Chapter 2:

Risk Episodes and Evolution of Supervisory Control

2.1. Introduction

The stability of the financial system and the potential for systemic risks to alter the functioning of that system has long been important topics for central banks and for the related research community. However, recent experiences suggest that existing models of systemic shocks in the financial system may no longer adequately capture the propagation of major disturbances. These models do not fully reflect the increasing complexity of the financial system’s structure, the complete range of financial and information flows, and the diverse nature of the endogenous behavior of different agents in the system. Fresh thinking about systemic risk is, therefore, desirable. As a result, the importance of sophisticated risk management process is necessitated strongly and is under implementation around the world on an on-going basis. It could rightly be said that the risk that an event will trigger a loss of economic value or confidence in, and attendant increases in uncertainty about, a substantial portion of the financial system may be serious enough and can quite probably have significant adverse effects on the real economy. Banks have long been at the center of financial activity. They remain so today,
even though their share of financial intermediation has been reduced by the growth of capital markets and mutual funds and other developments of the last few decades. The activities of Banks include making loans to corporations and individuals; underwriting debt and equity securities offerings; acting as dealers in foreign exchange, securities, and derivatives markets; providing asset management services; providing payments, settlement, and custodial services; and taking deposits. This instability is seen by considering a case in which each depositor at a particular bank would be willing to leave his or her funds on deposit, but believes that other depositors are likely to withdraw their funds, thus making it necessary for the bank to call in its loans and suffer the associated losses. In this case, all rational depositors will seek to withdraw their funds as quickly as possible, producing a “run” on the bank. In this simplified model, bank runs can be caused by concerns over liquidity even if the bank’s assets are fundamentally sound on a going-concern basis (that is, the bank is solvent). Here come the necessities of maintaining Economic Capital which can be quantified by the sound risk management process.

2.2 Contemporary Risk Scenario

The initial years since the inception of globalization process has evidenced several financial crises of which Asian crisis was the most disastrous one. The Asian crisis was characterized by a significant interplay between macroeconomic and financial sector factors. This
interplay reflected weakness in the banking sectors of some countries that, while not the root cause of the crisis in all cases, clearly affected how the crisis played out and how well each country absorbed the macroeconomic impact of the crisis. In consistent with the model of bank runs outlined earlier, contagion figured very prominently in the Asian crisis. Indeed, the events demonstrated a new mode of contagion. Various trading and risk management strategies now commonly used by market participants created linkages between different assets and activities that may not have previously existed, in some cases requiring positions in one currency to be adjusted largely as the result of movements in another. In some instances, a problem triggered by a currency or maturity mismatch in one country or market would lead global investors seeking to reduce risk to identify similar vulnerabilities in other markets. A year later, contagion figured in the relationships between Russian debt and the debt of Brazil and other emerging economies. Although the economies of Russia and Brazil are not themselves closely integrated, the prices of their debt fluctuated largely in tandem. In part, these parallel fluctuations reflected the fact that many of the holders of this debt specialized in holding the debt of emerging market countries, regarded these countries as proxies for each other, and needed to maintain some stability in their overall risk profile. Thus, when Russian debt began to be perceived as increasingly risky and to lose liquidity, some of these participants began to sell their Brazilian debt to reduce their risk profile and to
take advantage of the Brazilian debt’s greater liquidity. Ultimately, of course, the correlation between these two assets broke down as Russia defaulted while Brazil did not.

The Russian government default of August 1998 occurred against the backdrop of the Asian crisis that had been playing out over the preceding year, but otherwise took place in a period that was characterized both by the strong macroeconomic performance of the United States and by the strong financial condition of the major financial intermediaries. Nevertheless, the Russian default set in motion a chain of events that created significant fear among the leadership of those same intermediaries and served to reduce liquidity across most of the world’s capital markets for some months.

Long-Term Capital Management (LTCM) was a hedge fund that conducted leveraged trades involving both securities and derivatives on a large scale and used highly sophisticated mathematical approaches to manage its risk. The firm suffered a severe loss of capital when prices moved against its positions following the Russian default. While LTCM’s uniquely high leverage made it a fragile enterprise, it may not have been the only leveraged investor to be vulnerable, and this broader vulnerability may have played a role in amplifying the price shocks that occurred in a number of markets following the Russian default. For a year or two before the crisis, the liabilities of financial intermediaries had increased substantially relative to the liabilities of the nonfinancial sector, suggesting that others besides LTCM had also leveraged up and were similarly
vulnerable to price volatility and liquidity shocks. At the onset of the crisis, however, signs of an abrupt scaling back of leverage in trading activity emerged. For example, the repurchase contracts that securities dealers use to finance their own and customers’ trading positions showed a sharp and unusually sustained decline in volume. These chains of different disaster events cause contagion risk which spreads rapidly though liberal cross-market linkage.

2.3 Lessons from Recent Risk Generated Financial Disasters

While macro level risk episode swept away the affected economic out of their stability epicenter, financial institutions at the micro level also had to bear the brunt of the risk disasters. Risk management had been used since the 1960’s, but emerged more fully in the 1990’s in response to financial institutions’ quest for sound risk management systems during a time of huge financial disasters. The disastrous incidents include the followings:

*Barings Bank*

The bank was founded in 1762; known as the Queen’s bank, it financed Britain in the Napoleonic war; America’s Louisiana Purchase and the construction of the Erie Canal. The bank collapsed in February 1995 with a huge loss of $1.3 billion due to unauthorized derivatives trading in the Japanese Nikki stock market by a single 28-year-old trader, Nick Leeson. All of these losses were accumulated without the bank’s management being aware of them.
Daiwa Bank

Japan Daiwa bank announced losses of $1.1 billion on September 1995, which were attributed to Toshihide Igushi, a 44-year-old trader who accumulated huge losses over 11 years whilst trading in the U.S. Treasury bonds market.

Orange County

California’s Orange County went bankruptcy on November 1994 when Bob Citron, the County Treasurer, invested a huge amount in highly risky derivatives. Interest rate hikes in 1994 led to huge losses of $1.7 billion. The board members were not aware of the risks that Citron undertook.

Metallgesellschaft

MG Refining and Marketing, the US subsidiary of Germany’s Metallgesellschaft AG declared losses of $1.3 billion in the futures market; when oil prices fell sharply in 1993. Consequently the U.S. subsidiary of MG suffered basis risk\(^6\) due to huge positions in oil futures built to ‘hedge rolling’ their long term exposure.

These financial disasters generated losses in excess of $1 billion and in most cases the losses were a result of individuals taking personal decisions without the knowledge of their senior managers and exposed their organisations to bankruptcy. These disasters disclosed the severe lack of control and absence of risk management systems present in these institutions, which allowed

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\(^6\)Basis risk is the risk that arises when the relationships between products used to hedge each other change or break down ‘Value At Risk, the New Benchmark for controlling market risk (Jorion, 2001).
some individuals to have control over back office activities and trading desks. In general, these disasters are the inevitable consequence of weak risk management systems.

In the wake of these publicised crashes and the growing concern about risks from largely growing unregulated derivatives, the regulatory bodies increased their interest in financial risk management techniques. Consequently a consultative group: “the Group of 30” consisting of the foremost banks, academics and financiers; published a groundbreaking 68 page report in 1993, known as ‘Derivatives: Practices and Principles’ in the quest for good financial risk management practices. The report advocated guiding principles for managing derivatives activities as they “make a contribution to the overall economy that may be difficult to quantify, but is nevertheless favorable and substantial.” (Group of Thirty, 1993). Although the report concentrated on derivatives activities, it was at the same time, applicable to any other portfolio. The report recommended marking to market the portfolios and also using value at risk and stress testing to measure risks. This report was the first published report promoting the use of VaR systems.

Various reports followed such as those issued by: the US General Accounting Office in 1994; the Bank for International Settlements (BIS); and the International Organization of Securities Commissions (IOSCO) in 1994; amongst others. All presented sensible recommendations concerning the importance of risk comprehension by senior managers and the importance of separating back office from
traders in order to audit and control any rogue trading. Most also advocated the use of internal value-at-risk models to assess financial risks and value positions at market. Such recommendations generally became the yardstick for financial risk management.

2.4 Types of risks

With risk concerns emerging at the surface, types of risks eventually were identified. There are two main types of risk: ‘systematic risk’ and ‘unsystematic’ risk. Systematic risk involves the entire economic or financial system impacting upon all the entities and therefore undiversifiable. Examples include: market risk and political events. Specific risk is the additional risk over systematic risk and is country or company specific, it may affect a small number of assets and can be eliminated by diversification.

Business entities usually confront specific types of risks, which are discussed below:

*Business risk*

This concerns a firm’s exposure to uncertainty in the product market in which the firm operates. For example, a business may be unable to meet ongoing operations expenditure and have uncertainty about profit and revenues due to financial difficulties. This could be due to changes in demand; adverse economic conditions; technology or competition.

*Strategic risk*

These are strategies that are hard to hedge because they may
relate to essential alterations in the economy or political environment. Strategic risk also incorporates losses due to poor, faulty or misjudged strategic decisions so that the company fulfills its aims and objectives.

Financial risk

Financial risk pertains to the probable losses in financial markets, for example, a business is unable to meet its financial obligations and provide payback to its investors. In other words it is the use of financial leverage that would result in an increase in stockholders’ risk over the business risk. Financial risk includes market, credit, operational, legal and liquidity risks.

Market risk

Also known as systematic risk, market risk commands most serious concerns among all types of risk and arises from uncertainty over movements in market prices such as the price of financial assets, or interest rate risks, widely known as volatility. This would result in a security’s value – stocks or options, to decline and a possible capital loss. Also known as the risk of ‘losses in on- and off-balance sheet’\(^7\), it reflects the probable economic loss in the market value of the portfolio. The main principle for the VaR approach is to quantify market risk. There are four market risk factors: equity risk; interest rates risk; currency risk; and commodity risk.

Credit risk

Credit risk occurs when counter parties or debtors are unable to meet their obligations, including the inability to pay principal or

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\(^7\) [www.riskglossary.com](http://www.riskglossary.com) [2006]
interest on debt obligations, and hence debt downgrading by credit agencies; and sovereign risk\(^8\), which is a country specific risk. This is of special concern to investors that hold bonds in their portfolios. When debtors fail to repay their obligations they are in default, however credit risk is far less volatile than market risk.

_Liquidity risk_

Liquidity risk is uncertainty over the ability to find an immediate market for financial assets such as uncertain liquidity or unexpected cash outflows, for example, a firm’s inability to meet financial demands due to insufficient working capital. However, liquidity risk compounds other types of risks such as market risk or credit risk; thus it is difficult to isolate liquidity risk and it should be managed with other types of risk.

_Operational risk_

Operational risk is defined according to the Basel Committee (2004) as the “risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events.” This means losses arising from defective internal management and control systems, employee fraud or natural and man made disasters.

_Legal risk_

Legal risk is due to the uncertainty of a legal action, laws or regulations; such loss may arise for example, when a party breaches a contract and the contract cannot be legally enforced. The subject

\(^8\) Sovereign risk: when countries impose foreign exchange controls whereby counterparties become unable to meet their obligations.
matter of legal risk is a crucial factor that concerns companies and investment in foreign counties. The doctrine of legal risk relates to the existence of suspensions and doubts regarding the legal system that might govern the relationship, in other words, companies investing in foreign countries have doubts regarding the legal uncertainties that might occur in practice. In particular, uncertainties in the arena of banking law, tax law and financial laws that essentially affect the legal and financial position of a company.

2.5 Risk Regulation

Along with identifying types of risks, the importance of regulatory bodies was gaining greater recognition. The Bank for International Settlement (BIS) was established in the context of the Young Plan (1930). This plan dealt with the issue of the reparation payments imposed on Germany following the First World War. Later BIS focused its activities entirely on the cooperation between central banks and other agencies in pursuit of monetary and financial stability. Later, the focus of BIS was shifted primarily to implementing and defending the Bretton Woods system, which was basically an obligation for each country to adopt a monetary policy that maintained the exchange rate of its currency within a fixed value (plus or minus one percent) in terms of gold. Later on, with changing dynamics of financial markets, the nature of risk regulation became more stringent, complex and far reaching.
2.5.1 Formation of Bank of International Settlement

The central bank cooperation at the BIS has taken place through the regular meetings in Basel of central bank Governors and experts from central banks and other agencies. The main goal of this international cooperation is to prevent liquidity and solvency problems in the financial sector. In 1974 the bankruptcy of the German bank Bankhaus Herstatt almost caused a global financial crisis. This brought the issue of regulatory supervision of internationally active banks to the foreground and resulting in the establishment of the Basel Committee on Banking Supervision (BCBS). The Committee consists of the supervisory authorities and central banks of the G-10 countries (currently 13 countries). In 1988, the BCBS has proposed guiding principles for the banking industry in the Basel Capital Accord. The Basel Capital Accord was gradually adopted by the central banks. Although the BIS does not occupy itself with the implementation of regulation, its reputation and influence is of such nature that its recommendations are considered as best practise. More recently the issue of financial stability in the wake of economic integration and globalisation has received a lot of attention. The Basel I capital accord is now widely viewed as outmoded. It is risk insensitive and can easily be circumvented by regulatory arbitrage. Regulatory arbitrage is where a regulated institution takes advantage of the difference between its real risk and the regulatory position. A new capital accord, the Basel II Accord, has been created to cope with this problem. In Table below, a timetable of the development of the regulatory
environment and the capital accords is given. The new capital accord promotes greater consistency in the way banks and banking regulators approach risk management. The implementation of the Basel II Accord is expected by 2007 in many of the over 100 countries currently using the Basel I accord. In this chapter later, the Basel II accord will be discussed in more detail.

Table 2.5.1: Evolution of the Regulatory Environment

<table>
<thead>
<tr>
<th>Year</th>
<th>Event</th>
</tr>
</thead>
<tbody>
<tr>
<td>1988</td>
<td>Basel Capital Accord</td>
</tr>
<tr>
<td>1996</td>
<td>Market Risk Capital Amendment</td>
</tr>
<tr>
<td>1996-1998</td>
<td>Ad hoc rules for credit derivatives</td>
</tr>
<tr>
<td>Jun. 1999</td>
<td>Consultative Document from Basel Committee</td>
</tr>
<tr>
<td>Jan. 2001</td>
<td>Basel Committee proposes New Capital Accord</td>
</tr>
</tbody>
</table>

Apart from fostering monetary policy cooperation, the BIS performs and has performed numerous other functions. The BIS has always performed "traditional" banking functions for the central bank community. It has done gold and foreign exchange transactions and employed trustee and agency functions. The BIS was the agent for the European Payments Union (EPU, 1950-58) and has acted as the agent for various European exchange rate arrangements. One of these exchange rate arrangements was the European Monetary System (EMS, 1979-94) which preceded the move to a single currency. The BIS has provided or organised emergency financing to support the international monetary system when needed. During the 1931-33 financial crisis, the BIS organised support credits for both the Austrian and German central banks. In the 1960s, the BIS arranged
special support credits for the French franc (1968). More recently, the BIS has provided finance in the context of IMF-led stabilisation programmes (Mexico in 1982 and Brazil in 1998). The BIS has developed its own research in financial and monetary economics and makes an important contribution to the collection, compilation and dissemination of economic and financial statistics.

2.5.2 Formation of Basel I Capital Accord

The Basel I Capital Accord represented the first step toward risk-based capital adequacy requirements. The accord was an agreement by the members of the BCBS with respect to minimum regulatory capital for credit risk. Credit risk is the possibility of a loss as a result of a situation that those who borrow money to the bank may not fulfil their obligation. Regulatory capital refers to the risk-based capital requirements under the Capital Accord. The purpose of regulatory capital is to ensure adequate resources are available to absorb bank-wide unexpected losses. Under the rules of the Basel I accord, the minimum regulatory capital associated with loans or other cash assets, guarantees, or derivative contract is calculated as:

\[
\text{Regulatory Capital} = \text{Risk weights} \times \text{Exposure} \times 8\% = \text{Risk-weighed-Assets} \times 8\%
\]

In the above formula the constant 8% is the minimum ratio of regulatory capital to total Risk-Weighted Assets (RWA). This value was determined by the Basel Committee. In the following paragraphs
the formula for the calculation of regulatory capital is discussed. At the end of this first part of this Chapter the shortcomings of the Basel I Capital Accord are discussed.

**Risk Weights**

The risk weights reflect the relative credit riskiness across different types of exposures. The Risk Weight for a transaction is determined by characteristics of the obligor. In Table 2.5.2.1 the risk Weights from the Basel I Capital Accord are given. Roughly speaking, three kinds of obligors can be distinguished: Sovereigns, Banks and Corporates with corresponding risk Weights of 0%, 20% and 100%.

**Table 2.5.2.1: Risk Weights and Obligor as per the Basel I Capital Accord**

<table>
<thead>
<tr>
<th>Obligor</th>
<th>Risk Weights</th>
</tr>
</thead>
<tbody>
<tr>
<td>OECD central government(^9)</td>
<td>0%</td>
</tr>
<tr>
<td>Domestic public sector entities (excluding central governments)</td>
<td>0%, 10%, 20% or 50% Percentage Set by domestic regulator</td>
</tr>
<tr>
<td>OECD banks and regulated firms</td>
<td>20%</td>
</tr>
<tr>
<td>Loans fully secured by residential property</td>
<td>50%</td>
</tr>
<tr>
<td>Counter parties in derivatives transactions</td>
<td>50%</td>
</tr>
<tr>
<td>Public sector corporations; non-OECD banks</td>
<td>100%</td>
</tr>
</tbody>
</table>

**Exposure**

The type of instrument determines the Exposure:

- For fully funded loans or bonds, the exposure is the face

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\(^9\) Organisation for Economic Co-operation and Development (OECD) is an international organisation of those developed countries that accept the principles of representative democracy and a free market economy.
amount.

- For unfunded commitments; the exposure is 50% of the commitment for undrawn commitments with maturity over one year and 0% of the commitment for undrawn commitments with maturity less than one year.

- For credit products (e.g. guarantees) the exposure is 100% of the notional value of the contract.

- For derivatives the exposure is determined by the equation: Replacement Costs + (Add-On Percentage \times \text{Notional Principal}). In Table 2.5.2.2, the add-on percentages are given.

Table 2.5.2.2: Add-on Percentages for Derivative Contracts:

<table>
<thead>
<tr>
<th>Basel I Accord</th>
<th>Interest Rate</th>
<th>Exchange Rate and Gold</th>
<th>Equity</th>
<th>Precious Metals Except Gold</th>
<th>Other Commodities</th>
</tr>
</thead>
<tbody>
<tr>
<td>One year or less</td>
<td>0.0%</td>
<td>1.0%</td>
<td>6.0%</td>
<td>7.0%</td>
<td>10.0%</td>
</tr>
<tr>
<td>More than one year to five years</td>
<td>0.5%</td>
<td>5.0%</td>
<td>8.0%</td>
<td>7.0%</td>
<td>12.0%</td>
</tr>
<tr>
<td>More than five years</td>
<td>1.5%</td>
<td>7.5%</td>
<td>10.0%</td>
<td>8.0%</td>
<td>15.0%</td>
</tr>
</tbody>
</table>

Shortcomings of Basel I Capital Accord

Although Basel I helped to stabilize the declining trend in banks’ solvency ratios, it suffered from several problems that became increasingly evident over time. The Basel I Capital Accord dates from 1988 and since then the financial world has changed dramatically. It is criticized on generally three grounds:
1. The Basel I Capital Accord provides inconsistent treatment of credit risks. For example, a relatively risky bank in an OECD country requires less regulatory capital than a relatively less risky corporation.

2. The Basel I Capital Accord does not measure risk on a portfolio basis. It does not take account of diversification or concentration and there is no provision for short positions. For example the amount of regulatory capital on a mortgage loan in a portfolio consisting only out of mortgages is the same as when the mortgage loan is part of a portfolio consisting of a variety of loan products.

3. The Basel I Capital Accord provides for no regulatory relief as models and management of capital improve.

2.5.3 Formation of Basel II Capital Accord

In January 2001 the Bank for International Settlement released its proposal for a new Accord. This new Accord, the Basel II Capital Accord, is the successor of the Basel I Capital Accord. The Basel II Capital Accord attempts to improve the Basel I Capital Accord in the following points:

- In the Basel II Capital Accord banks are granted a greater flexibility to determine the appropriate level of capital to be held in reserve according to their risk exposure.

- The Basel II Capital Accord focuses on the enhancement of the stability and reliability of the international financial system.
- The Basel II Capital Accord stimulates the improvement of risk management.

In the remainder of this chapter the Basel II accord is described.

2.5.3.1 The three pillars as per the Basel II

The Basel I Capital Accord focused only on minimum regulatory capital requirements. The Basel II Capital Accord broadens this focus by describing the supervisory process in the Basel II Capital Accord by “three pillars”:

- Pillar 1 - Minimal regulatory capital requirements.
- Pillar 2 - Supervisory review of capital adequacy.
- Pillar 3 - Market discipline and disclosure.

Below the contents of the Pillars are shortly discussed.

Figure 2.5.3.1: The Three Pillars Concept of Basel II Capital Accord

Pillar 1- Minimum Regulatory Capital Requirements

For the first pillar of the Basel II Capital Accord the Basel Committee proposed capital requirements associated with three categories of risk:
1. Market Risk

Market Risk is the risk that the value of an investment will decrease due to moves in market factors. Within the Basel II Capital Accord, there are two methods to measure market risk: The Standardized Approach and the Internal Models Approach.

2. Operational Risk

Operational risk is defined in the Basel II as the risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events. Three different methods can be used to measure operational risk: The Basic Indicator Approach, the Standardized Approach and the Advanced Measurement Approach.

3. Credit Risk

Credit risk is the possibility of a loss as a result of a situation that those who borrow money to the bank may not fulfil their obligation. The following methods can be used to determine credit risk: The Standardized Approach, The Foundation Internal Rating Based Approach and the Advanced Rating Based Approach. The Standardized Approach provides improved risk sensitivity compared to Basel I. The two IRB approaches, which rely on banks’ own internal risk ratings, are considerably more risk sensitive.

Pillar 2 - Supervisory review of capital adequacy

The second pillar of Basel II is a supervisory review of capital adequacy. The second pillar notes that national supervisors must ensure that banks develop an internal capital assessment process...
and set capital targets consistent with their risk profiles. Furthermore it encourages the bank's management to develop risk management techniques and their use within capital management. The supervisors are responsible for evaluating how the banks are assessing their capital adequacy needed relative to their risks. Internal processes of the bank are subject to supervisory review and intervention. In India the role of supervisor is fulfilled by Reserve Bank of India (RBI).

Pillar 3 – Market discipline and disclosure

The third pillar of the Basel II Capital Accord is about market discipline and disclosure. The main goal of this pillar is to promote the development of financial reporting about risks. In this way market participants can get a better understanding of banks risks profiles and the adequacy of their capital position by disclosure. Pillar 3, sets out disclosure requirements and recommendations in several areas, in the Basel II Capital Accord. These requirements apply to all banks and when a bank cannot meet these requirements it can be constrained in the way it manages capital. For example the bank may not use any of the advanced techniques under Pillar 1.

The objectives of Basel II are to encourage better and more systematic risk management practices, especially in the area of credit risk, and also to provide improved measures of capital adequacy for the benefit of supervisors as well as the marketplace. Though Basel Committee's proposals have evolved considerably over the past several years, these fundamental objectives and the three-pillar
approach have held constant. The main thrust is to emphasize the importance of banks and banking systems to financial and economic stability. The ability of a sound and well-capitalized banking system to help cushion an economy from unforeseen shocks is well known. There are the negative consequences of a banking system that itself becomes a source of weakness and instability. A critical potential weakness of financial markets is that risks are in many cases under-estimated and not fully recognized until too late, with a concomitant potential for excessive consequences once they have been fully realized. This is the reason the Basel Committee’s efforts to promote greater recognition of risks and more systematic attention to them are vitally important. The essence of Basel II is a focus on risk differentiation and the need for enhanced approaches to assessing credit risk. It is also critically reviewed that it is preferable to downplay differences in risk, and indeed forbearance can sometimes appear the most expedient strategy. But experience has also shown that this will not work as an overall approach because ignoring risks inevitably usher in to larger problems down the road. Thus, one of the key messages of Basel II is that bankers, supervisors, and other market participants must become better attuned to risk and better able to act on those risk assessments at the appropriate time. The objective of the Risk Regulation is to address the issues on proactive basis rather than addressing those when crisis arises.
2.6  Basel Norms: A Critical Evolution

Basel II aims at reduction of risks and the costs of insolvency. The standardized approach is closer to the approach used in Basel I. The standardized method is the approach and it is meant for the small and medium size bank, not prepared for advanced approach. In standardized approach, the bank relies on external evaluation for riskiness of its loan portfolio. Risk weights are mapped into risk weights as described in the framework, but those tables containing risk weights should have flexibility to distinguish the banks rather than treating same similarly, as per their investment philosophy. Further, there is tricky are as to ECAIs for implementation, specially with the countries with no sufficient ECAIs and force those countries to adopt to Foundation IRB approach for use of own estimate of Probability of Default. Especially with the degree of complexities given to the treatment of securitization not only causes problem for the bank but also poses a challenge for the supervisors to validate bank’s method of compliance. For Basel II, although capital requirement for credit risk may go down due to adoption of more risk sensitive models but will be more than offset by additional capital charge for operational risk and increased capital requirement for market risk. Also the huge implementation cost put huge pressure on small banks. The Basel II leaves scope for a revision of the accord through amendments and implementation guidance.