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Theme 194
BASEL II - PILLAR 1

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JANUARY 2008

Theme No. 194 : BASEL II – PILLAR I

Introduction

Credit risk, Market risk and Operational risk are covered under Pillar 1 of Basel II framework. Credit risk still claims the largest share of the regulatory capital and it underscores the significance of credit risk in bank's operations. This is hardly surprising reckoning that the several banking crises in many countries had their roots in lax credit standards, poor portfolio risk management, and the inability or failure to evaluate the impact of the changing economic environment on credit worthiness of the banks' borrowers. The sub-prime crisis in the USA is the most recent example of the inadequate credit risk assessment. The advent of advanced approaches for credit risk in India under the Basel II framework in the days to come, could be expected to provide an impetus for adopting more sophisticated credit risk management techniques in banks.

What is Credit Risk?

Credit Risk is defined as "The inability or unwillingness of the customer or counter party to meet commitments in relation to lending, hedging, settlement and other financial transactions." Hence Credit Risk emanates when the counter party is unwilling or unable to meet or fulfil the contractual obligations / commitments thereby leading to defaults.

What are the options for computing capital charge for credit risk?

Under Pillar 1, the framework offers three distinct options for computing capital requirement for credit risk. These approaches for credit risks are based on increasing risk sensitivity and allow banks to select an approach that is appropriate to the stage of development of bank's operations. The approaches available for computing capital for credit risk are Standardised Approach, Foundation Internal Rating Based Approach and Advanced Internal Rating Based approach.

RBI has decided to implement the Standardised Approach within the stipulated time frame. As regards the migration to advanced approaches, the RBI has not indicated any specific time frame. However, the banks that plan to migrate to the advanced approaches would need prior approval of RBI – for which requisite guidelines would be issued in due course.

What is Standardised Approach?

Standardised Approach is the basic approach which banks at a minimum have to use for moving to Basel II implementation. It is an extension of the existing method of calculation of capital charge for credit risk. The existing method is refined and made more risk sensitive by:

- Introducing more number of risk weights thus aiding finer differentiation in risk assessment between asset groups.
- Assignment of Risk weights based on the ratings assigned by External Credit rating agencies recognized by RBI, in case of exposures more than Rs.5 crores.
- Recognizing wide range of collaterals (securities) as risk mitigants and netting them off while determining the exposure amount on which risk weights are to be applied.
- Introducing Retail portfolio with total exposure up to Rs.5 crores and yearly turnover less than Rs.50 crores as a separate asset group with clear cut definition and criteria.
- Assignment of Risk weight for NPA accounts.

The rating assigned by the eligible external credit rating agencies will largely support the measure of credit risk. Unrated exposures will normally carry 100% risk weight. But for the financial year 2008-09, all fresh sanctions or renewals in respect of unrated borrowers in excess of Rs.50 crores will attract a risk weight of 150%. From 2009-10 onwards, unrated borrowings in excess of 10 crores will attract risk weight of 150%.

What is meant by Credit Risk Mitigation?

CRM refers to permitted methods of netting the exposure value for computing Risk Weights by using Collateral, Third party guarantee (Guarantee) and On-balance sheet netting. CRM is available subject to several conditions. Before netting, Exposure Value (EV) and Collateral Value (CV) are to be adjusted for volatility and possible future fluctuations. EV to be increased for volatility (premium factor) and CV to be reduced for volatility (discount factor). These factors are termed as ‘Haircuts’ (HC).

Therefore, EV after risk mitigation = (EV After HC – CV After HC)

EV after Risk mitigation will be multiplied by the Risk Weight of the customer to obtain Risk-weighted asset amount for the collateralized transaction.

What is meant by Market Risk?

Market Risk is the possibility of loss to a bank caused by changes in market variables. Market risk is also defined as “the risk that the value of on or off balance sheet positions will be adversely affected by movements in equity and interest rate markets, currency exchange rates and commodity prices. Market Risk Management of a bank thus involves management of interest rate risk, foreign exchange risk, commodity price risk and equity price risk. Market risk is also concerned about the banks ability to meet its obligations as and when they fall due, as a consequence of liquidity risk. Sound liquidity management can reduce the probability of a default. Liquidity risk is related to banks inability to pay to its depositors. It has a strong correlation with other risks such as interest rate risk and credit risk. Under Basel II, the present system of computing capital requirement for Market risk under the standardized – duration method will continue.

Define Operational Risk

Operational risk is defined as the risk of direct or indirect loss resulting from inadequate or failed internal processes, people and systems or from external events. The definition includes legal risks, but excludes strategic and reputation risk. Operational risk is pervasive and its ownership and measurement are challenges. Some of the important causes for operational risk are inadequate segregation of duties, insufficient training and poor HR Policies, lack of management supervision and inadequate security measures and systems.

What are the methodologies for calculating operational risk capital?
Basic indicator approach, Standardised approach and Advanced Measurement Approach are the three methodologies allowed under Basel II for arriving at the capital charge for operational risk. RBI has advised the banks to apply the Basic Indicator Approach to migrate to Basel II in the beginning. Under Basic indicator approach, banks have to hold capital for operational risk equal to a fixed percentage of the average of positive annual gross income over the previous 3 years. Thus, capital charge under Basic indicator approach KBia = (GI / n) x A, where,

- KBia = Capital charge under Basic Indicator Approach
- GI = Total gross income over the previous three years
- A = 15%
- n = No. of years ie 3 years for which income is positive.

What is the total capital requirement under Basel II?
Banks in India are required to maintain a minimum Capital to Risk-weighted Assets Ratio (CRAR) of 9% on an ongoing basis (However, Basel II prescribes 8% only). RBI may consider prescribing a higher level of minimum capital ratio for each bank under the pillar 2 framework on the basis of their respective risk profiles and their risk management systems. Banks are also encouraged to maintain a Tier 1 CRAR of at least 6% and banks which are below this level, must achieve this ratio on or before 31st March 2010.

Conclusion
The concept of attributing various degrees of credit risk weight on bank's asset by the financial regulators, is also being used as a means of credit control. If the regulator wants to facilitate increased flow of credit to a specific sector, it can reduce the risk weight attributed to the bank's exposure in that particular area. For example, in order to promote the educational loan portfolio of banks, RBI has, vide its notification dated 17th January 2008, decided to reclassify the 'educational loans' as non-consumer credit from that of consumer credit. With this, the credit risk weight on educational loans will be 100% as against 125% under Basel I. Under Basel II framework, educational loans will be treated as a component of regulatory retail portfolio, and hence the reduced risk weight of 75%.

Components of Capital

The Basel Capital Accord classifies capital under three Tiers. Tier 1 capital and Tier 2 capital include the following:

Tier 1 capital	Tier 2 capital
a. Permanent shareholders' equity	**a.** Undisclosed reserves
b. Perpetual non-cumulative preference shares	**b.** Revaluation reserves
c. Disclosed reserves	**c.** General provisions/general loan-loss reserves
d. Innovative capital instruments (Instruments with no maturity date. Therefore, it may be treated as equity, not as debt.)	**d.** Hybrid debt capital instruments (a range of instruments which combine characteristics of equity capital and debt)
	e. Subordinated term debt

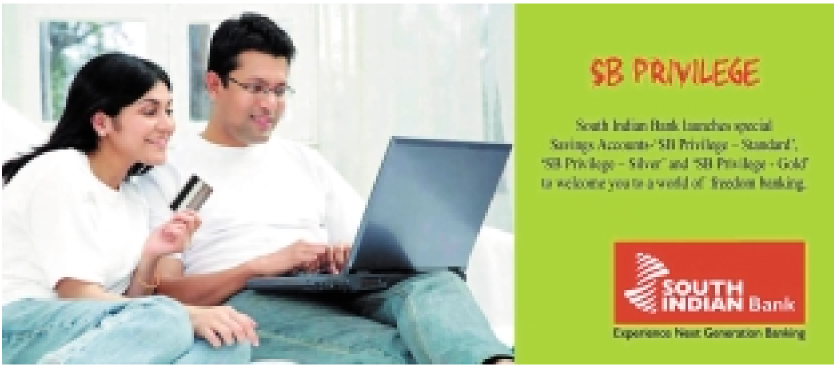
Further, at the discretion of the financial regulator of the individual countries, banks may employ a third tier of capital (Tier 3), consisting of short-term subordinated debt for the sole purpose of meeting a proportion of the capital requirements for market risks. However, since Tier 3 capital is short term in nature and is an optional item of capital for meeting a portion of banks' exposure to market risks, this option has not been considered by RBI for the present.

Capital Adequacy Ratio (CAR or CRAR)

It is a measure of a bank's capital strength. It is expressed as a percentage of a bank's risk weighted credit exposures.

$$\text{CAR} = \frac{\text{Eligible total capital funds}}{\text{Risk Weighted Assets (Credit, Market and Operational Risk)}}$$

This is also known as "**C**apital to **R**isk Weighted **A**ssets **R**atio (CRAR). This ratio is used to protect depositors and promote the stability and efficiency of banks.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