Chapter 7

Basel II is a definite improvement over Basel I. Its implementation will improve the standards of risk management practices across most of the banks subject to its provisions. It adopts a more sophisticated approach to risk management and to how credit derivatives and securitised assets are treated. But it is not a panacea, and whether it could have prevented or lessened the impact of the recent crisis is very debatable.

Most important for banks is that they ensure that the key elements of their Basel II risk management governance structures, policies, processes and systems are robust, integrated, and able to incorporate both the economics lessons and regulatory implications of the credit and liquidity crunch. The credit crunch has made very evident areas for further improvement in Basel 2, but many of these should have been identified far earlier. Basel 2's ratings and models need to be used wisely; they are not a one-shot solution; Pillar II is critical and needs to be implemented effectively; regulators need sufficient resource to deal with complexity and courage to make judgements; and capital and liquidity regulation need to be properly integrated. Properly implemented and resourced Basel 2 remains an opportunity not a threat.

Many economists are now predicting that this “Great Recession” of 2008/09 will be the worst global recession since the 1930s. The IMF made its customary forecast for global growth in the World Economic Outlook published in October 2008. By early November, the IMF had revised its forecast for global growth downwards – from 3.9 per cent to 3.7 per cent for 2008, and from 3.0 per cent to 2.2 per cent for 2009. There are two inferences that follow from this. First, that the global situation has deteriorated rapidly, in
a space of less than two months. Second, that 2009 is going to be a more challenging year than 2008.

The global credit crisis has threatened to undermine the three pillars of Basel II – with potentially serious implications for the South African banking regulator. Many of the world’s major commercial and investment banks have had to write-down huge losses caused by exposure to “toxic assets” on their balance sheets. A large number of such banks have since been forced to replenish their balance sheets with funding from governments in order to avoid an economic crisis. It is a crisis that has exposed fundamental fault lines in the regulation of the banking system in countries that had not properly implemented Basel II.

In a bid to strengthen the regulation and supervision of internationally active banks in light of weaknesses revealed by the ongoing global financial markets crisis, the Basel Committee on Banking Supervision issued a package of consultative documents to strengthen the Basel II capital framework, in January 2008.

The proposed changes to capital requirements cover trading book exposures, including complex and illiquid credit products, certain complex securitisations in the banking book like collateralised debt obligations of asset backed securities and exposures to off-balance sheet vehicles like asset-backed commercial paper conduits.

The committee is also proposing standards to promote more rigorous supervision and risk management of risk concentrations, off-balance sheet exposures, securitisations and related reputation risks.

Through the supervisory review process, the committee is promoting improvements to valuations of financial instruments, the management of funding liquidity risks and firm-wide stress testing practices.
In addition, the Committee is also proposing enhanced disclosure requirements for securitisations and sponsorship of off-balance sheet vehicles, which should provide market participants with a better understanding of an institution's overall risk profile.

"The capital requirements for the trading book be implemented in December 2010 while the other improvements, including those related to risk management and disclosures, be introduced by the end of 2009," proposed the committee.

These proposed changes are part of the committee's broader work programme, as set out in its 20 November 2008 press release, to strengthen in a fundamental way bank capital adequacy, risk management and supervision.

Nout Wellink, chairman of the Basel Committee and President of the Netherlands Bank, said that "the proposed enhancements will help ensure that the risks inherent in banks' portfolios related to trading activities, securitisations and exposures to off-balance sheet vehicles are better reflected in minimum capital requirements, risk management practices and accompanying disclosures to the public."

In particular, this includes assessing ways to mitigate procyclicality, for example, by promoting capital buffers above the regulatory minimum that can be drawn upon during periods of stress. These efforts are in support of the April 2008 recommendations of the Financial Stability Forum and the G20's November 2008 action plan. Wellink underscored that "the committee intends to coordinate and implement this work programme in a manner that strengthens financial confidence and avoids aggravating current market conditions.

It will not increase required global minimum capital ratios during periods of economic and financial stress.
The Committee notes that adequate capital buffers above the regulatory minimum are designed to absorb losses and support continued lending to the economy."

Comments on the revisions to the Basel II market risk framework and the guidelines for computing capital for incremental risk in the trading book should be submitted by March 13, 2009.

Comments on the proposed enhancements to the Basel II framework should be submitted by April, 17, 2009, said the committee.