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ABAC

With APEC Business Advisory Council

# Financial Stability in the Asia Pacific: Improving Risk Management

## Executive Summary

The new Basel Capital Accord (or Basel 2) for the supervision of banks holds promise of a more internationally coherent and efficient approach to bank supervision, which can assist in promoting a more resilient and stable financial sector in the APEC region.

This was the topic of discussions at a Symposium on Risk Management, Pricing and Capital Provisioning held in Sydney in May 2002. Senior officials of regulatory agencies, multinational agencies, banks, financial advisory firms and academics from the APEC region attended the symposium.

The Symposium was the initiative of the Finance Task Force of the APEC Business Advisory Council (ABAC), in collaboration with the Finance Forum of PECC, and designed to be an institutional capacity building program as part of the larger agenda of strengthening financial systems within the region.

Basel 2 encourages strengthened active credit risk portfolio management by financial institutions, with built in rewards and sanctions. It will reward those banks which implement advanced methods of internal risk management procedures by requiring differentiated capital requirements for certain asset classes. On the other hand, those banks which do not elect to adopt advanced methods will continue to bear the 8% capital adequacy requirement over all asset classes, as presently required under the 1998 Basel Accords. Basel 2 is expected to be implemented by late 2006.

The process of interpreting, influencing, and implementing Basel 2 will pose significant challenges and resource intensive tasks for bank regulators from the region over the next 5 – 10 years.

Adopting Basel 2 in the Asia Pacific region will be challenging, particularly given the broad range of countries that are at different stages of development in their banking and broader product and capital markets.

Despite these challenges, the Symposium offered some solutions to the impediments to a smooth journey towards more efficient and soundly supervised banking systems in the region. Indeed, a key message of the Symposium was that focusing on the journey rather than some specific end point is the appropriate framework for considering Basel 2's implications for the region.

The Symposium strongly supported the need for greater public/private sector co-operation to overcome the challenges of implementing Basel 2. It was argued that there are no benefits and potentially significant costs, if regulators and banks are at different stages on the learning curve regarding new risk measurement and management techniques. Capacity building initiatives should include greater information exchange and training between banks, regulators and academic sources.

## Recommendations

***Recommendation 1: APEC economies should recognise that there is a crucial need for better risk management and pricing and capital allocation measures as reflected in Basel 2.***

Basel 2 should provide greater discipline in banking activities, to improve efficiencies and to minimise banking risks through enhanced regulatory standards and to enhance the disciplines of the market – thereby contributing to banking system stability and profitability.

***Recommendation 2: The need for a sound risk management and pricing system as an integral element of a bank's management and governance systems applies irrespective of whether a bank elects to use the standardised approach or the advanced approach of Basel 2.***

This is essential to sound banking practice and particularly relevant in banking cultures where lending has been mainly based on banking/customer relationships.

***Recommendation 3: To facilitate the adoption of Basel 2 across the APEC region, noting the complexities of the issues involved.***

It will take to fully implement improved risk management procedures, co-operative measures involving governments, relevant regional and international agencies, banks, regulatory agencies, academics and financial research specialists, are required to prepare for the development of the infrastructure and the human resource skills that will be necessary. Careful preparation for this journey through a transition phase will be highly important to the successful implementation of Basel 2.

Specifically, the following measures are recommended for APEC economies:

***Recommendation 4: Consider the resourcing needs of financial regulatory agencies as Basel 2 is implemented.***

Benchmarking studies of the actual resourcing needs of financial regulators and resource requirements could be an item for inclusion on the work programs of the ABAC and PECC finance groups.

***Recommendation 5: Develop information sharing arrangements between regulatory bodies on regulatory developments and in such areas as the promotion of regional credit markets***

***Recommendation 6: Develop practical and transparent transition arrangements that will guide banks on the implementation of Basel 2 and promote co-ordination between regulators in the region aimed at avoiding regulatory discrepancies and minimising opportunities for regulatory arbitrage as Basel 2 is implemented.***

***Recommendation 7: Give special attention to supporting capacity building of bank regulators to prepare for implementation of Basel 2.***

By renewing the APEC Financial Regulators Training Initiative or establishing similar programs in the region. Co-ordinating with other relevant institutions in this endeavour, including the private sector, academics and finance research specialists (noting the value of the model of training in Life Insurance and Pensions which was developed by the Australian APEC Study Centre and sponsored by the ADB, the Australian government and Australian finance institutions), the BIS and the Basel Committee's Accord Implementation Group.

***Recommendation 8: Consider lower risk weights for SME loan portfolios.***

Where those SME portfolios are secured and priced for risk and where the enforceability of securities is certain under local legal systems, immediate changes can be proposed to the BIS to give effect to lower risk weights in the lead-up to the Basel 2 Accord

The following measures are recommended for APEC economies and regional banks:

***Recommendation 9: Seek to be involved in consultations with the BIS on the further development of Basel 2.***

The value of redefining the risk weighting for loans to SMEs was noted above, for example.

***Recommendation 10: Develop joint private/public sector initiatives for training and building the skills of bank risk managers (and bank boards) and bank regulators in the techniques and strategies to support Basel 2.***

Capacity building initiatives should involve the private sector, through bodies such as ABAC, PECC, financial academic research groups, regional and local bankers' associations (eg. the Asian Bankers Association) and private financial institutions willing to share their resources and knowledge in these efforts

The following measure is recommended for ABAC and PECC.

***Recommendation 11: Build on the work of the Symposium to develop further public/ private sector initiatives to support APEC economies in institutional strengthening of regulatory agencies in the banking sector in preparing for the implementation of Basel 2.***

## Introduction

The new Basel Capital Accord for the supervision of banks (hereafter referred to as Basel 2) holds promise of a more internationally coherent and efficient approach to bank supervision, which can assist in promoting a more resilient and stable financial sector in the APEC region. Basel 2 is expected to be implemented by late 2006.

The philosophy underlying Basel 2 involves active credit risk portfolio management by financial institutions with built in rewards and sanctions. It will reward those banks which adopt advanced internal risk management procedures. On the other hand, banks which do not elect to stay with a standardised approach to asset management will have to meet capital adequacy standards required under the 1998 capital accords. These are likely to be more onerous.

Basel 2 endeavours to address a number of problematic attitudes and practices in risk management evident in the global banking system. An area of great significance for example is in customer risk assessment and loan approval, where the longer term relationships between banks and their customers, common in a number of Asian jurisdictions, can often have more relevance to credit decisions than the use of more rigorous and data based risk assessment techniques.

Basel 2 is not just a high level conceptual initiative to improve risk management, but drills deep into the day to day practices of bank management including data collection on customers, management, staff culture and tradition. It will challenge banks to achieve higher levels of transparency in all aspects of their operations. Risk management will in effect become the central aspect of a bank's system of governance - irrespective of whether or not a bank elects to adopt the standard or the advanced approach to risk management.

Approximately 90 delegates attended a Symposium in Sydney in May 2002 on these issues. Participants included senior officials of regulatory agencies, multinational agencies, banks, financial advisory firms and academics from the APEC region. They identified the nature of the challenges to implementing Basel 2, and offered some solutions to the impediments to a smooth journey towards more efficient and soundly supervised banking systems in the region.

The symposium was the initiative of the Finance Task Force of the APEC Business Advisory Council (ABAC), in collaboration with the Finance Forum of PECC, and designed to be an institutional capacity building program as part of the larger agenda of strengthening financial systems within the region.

## Key Pillars of Basel 2

Basel 2 provides a framework to deal with both large banks operating in well developed capital markets with access to sophisticated risk management techniques, as well as smaller banks operating at quite different levels of management sophistication. Within the region, banks and financial markets span that spectrum, and regulators will have a difficult task in dealing both with that diversity and managing the transition as banks respond to Basel 2, to financial reform more generally, to innovation and to technological change.

The Bank of International Settlements does not have the authority to enforce Basel 2 and therefore it is seeking the cooperation with regional groups that have an interest in banking regulatory matters. As a result, Basel 2 has an architecture that is based on the principle of transparency of information and stakeholder activism to ensure compliance using three mutually supportive pillars.

Pillar 1:
Minimum capital requirements which adequately reflect risk taking by banks, so that there is an adequate capital buffer to absorb risk, and so that it has been appropriately priced.

Pillar 2:
An efficient and effective supervisory process, where there is more cooperation between banks and regulators.

Pillar 3:
Increased reliance on information disclosure and the discipline of the financial market.

Basel 2 should represent a major improvement in risk management practices. However, the key issue will be its proper implementation. There is a danger that significant and unnecessary costs may result if Basel 2 is poorly implemented. The risk of poor implementation is high where national regulators exercise discretion over certain aspects of the new approach.

## Main Differences with Existing Arrangements

Basel 2 builds on the Basel Accord of 1988 where banks maintain a capital adequacy requirement equal to 8 per cent of a basket of risk weighted assets. Basel 2 offers banks a two tier approach in the transition process to better calibrate their capital reserves to both credit, market and operational risk exposures.

The basic tier is the 'standard approach'.

- It is designed for domestically focussed banks with relatively simple business models.
- There is expected to be minimum change from existing capital requirements.
- However, it will require greater disclosure of information and more discrete classification of risk groups for calculating the basket of risk weighted assets.
- It is seen as a transitory step by which banks will over time, develop systems to a point where they can move to the advanced approach.

The second tier is referred to as the 'advanced approach' and is aimed at more sophisticated banks with international operations.

- It relies on a 'bottom up' methodology with an objective scale to rank credit risk, including probability of default of a loan and the expected loss arising from default.
- Banks will internalise their risk management processes and these will required to be approved by local regulators
- There are strong incentives to better manage risk with the reward of lower capital provisioning requirements over some asset classes; this should lower banks' capital costs.
    - o Significant opportunities should emerge to augment competitive advantage for Banks that are to adopt the advanced approach.

The two tier approach however could raise concerns where international banks operate along side domestic banks which elect to use the standard approach. In the initial phase after implementation, some domestic banks, are unlikely to have the human and capital resources to move to the advanced system, and depending on the markets in which they operate, they may suffer some competitive disadvantages.

Another important feature of Basel 2 is the incorporation of an allowance for operational risk into the capital adequacy standards.

Operational risk is "the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events".

- It includes for example, actions by governments and regulators, damage to premises and the environment, financial infrastructure failure, IT systems failure, outsourcing failure, fraud, legal disputes, modelling errors, compliance failures and theft and other crimes.
- Data collection on operational risk loss has not generally been undertaken and as a consequence many losses that would, in the past, have been attributed to credit risks might well have been better classified as operational risks.
- More data is now being collected and new risk models for use in operational risk management will be developed over the next 5 years or so.

## Implementation Challenges in the Asia Pacific

The process of interpreting, influencing, and implementing Basel 2 will pose significant challenges and resource intensive tasks for bank regulators from the region over the next 5 – 10 years.

Adopting Basel 2 in the Asia Pacific region will be challenging, particularly given the broad range of countries that are at different stages of development in their banking and broader product and capital markets. It was noted that banks from within the Asia and Pacific region have not been actively involved in the formulation of Basel 2, and that there is some urgency to consult the region as Basel 2 is further refined in the run up to implementation.

Furthermore, it should not be assumed that the goal of reaching the advanced approach status and its associated rewards will be easy to achieve, even for the international banks. Indeed, it may well prove to be the case that the advanced approach will not be relevant to many banks in the region for some period ahead. The implications of this will need further consideration. Nonetheless, all banks will need to consider measures to implement the more exacting standards, particularly in meeting the disclosure and reporting requirements of Pillars 2 and 3, that will be required under Basel 2.

While there are a number of sophisticated risk analytical tools available to banks, many banks do not have the capacity or the human resources to use them and in a number of emerging economies, the information flows and the experiences that are needed to build reliable predictive risk models is simply not available. These factors pose significant challenges to both domestic banks and to regulators in emerging markets for the implementation of Basel 2.

## Addressing the Weakest Links

The reliance on the third pillar, market disclosure and discipline, is potentially the weakest component of the Basel 2 proposal. Substantial further work is required by governments, business, regulators and the research community to improve the understanding of the interaction of market development and regulatory structures. In particular, regulators need to be familiar with risk products and the activities of such markets, they need to facilitate their development, and they must be able to monitor and supervise bank involvement in such markets.

The development of reasonably advanced financial markets and market discipline is a key ingredient underpinning Basel 2, which will present fundamental challenges to its implementation in some APEC member economies. For instance, credit risk management techniques increasingly involve the use of trading or transferring of credit risk, such as credit derivatives, securitisation and derivative markets. Equally, the development of bond and equity markets through which information about borrowing companies is reflected in prices are important for benchmarking bank credit risk assessments and for the application of some of the more sophisticated risk measurement techniques These are important for the efficient transfer of market risk but are poorly developed in some Asian economies.

Although there are proprietary aspects to the risk management processes and techniques which banks and consulting firms develop, there is much in the public domain which can be shared in general training to assist in strengthening regulatory capacity. And while such techniques can be complex, presentations at the Symposium highlighted how significant insights and understanding can be gained from the application of relatively straight forward principles.

## Small to Medium Size Enterprises - A Special Case

Finally, another challenge with implementation of Basel 2, concerns the consistency of treatment of groups of assets under the advanced approach across banks in an economy. This challenge includes the weighting to be applied to capital to support lending to small to medium size enterprises (SMEs) and to resolve the problems arising from the lack of historical data on lending to some segments of the market. The way that regulators handle this aspect of the transition to Basel 2 will be crucial to regional development, especially for small and emerging economies, including Pacific Island states. The weighting for loans to SMEs and to micro-finance institutions has particular importance in the smaller economies, because they are unlikely to have the capacity to fully implement Basel 2 due to resource constraints and the smallness of their banking systems.

## A Way Forward: Public/ Private Cooperation

### Greater Information Exchange

A key factor in the successful implementation of Basel 2 will be public/ private sector co-operation.

Cooperation would constitute the sharing of knowledge and contribute to:

- strengthen the regulatory process within the region;

- design measures, in co-operation with policy makers and regulators, to facilitate transition to new regulatory regimes;
- understand the interaction of market disciplines and regulatory reform; and
- develop and test new portfolio modelling techniques.

## Need for More Capacity Building Initiatives

There is a need for regulatory capacity building aimed at strengthening financial systems in the APEC region. While some important measures are in place to meet this need, more work is required.

APEC/ABAC and PECC have proposed significant financial sector initiatives related to capacity building - the Sydney Symposium being an example. The Finance Forum of the PECC group is currently undertaking a review of financial institution ownership and risk management practices within the PECC economies. This will provide a valuable comparative resource for assessing risk management techniques in the region against best practice benchmarks.

In addition, the ABAC Finance Task Force Work Program for 2002 will include recommendations to Ministers on further measures to support capacity building in banks and in regulatory agencies in the region to prepare for the implementation of Basel 2. It will also make recommendations to promote the deepening and broadening of capital markets and on regional monetary developments.

There is increasing recognition of the value of industry/ regulator/academic co-operation in capacity building, particularly in complex areas of financial system regulation at a time when regulators and policy makers adjust to a more dynamic capital markets. In these circumstances, regulator and bank complementarity is critical as there are no benefits, and potentially significant costs, if regulators are at different stages on the learning curve regarding new risk measurement and management techniques.

Topics of mutual interest include the design of transition modalities to new regulatory regimes, the interaction of market disciplines and regulatory reforms, as well as the development and testing of new portfolio modelling techniques.

## Web Site Links to Presentations and Background Notes.

ABAC
http://www.abaconline.org/members/02junabacpecc_symreport.htm

PECC
http://www.pecc.net/finance/pecc&abac_symposium.htm

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