TW3421x - An Introduction to Credit Risk Management

Introduction

The Basel Accords: Basel III

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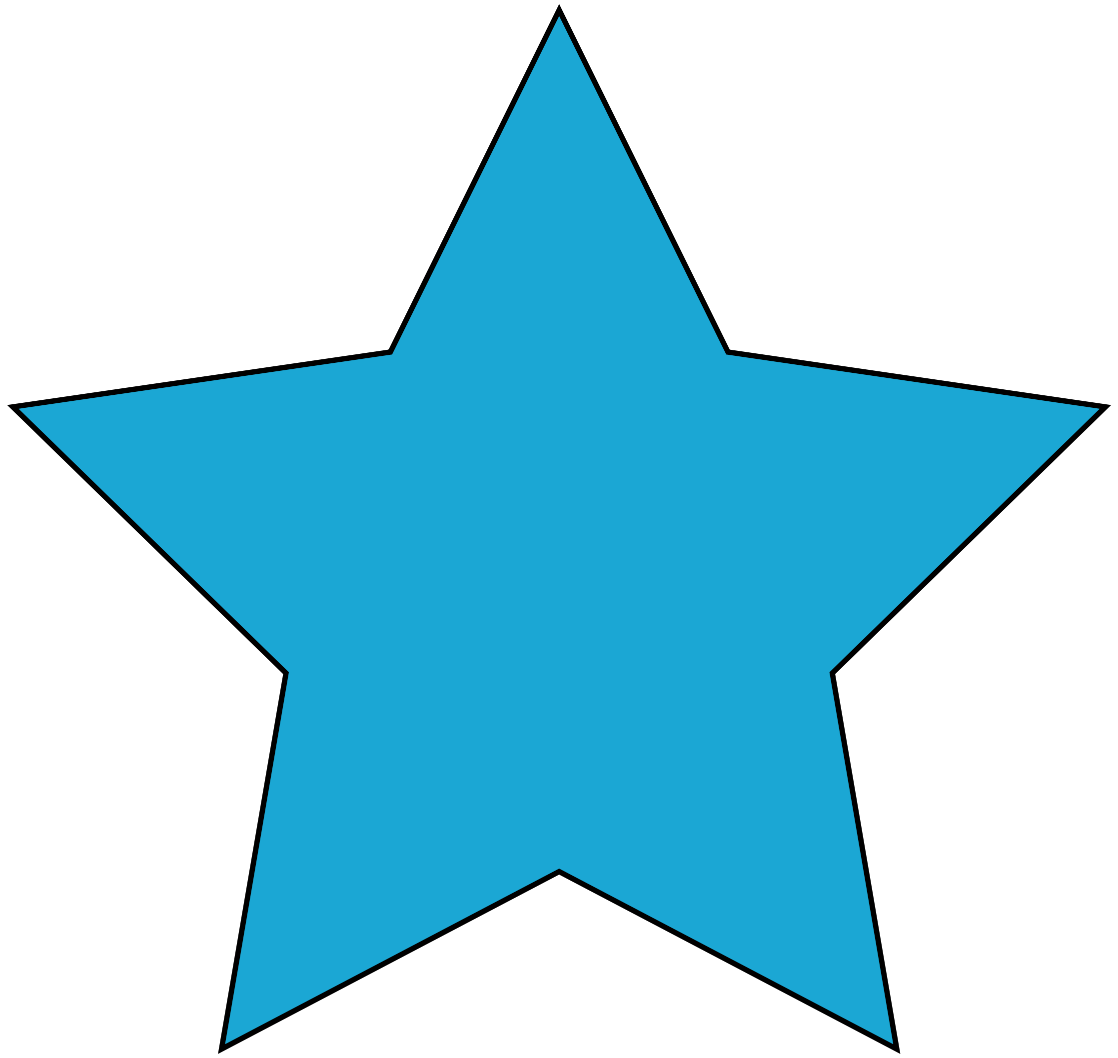
Week 1

Lesson 3

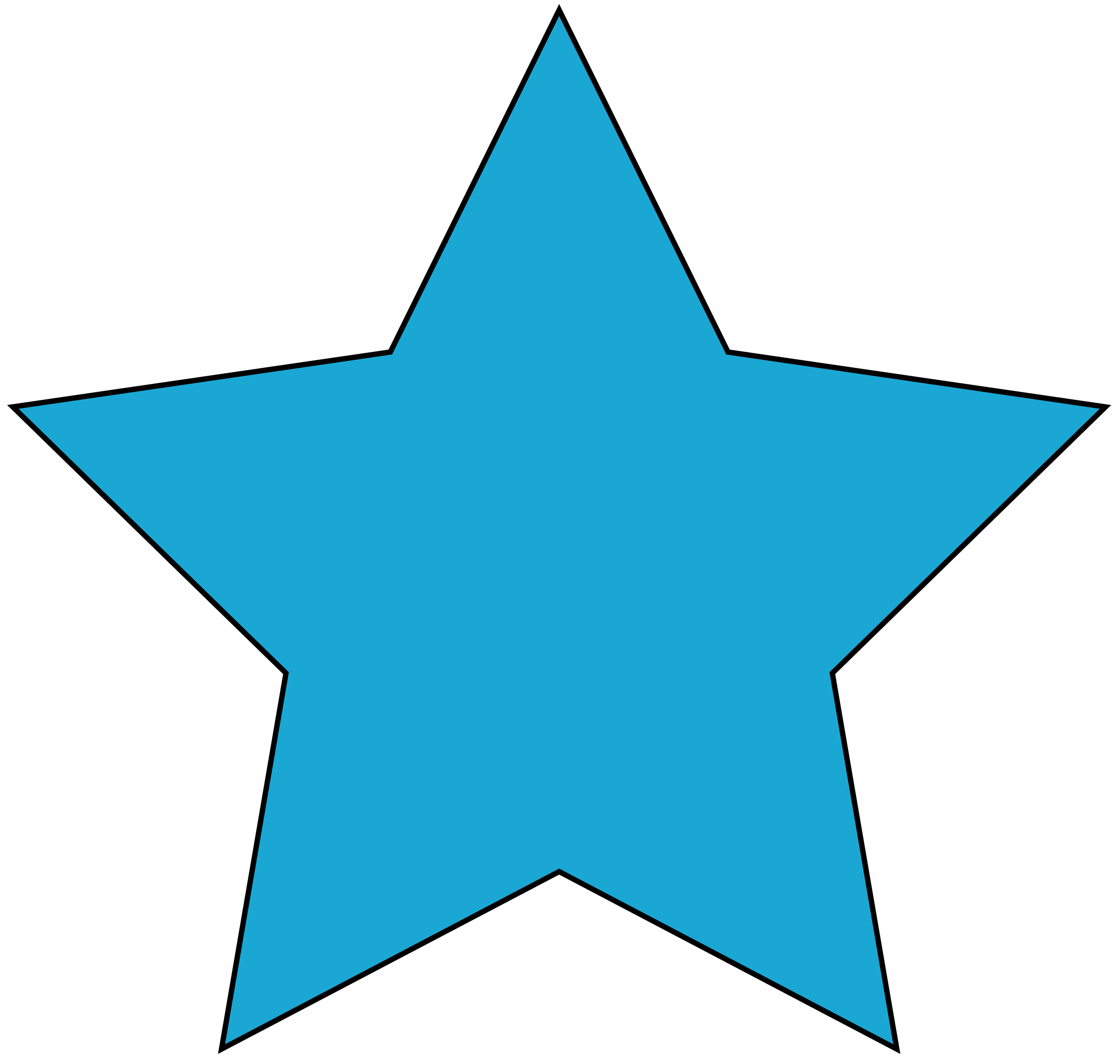
2007-2008: The Crisis

The flaws of Basel II



The flaws of Basel II

Insufficient Capital Reserve



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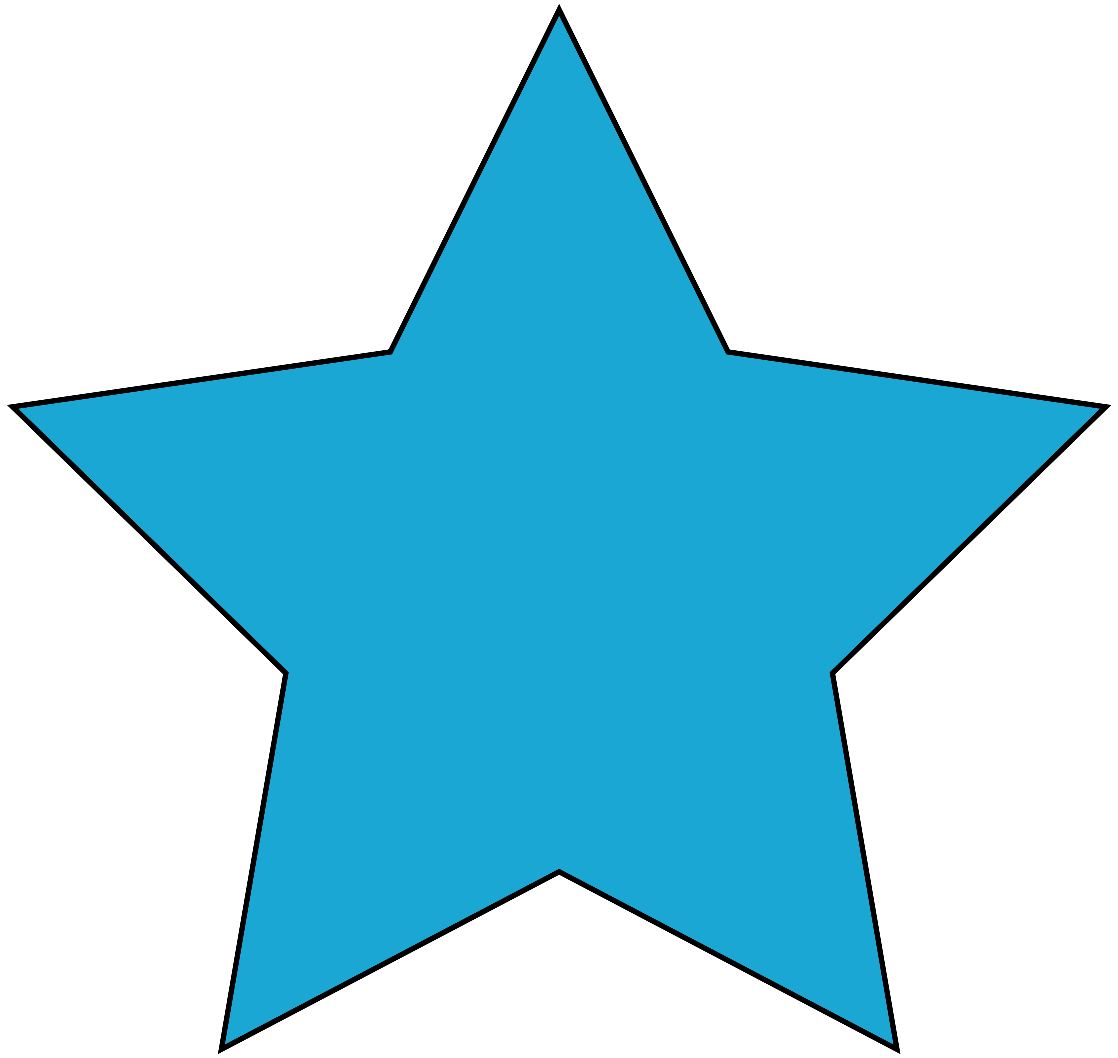

No uniform definition of capital

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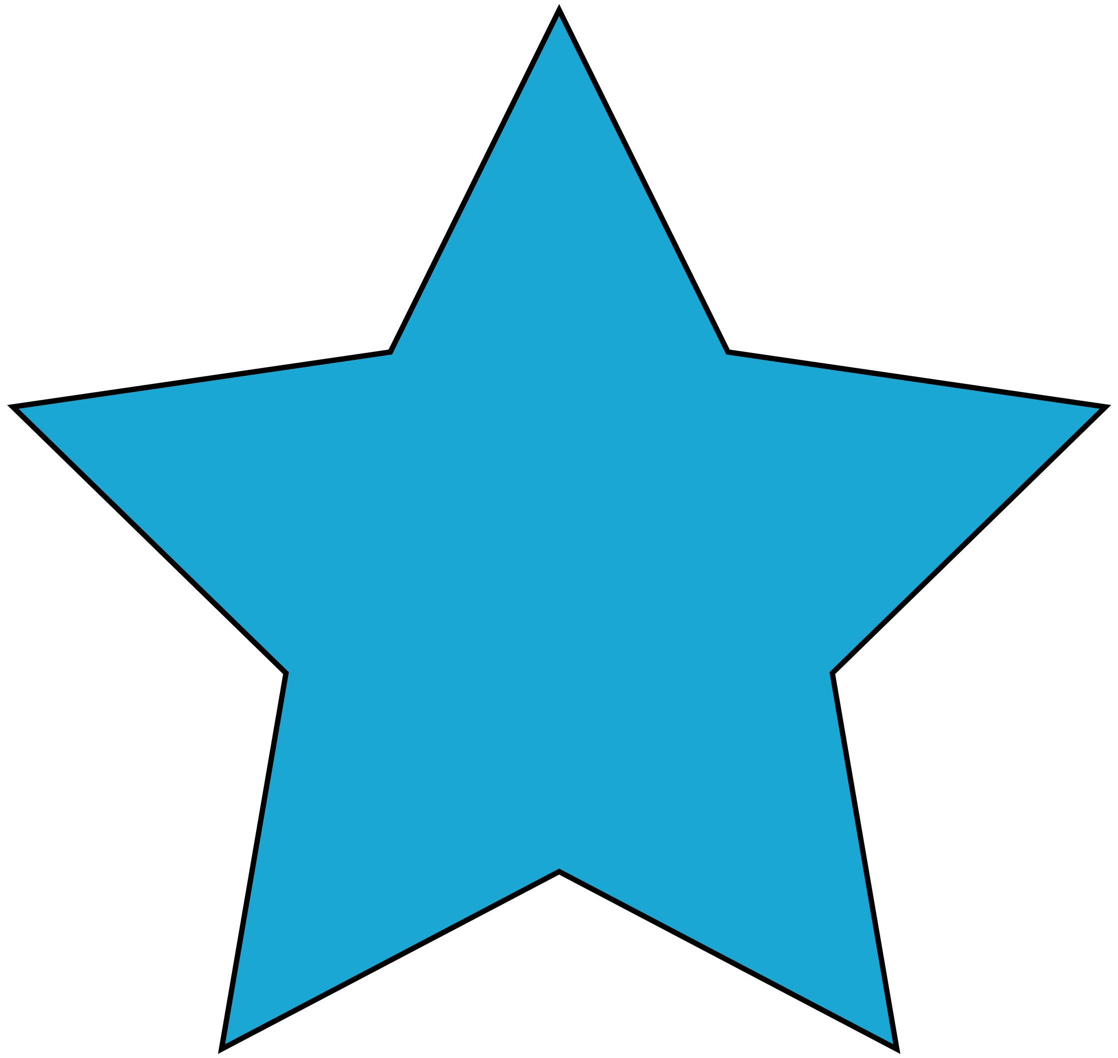

No uniform definition of capital

Inadequate risk management approach

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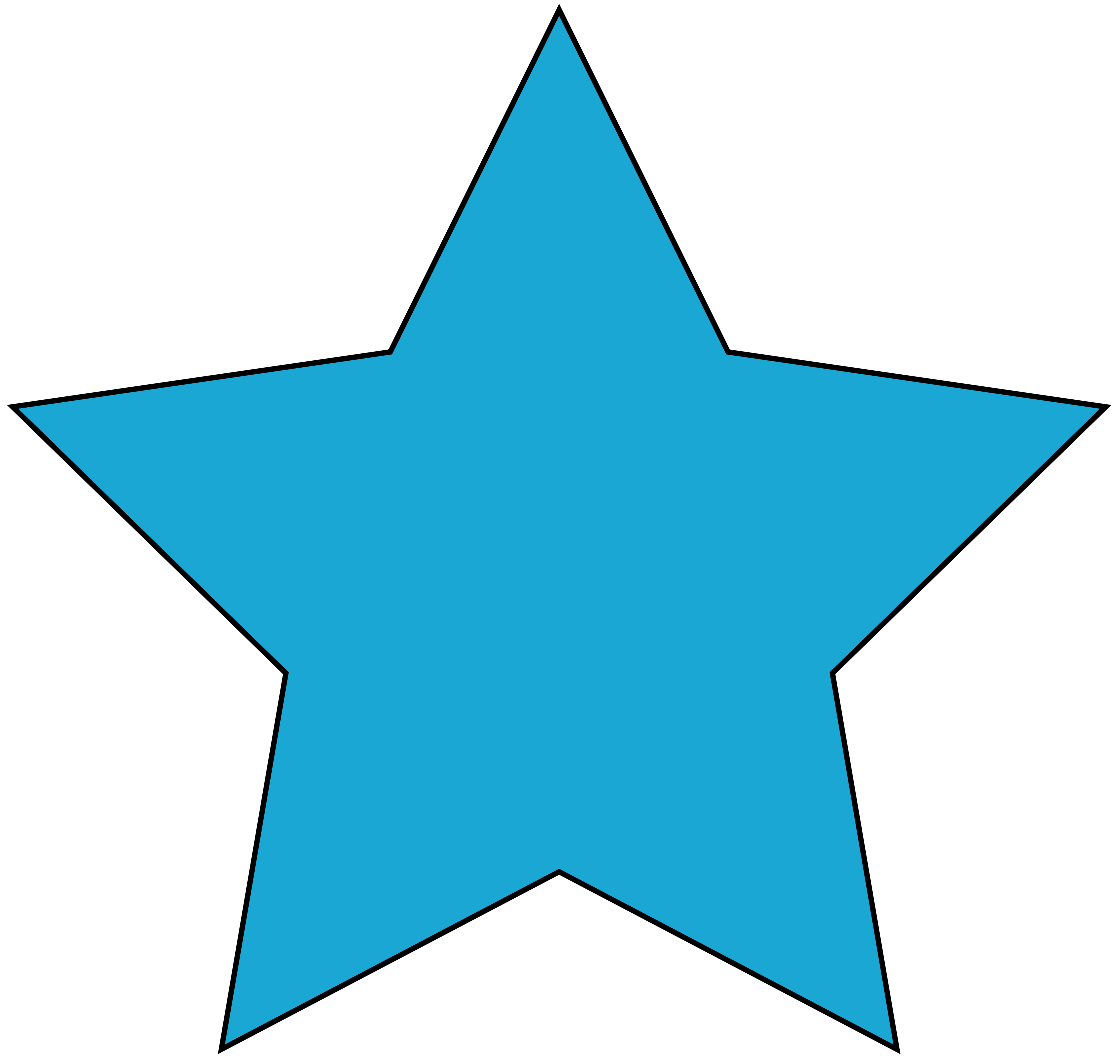
No uniform definition of capital

Underestimation of liquidity risk and excessive leverage

Inadequate risk management approach

Insufficient Capital Reserve

Pro-cyclicality



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Basel III

- (Basel 2.5 in 2011)
- First Basel III proposals in 2009.
- First version in 2011.
- Many amendments.
- The implementation is now ongoing.
- Fully operative in 2018/2019.

The key points

- Capital definitions and requirements.
- Capital conservation buffer.
- Countercyclical buffer.
- Leverage ratio.
- Liquidity risk.
- Counterparty Credit Risk.

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Core capital:

- Share Capital
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Capital Definitions & Requirements

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~~**TIER 3**~~

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- Basel III asks banks to have additional capital buffers, in order to hedge risk.

- They must be met with Tier 1 capital.

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2.5% of RWA

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0-2.5% of RWA

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- In addition to the capital requirements based on RWA, banks are supposed to keep a minimum leverage ratio of 3%.
- The leverage ratio is the **ratio of capital to total exposure**.
- Regulators may impose stricter regulations.
  In the US, for some **Systemically Important Financial Institution** (SIFI) the leverage ratio is at least 6%.

- Liquidity risk is the risk that manifests itself in situations in which **a party interested in trading an asset cannot actually do it because nobody in the market wants to trade for that asset.**
- For banks it generally arises because banks have the tendency to finance long-term needs with short-term funding.
- In good times, this is not generally a problem.
- In bad times, it can lead a bank to the impossibility of rolling over and financing itself.

- Under Basel III, for each of its derivatives counterparties, a bank has to compute a quantity known as **credit value adjustment**, or CVA.
- CVA can vary because of changes in the market variables influencing the value of the derivatives, or because of variations in the credit spreads applicable to the counterparty.
- If you are interested, this can be the topic of Week 7.

Thank You