

International Basel II Training: More Important Now than Ever Before

By Dr. Linda Eagle

Financial institutions across the world have implemented the Basel II framework for measuring capital adequacy in an effort to protect customers, employees and the organizations as a whole. First issued in June of 2004, Basel II is the second accord to come from the Basel Committee on Banking Supervision, which outlines appropriate capital adequacy requirements banks should abide by in order to prevent bank failure. As a result of the current tumultuous times in Financial Services, this framework has become more important than ever, protecting banks and other financial institutions against the impact of the global banking crisis. The Basel II framework has become an international standard for banks to use to ensure that they have enough capital in reserve, using these funds as a safety net against various forms of risk.

However regulatory guidelines and compliance oversight are only the first step. In order for Central Banks and other regulatory authorities to achieve their goals of stability and soundness in the financial system they must implement strong controls with real consequences tied to non-compliance. Most importantly, the laws and regulations governing areas such as ethics and compliance are not worth the paper they are printed on without standardized certifications and role-based training.

What Is Capital Adequacy?

Capital adequacy is the ratio of the bank's capital to its assets. This ratio is used to measure the amount of risk the bank faces. Basically, the bank should not lend out more than it has in coming in or in reserve. Pillar One of Basel II addresses capital requirements. In order for a bank to determine how much capital it should keep in reserve, the bank must calculate its credit risk. Depending on the size of the bank, credit risk is measured in one of three ways:

- **The Standardized Approach** – used to calculate Risk Weighted Assets (RWA). This approach uses External Credit Assessment Institutions (ECAIs) that use their own approved credit ratings systems for the calculation.
- **The Foundation Internal Ratings Based Approach** – involves a bank's creation of an internal ratings system. This system measures Probability of Default (PD), Exposure at Default (EAD) and Loss Given Default (LGD). In this approach the PD is measured internally and the LGB and EAD are provided by a regulator.
- **The Advanced Internal Ratings Based Approach** – involves a bank's creation of an internal ratings system. This system measures Probability of Default (PD), Exposure at Default (EAD) and Loss Given Default (LGD). In this approach all three are measured internally.

All three methods measure capital charges in relation to risk weighted assets. Knowing the credit risk the bank faces in addition to its operational and market risk can help the bank determine the amount of capital that it requires for adequacy.

It is important for the lending policies and procedures of the bank to be in line with the capital adequacy requirements that it has laid out to prevent loss and combat risk. There is no absolute way to ensure that a bank will not fail, or suffer loss, but there are measures that should be in place to prevent these events from happening, and appropriate capital adequacy is one of them.

Other than Basel II, some banks use a method for measuring risk called stress testing. Stress testing is the process of the bank calculating capital adequacy using statistically unlikely but possible extremes. Using a stress test, banks must ask themselves if things continue to get worse, can the bank survive? Stress testing can be used as both an alternative to Basel II methods or as a supplement.

Impact of the Global Banking Crisis

At the heart of the global banking crisis is the lack of capital adequacy. Because so many financial institutions participate in international banking relationships, a small problem with capital at one bank can turn into a larger problem for the global banks it does business with. The purpose of capital reserve is for the bank to have a certain amount of funds on hold to compensate for loss. This loss could result from a customer not repaying a loan. The loss of bank capital could have been prevented by the implementation of Basel II, which prepares banks to handle a potential or actual loss of capital.

For example, a bank in the U.K. had to stop lending to customers when it could not maintain its required capital reserves. When an event such as this occurs, it only adds to the stress on the Bank's reserves. By not lending money the bank is also not earning interest, and therefore must resort to other methods in order to make money to maintain reserves and begin lending again. This pattern is common at banks all over the world and negatively impacts the global economy as a whole.

Why Basel II Training?

Basel II training is critical to all staff so that they comprehend and appreciate the lending and financial framework that the bank has instituted to protect itself, its employees and its customers from credit risk and financial loss. The current economic crisis has put all financial institution employees at risk, making it even more valuable for them to understand the foundation of the bank's decision making, and be able to fall in line with policies and procedures at all times.

With this goal in mind, many banks have turned to enhancing their capital adequacy standards and have begun implementing portions of Basel II into their decision making foundation. Adequate training in Basel II policies and procedures, as well as overall Basel II methodology will give bank staff the confidence knowing that the bank is taking an active roll to protect itself in the current financial market and for the years to come.

Final Word

The current state of the global economic climate has put banks on the defense with regard to lending and credit risk. Many international banks have protected themselves before and during this crisis by implementing Basel II preventative measures. But for every bank that has implemented Basel II measures, there are still a number of global banks searching for ways to prevent future damage. To prevent loss from occurring, banks must train employees on the policies and procedures put into place by Basel II. Training will not only educate staff on how the bank is protecting itself in this time of financial turmoil, but also give them the confidence that the bank is taking steps to fall in line with international standards to prevent bank loss, Basel II.



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