing information to the market. Challenges facing Basel II The implementation of the provisions of Basel II has not been smooth sailing. It has presented some apparent challenges to banks across the globe. The new framework has led to the mobilization of the risk, information systems andfinancedepartments of the banks given the fact that far reaching provisions contained in the accord. This in itself will involve the use of resources in terms of manpower andmoney(Accenture, 2007).

Banks are also faced with the challenge of implementation of the framework in terms of the change in the product portfolios as well as economic environments. This is in terms of the capital requirements which under the accord, should be above the minimum limits. The assessment of capital requirements may also lead to changes in product portfolios thus leading to introduction and withdrawal of other products. Despite the apparent benefits

brought about by the new accord, some banks view Basel II as a regulatory bottle neck in their operations.

Other challenges that accompany the implementation of Basel II is that of the cost implication. Given the far reaching provisions of the framework, the costs to be incurred in setting up supervisory teams and risk assessment mechanisms may be out of reach of smaller banks or even ‘ eat’ into the profits of well established banking institutions. The costs involved have led to uncertainty among many bank heads (Accenture, 2007). The current information systems in most banks around the globe cannot adequately meet the requirements of Basel II.

This means that banks will have to either improve on their information systems or overhaul them completely. This brings us back to the issue of cost involved in the implementation of the framework. The need of historical data in the calculation of credit risk, advanced internal rating based approach which requires up to 7 years in historical data or advanced measurement approach which requires up to 5 years of historical data will definitely increase the need of databases by banks which also has cost implications attached to it (Accenture, 2007).

The implementation of Basel II will lead to the complete change in the existing systems and processes in order to meet the new regulations in risk determination and management as well as capital adequacy. The implementation of the accord will also see the changes in operations of the banks at the same time calling for closer supervision The adoption of the recommendations of the accord has received widespread acceptance although the level of implementation is varied.

The effect of this is that there may be lack of uniformity hence making comparisons difficult between different banks (Accenture, 2007). Conclusion Despite all the above mentioned challenges, the benefits brought about by the implementation of Basel II far outweigh the drawbacks. The provisions enable banks to have and develop credit management and assessment systems that will help them to mitigate these risks effectively. The regulatory capital requirements under the accord will also enable the banks to have adequate capital to finance their operations as well as manage any risk arising thereof.

The disclosure requirements also ensure that the market is aware of the operations of the banks. References Accenture. (2007, December 10th). Basel II Impacts: Challenges and Opportunities. Retrieved March 16th, 2009, from Accenture: http://www. accenture. com/xdoc/en/industries/financial/banking/capabilities/BII_Survey_SAP. pdf BIS. (2009, March 10th). Basel II: Revised International Capiatl Frameork. Retrieved March 16th, 2009, from Bank for International Settlements: http://www. bis. org/publ/bcbs128. htm