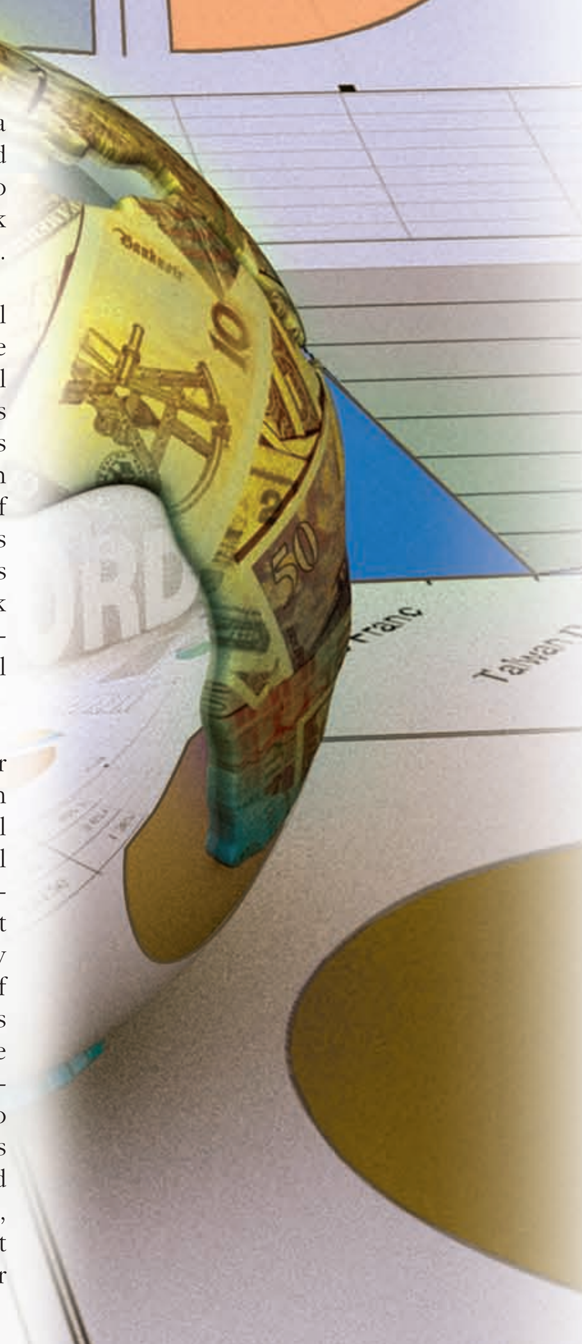
Basel II
Why It's Important to *Your* Credit Union



What Basel II Means for Credit Unions

In June of 2004, the Basel Committee on Banking Supervision issued its "International Convergence of Capital Measurement and Capital Standards: A Revised Framework," also known as Basel II. While implementation of the standard will vary from one credit union system to another, and the long-term impact of the Accord is only conjecture at this point, one thing is nearly certain: Basel II will compel credit union systems to do an even better job of analyzing risk and adopting processes to mitigate it.

History of the Basel Accords

The Basel Committee on Banking Supervision (Basel Committee) of the Bank for International Settlements (BIS) is comprised of banking regulators in the Group of 10 (G-10) countries. It develops banking regulatory best practices and coordinates the activities of banking regulators in G-10 countries, Spain and Luxembourg.

The first Basel Capital Accord (Basel I) was issued in 1988 to provide internationally active banks in G-10 countries with a level playing field on capital standards and to ensure banks had a sound amount of capital. It required participating financial institutions to maintain a minimum capital-to-risk weighted asset ratio of eight percent.

The importance of sufficient capital levels was summed up by Jaime Caruana, chairman of the Basel Committee, during World Council's (WOCCU) conference in Rome this past summer. "No institution can maintain the public's trust for long if it is not properly managed or lacks sufficient capital. Since capital is the last line of defense against bank insolvency, regulatory capital requirements are one of the fundamental elements of financial supervision."

Basel I was implemented in over 100 countries and applied to both large and small banks and several credit union movements. As financial industry regulation has been consolidated in many countries, credit unions have become increasingly subject to the capital standards of the BIS. Credit union movements in Australia, Ecuador, Bolivia, the Dominican Republic and four provinces of Canada have been subject to a risk-based capital standard that is based on Basel I for many years, and many European cooperative banks, which are ancestral relatives of credit unions, have been operating under Basel I for over a decade.

From 2000 to 2004, the Basel Committee worked to create a standard that better served the Accord's mandate to create meaningful capital requirements. World Council played an active role in these discussions to ensure that the credit union voice was heard.

Defining Capital

The definition of capital has changed only minimally from Basel I to Basel II. Capital is still comprised of two types, or tiers. Tier one capital is comprised of permanent shareholder equity (issued and fully-paid ordinary shares/common stock and perpetual non-cumulative preference shares) and disclosed non-distributable reserves that are created or increased by appropriations of retained earnings, capital donations or other surpluses.

Tier two capital is comprised of less secure sources of capital and therefore may not account for more than 50 percent of the total capital of an organization. Tier two capital includes undisclosed reserves, asset revaluation reserves, general provisions/general loan loss reserves (loan loss reserves are not applicable under the internal rating based approaches), hybrid (debt/equity) capital instruments and subordinated debt, which cannot exceed 50 percent of total capital. In those instances where credit unions have converted their ownership shares from being withdrawable to permanent sources of capital in line with International Accounting Standard 32—which provides guidance on how to characterize shares of cooperatives—these shares cannot comprise more than 50 percent of capital. As is the case under Basel I, if the ownership shares in credit unions are unencumbered and fully withdrawable, the shares cannot be considered part of either tier one or tier two capital in Basel II.

What's new in Basel II?

Basel I defined a standard method for calculating the acceptable capital-to-asset ratio of a financial institution:

Pillar one

The amount of capital held by the financial Institution ÷ Assets classes (by risk) = Acceptable capital-to-asset ratio

As mentioned earlier, the minimum acceptable capital-to-risk weighted asset ratio was eight percent under Basel I and remains the same for Basel II.

Basel II differs from Basel I in that it takes a broader, more flexible approach to monitoring and managing risk and introduces two new tools or pillars that increase oversight and decrease reliance on the capital-to-asset ratio (the capital-to-asset ratio is known as pillar one). These two new pillars are:

Pillar two

- A regulatory review process (pillar two) to assist supervisors in analyzing risk.

Pillar three

- A market discipline framework (pillar three) that dictates what information should be disclosed to the public regarding the capital structure of the institution.

Basel II also made substantial changes to the risk weights of the capital-to-asset ratio and introduced new risk mitigation techniques. Some of the most relevant changes for credit unions in Basel II are:

- Moving from a one-size-fits-all methodology for deriving the capital ratio to a menu of three choices: the Standardized Approach, the Internal Ratings-Based Approach (IRB) and the Advanced Internal Rating-Based Approach (AIRB). The main difference between the approaches is that the Internal Ratings-Based approaches allow very large institutions to rely on their own internal estimates of risk components in determining the capital requirement for an exposure, which will likely result in different risk weightings.
- The inclusion of operational risk in the capital-to-assets ratio.
- Much greater specificity in the risk weights and additional asset types in the Standardized Approach.
- The inclusion of external credit assessments from ratings agencies for loans and claims on governments, businesses and other financial institutions in the Standardized Approach.
- Greater allowance and recognition of credit risk mitigation techniques (e.g., collateral, guarantees and credit derivatives).

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Overview of the key differences for credit unions between Basel I and Basel II

Issue	Basel I	Basel II - Standardized
Capital ratio	8% risk-weighted assets	No change
Composition of capital	Tier 1 & Tier 2 capital	No change
Supervisory review	Not included	New guidance on supervisory review process
Market discipline	Not included	Introduced in new Accord
Operational risk	Implicit within ratio	Specific formula of 15% of average gross income in the basic indicator approach
Risk weighting of assets	One-size-fits-all	3 approaches (standardized, IRB foundation and IRB advanced)
Retail exposures (Standardized Approach)	100%	Treated separately with 75% risk weighting for qualifying exposures
Residential mortgages (Standardized Approach)	50% risk weighting	35% risk weighting
Loans 90 days past due (Standardized Approach)	100%	150% if specific provisions are less than 20% of outstanding loan amounts; 100% if specific provisions are at least 20% of outstanding loan amounts; 100% if specific provisions are at least 50% of outstanding loan amount with supervisory discretion to reduce risk weight to 50%

adequate reserves to ensure sound operation. Equally important is regulatory recognition that credit unions, as retail-oriented institutions, often present little systemic risk to a financial system.

There is a broad base of support from international organizations[2] to encourage regulators, especially in developing markets, to focus on a strong supervisory regime as opposed to implementing Basel II carte blanche without recognition of local conditions. "WOCCU has long recognized the important role that a strong regulatory system plays in the success of a credit union system. We believe that Basel II can be a valuable tool for regulators to use when evaluating risk and appropriate capital requirements," said Pete Crear, WOCCU CEO.

Should a Credit Union System Adopt Basel II?

The existence of prudential supervision should be the first consideration when determining if credit unions should apply Basel II. This is most typically a concern in non-industrialized countries.

Apply Basel II if...

- Strong, prudential risk-based supervision exists
  AND
- Credit unions compete directly with banks that adopt Basel II
  AND
- Credit unions/supervisors understand how to calculate the capital ratio under pillar one

Do Not Apply Basel II if...

- Credit unions are not prudentially supervised. Resources are better spent on ensuring strong examination and oversight
- Strong supervisory oversight exists but: Credit unions/supervisory staff would have a difficult time understanding, calculating and applying the capital-to-asset ratio under pillar one
  OR
- Credit unions do not compete directly with banks that use Basel II. Focus should be directed to strong risk-based supervisory system.

In the appropriate situations, implementation of Basel II may help establish regulatory neutrality and introduce a more risk-sensitive capital and management framework in credit unions. Prior to the application of Basel II, the credit union industry should be consulted by the regulatory agency and a quantitative impact study should be completed to understand the ramifications of applying Basel II to credit unions.

Conclusion

As regulators and lawmakers consider the application of Basel II to credit unions, they should recognize that there is not one approach that can be applied to all credit unions worldwide, and that Basel II's implementation should be made in the larger context of strengthening the supervisory structure for the financial sector, including credit unions.

figure 1.

Calculating the Capital-to-Asset Ratio in Basel II (pillar one)

Regulatory Capital ÷ (Credit Risk + Market Risk + Operational Risk) = Acceptable capital-to-asset ratio

Sample Institution: ABC Credit Union

Assets	Value on books	Risk Weight	Weighted Value
Cash on hand (in AA+ rated country)	$20	0%	$0
Financial investments in banks	$40	20%	$8
Mortgages	$150	35%	$52.5
Auto loans	$70	75%	$52.5
Personal loans	$30	75%	$22.5
Loans in default not provisioned	$5	150%	$7.5
Securities	$0		$0
Total Assets	$315		$143

Gross Income - for Calculating Operational Risk

Year 1	$20
Year 2	$4
Year 3	$12
Average Gross Income over 3 years	$12
Beta Factor in Basic Indicator Approach	15%
Ave. Gross Income adjusted by Beta Factor ($12 x .15)	$1.80
Equating operational risk to be 8% of risk weighted assets ($1.80 x 12.5 (reciprocal of 8%))	$22.5

Capital

Retained earnings	$11.8
Capital donation	$1.9
Total Capital	$13.7

Capital-to-Risk Weighted Asset Ratio (ABC Credit Union)

$13.7 Total Capital ÷ ($143 Risk Weighted Assets + $0 Market Risk + $22.5 Operational Risk) × 100 = 8.28% Asset Ratio

Capital to TOTAL Assets Ratio (ABC Credit Union)

$13.7 Total Capital ÷ $315 TOTAL Assets × 100 = 4.35% Asset Ratio

And while concerns about the impact of Basel II upon the competitive marketplace may be valid, credit unions should also realize the benefits the Accord could bring to their systems. Maintaining a strong capital position can guard the institution from catastrophic events and provide for better service and growth of the credit union. Credit unions have always had strong community ties that bolster public trust for them and a strong capital base will only deepen the foundation of trust.

–by Dave Grace
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footnotes

1 Emmons, William R., *Basel II Will Trickle Down to Community Bankers and Consumers*, The Regional Economist, April 2005. Paletta, Damian, *A Tale of Two Fed Staffers and a Paper on Basel II*, American Banker, January 14, 2005. *Quantitative Impact Study 3*, Bank for International Settlements. French, George, *Estimating the Capital Impact of Basel II in the United States*, Federal Deposit Insurance Corporation, December 8, 2003.

2 See article titled *Take Time to Prepare for the New Basel Rules*. London Financial Times, August 12, 2004 by Cesare Calari, Vice President, Financial Sector of the World Bank and Ryozo Himino, Secretary General of the Basel Committee on Banking Supervision.