

Basel II: three pillars and the turn to internal ratings

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By the late 1990s, the crudeness of the 1988 risk weights had become a source of distortion. Banks reduced their capital requirements through securitisation and other forms of regulatory arbitrage, transferring high-quality assets off their balance sheets and retaining those whose risk the weights understated. A loan to a corporate borrower rated AAA required as much capital as a loan to a speculative company, which created an incentive to concentrate on riskier borrowers within each category. Under the chairmanship of William McDonough of the Federal Reserve Bank of New York, the Committee published a first consultative paper on a new framework in June 1999.¹

Five years of negotiation and three consultative papers followed, accompanied by several quantitative impact studies in which banks calculated their requirements under the proposed rules. The Committee published the "International Convergence of Capital Measurement and Capital Standards: A Revised Framework" in June 2004, during the chairmanship of Jaime Caruana of the Banco de España, and a comprehensive version incorporating the market risk rules and other elements in June 2006.² The new framework, known as Basel II, rested on three mutually reinforcing pillars.

The first pillar set minimum capital requirements for credit risk, market risk and a new category, operational risk, which covered losses resulting from inadequate or failed internal processes, people and systems or from external events. The overall minimum ratio of 8 per cent and the definition of capital remained unchanged, while the calculation of risk-weighted assets became far more differentiated. For credit risk, banks could choose between the standardised approach, which drew its risk weights from the ratings of external credit assessment institutions, and the internal ratings-based approach, known by its abbreviation IRB.³

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Under the foundation IRB approach, banks estimated the probability of default of their borrowers themselves, while the supervisor prescribed the loss given default and exposure at default. Under the advanced IRB approach, banks estimated all these parameters. The parameters were then fed into risk-weight functions derived from an asymptotic single risk factor model, which assumed a well-diversified portfolio. Operational risk could be measured by a basic indicator approach, a standardised approach based on gross income by business line or by advanced measurement approaches that used internal loss data and models.⁴

The second pillar laid down the supervisory review process. Banks were to have an internal process for assessing their overall capital adequacy in relation to their risk profile, later known as the internal capital adequacy assessment process, and supervisors were to review that assessment and require additional capital where necessary. Risks not covered by the first pillar, such as concentration risk and interest rate risk in the banking book, were to be addressed here. The third pillar required banks to publish detailed information on their capital, risk exposures and risk assessment processes, so that market participants could exercise discipline.⁵

The European Union transposed Basel II through the Capital Requirements Directive of 2006, which consisted of a recast Banking Directive and a recast Capital Adequacy Directive and applied to all credit institutions and investment firms from 2007 and 2008. Switzerland implemented the framework from 1 January 2007, with the IRB approaches available from 2008. The United States, by contrast, decided to apply the advanced approaches only to its largest banks and delayed implementation, with the result that Basel II never became fully operative there before the crisis.⁶

1 Notes

1. Basel Committee, A New Capital Adequacy Framework (consultative paper, June 1999). To be verified. ↩
2. Basel Committee, International Convergence of Capital Measurement and Capital Standards: A Revised Framework (June 2004); Comprehensive Version (June 2006). To be verified. ↩
3. Basel Committee (2004), Part 2 (the first pillar – minimum capital requirements), sections II (credit risk – standardised approach) and III (credit risk – IRB approach) and section V (operational risk). To be verified. ↩

4. On the asymptotic single risk factor model underlying the IRB risk-weight functions, see Basel Committee, An Explanatory Note on the Basel II IRB Risk Weight Functions (July 2005). To be verified. ↩
5. Basel Committee (2004), Part 3 (the second pillar – supervisory review process) and Part 4 (the third pillar – market discipline). To be verified. ↩
6. Directives 2006/48/EC and 2006/49/EC of 14 June 2006 (Capital Requirements Directive); on the delayed and limited US implementation, see Tarullo (2008), chapter 4. To be verified. ↩

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