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The ABCs of Basel I, II, & III

Key Aspects and Differences

If, like many of our banking clients, you're scratching your head over the differences among Basel I, II, and III, this research brief offers an ideal starting point.

By summarizing key differences in the three Basel accords, and the business issues banks need to focus on as they strive to achieve compliance with the US Basel III Accord, this brief can help you:

Identify the additional effort involved in implementing Basel III's advanced approaches, compared to that of Basel II

Implement the standardized approach in Basel III—significantly more stringent than the standardized approach of Basel II, which is similar to Basel I

All three Basel regulations primarily focus on banks holding adequate capital commensurate with their risk profile. Since the maiden introduction of Basel I in 1988, however, each subsequent regulation has become more risk sensitive.

Introduction of new financial products—whose risks, in hindsight, were never fully understood—and more importantly, the lessons of the financial crisis of 2008–9, have mandated that banks address risks that, either had yet to be identified, or were deemed inconsequential in the past. This has ushered in a sea of challenges for banks in their efforts to remain compliant with the bare minimum regulatory requirements, let alone address Basel III's industry-leading practices.

Risk assessment methodologies have evolved significantly since the first accord. Yet, even with advancement in risk management, some risks remain difficult to quantify. The industry will continue to seek appropriate techniques in its effort to accurately measure these risks.

April 2014

Key Aspects and Differences among Basel I, II, and III

BASEL I

Released rule July 1988

Revolutionary, providing a paradigm to address risk management from a bank's capital adequacy perspective

Not as risk sensitive as Basel II and III

Backward looking, focused on existing assets rather than the future composition of a bank's portfolio

Credit risk only—no other risk types

Fixed, predetermined risk weights for different asset classes. Example: Cash, 0%; uninsured residential mortgage loans, 50%; corporate loans, 100%

Differentiated assets between banking and trading books

No advanced measurement of risk, based upon bank-specific portfolio

Simple tier calculations—tier 1 capital ratio of 4%, and total capital ratio (tiers 1 and 2) of 8%

BASEL II

Released US rule December 2007

Somewhat forward looking risk-sensitive approach to capital calculation

Provided smaller banks the option of adopting the more risk-sensitive advanced approaches or a less sophisticated standardized approach, which was modeled after Basel I

Introduced a three-pillar approach to risk management:

- **Pillar I** established minimum regulatory capital requirements for credit, market, and operational risks; banks had to develop their own (internal) models specific to their portfolios under the advanced approaches
- **Pillar II** established principals for a bank's Internal Capital Adequacy Assessment Process (ICAAP), which is intended to identify additional risks that are material, but not easily recognized. Such risks include strategic, reputational, and liquidity risks. Also established requirements to strengthen banks' capital adequacy by estimating economic capital to account for unexpected losses
- **Pillar III** established enhanced reporting requirements for market disclosure, such as credit risk exposure in different rating bands, and credit quality of securitization holdings

Improved oversight by raising the bar on supervisory responsibilities and expectations to normalize the way banks reported risk identification, measurement and management, as well as capital management practices

BASEL III

Released US rule July 2013, with phased-in implementation by 2019

Emphasis on reducing systemic risk by minimizing procyclicality and promoting countercyclicality via capital conservation and countercyclical buffers—building up capital in good economic times to use it in bad times, for example

Forward looking, addresses risks relevant to bank-specific portfolios and the macroeconomic environment

Mandates requirements for:

- Higher minimum capital
- Higher quality capital

Introduces leverage ratios, with the intent of improving financial system resilience, by limiting a banking organization's leverage

Introduces liquidity risk: 30-day liquidity coverage ratio (LCR), one-year net stable funding ratio (NSFR), and liquidity monitoring tools (only the LCR has been introduced in the US)

Mandates:

- Enhanced disclosure requirements
- Interaction between LCR and the provision of central bank facilities

Revises Basel II methodologies for securitizations

Enhances risk coverage by quantifying counterparty risk, credit value adjustments, and wrong way risk

More conservative market risk requirements

Increases the standardized approach risk sensitivity for:

- Residential mortgages
- Certain commercial credit facilities
- Exposures that are 90 days past due
- Exposures to foreign banks, public sector entities, and sovereigns

Stricter data governance and data requirements

About the Authors

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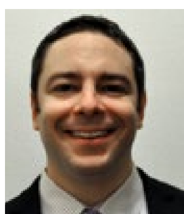
Varun has presented at numerous industry and trade conferences at both national and regional levels. His academic background includes a PhD in financial economics, an MS in quantitative economics and a bachelor's degree in engineering.



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As a consultant, Miles has worked exclusively for banking clients. However, prior to joining Capgemini, he held a variety of roles at the New York Mercantile Exchange, worked as an adjunct professor, and also enjoyed a stint in financial technology. His academic background includes a master's degree in financial engineering.

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