PECC Finance Forum Conference

Issues and Prospects for Regional Cooperation for Financial Stability and Development

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Day Two: Challenges of Regulatory Reform for Financial Institutions Development

Session II: Risk Management and the Regulatory Systems

RISK MANAGEMENT AND PRICING: FINDINGS FROM THE ABAC/PECC SYMPOSIUM

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I am delighted to participate in this PECC Forum; I thank the co-ordinating group for inviting me, particularly KOPEC, CTPECC, FIMA and the East-West Centre.

I cover three points in this address.

- ABAC and its role in APEC;

- major themes on ABAC's agenda;

- findings from the joint ABAC/PECC symposium in Sydney, 16/17th May;

ABAC and its role in APEC

Very briefly, the APEC Business Advisory Council was established by APEC Leaders to provide a business perspective on the APEC agenda. The Leaders of each 21 APEC economies appoint three business leaders to the Council.

ABAC has four major task forces - Finance, SMEs, Business Facilitation and Technology and a Committee - the Action Plan Monitoring Committee. It meets four times a year to plan its work and to prepare its recommendations to Leaders.

Mr. David Murray, CEO and MD of the Commonwealth Bank of Australia is appointed by Australia's Prime Minister to ABAC. One of my role's in advising CBA is to support the CEO in his capacity of the chairman of the FTF.

Major themes on ABAC's agenda

An overarching theme of APEC's business leaders is to recommend measures to support the liberalisation of trade and investment in the region.

There is a strong commitment in ABAC to the realisation of the Bogor goals and to provide specific action plans to further the processes of WTO and develop an environment for regional and global growth. ABAC has made specific recommendations to further the removal of barriers to trade - particularly trade in agriculture - for the adoption of international standards and to measures to facilitate business investment.

Much emphasis is placed on ways to deepen the benefits arising from greater economic interdependence. This year the Finance Task Force has provided views on ways to develop microfinance sectors to support disadvantaged and poor groups in the region, and measures to encourage the spread of e-technology to the poor.

Over recent years, the Finance Task Force has advocated policies aimed at deepening and broadening regional financial markets and, following the Asian financial crisis, it has encouraged policies to strengthen prudential standards, to encourage the adoption of international regulatory standards and ABAC promotes capacity building measures to assist regional regulatory agencies in adopting those standards.

ABAC is continuing its work in the area of institutional capacity building - and I will come back to that in a moment. As well, ABAC is sharply focused this year on measures to combat the financing of terrorism through the finance sector and to deal with the sharp rise in insurance premiums and the withdrawal of insurance cover.

To be relevant ABAC has to be responsive to the contemporary APEC agenda.

Findings from the ABAC/PECC symposium in Sydney, 16/17th May 2002

First a little background. The symposium was an institutional capacity building program designed in collaboration with PECC and responded to a call at the APEC Leaders' Shanghai meeting in 2002, to deepen and broaden national financial systems.

This was a joint public/private sector initiative - both in terms of sponsorship and in terms of presenters and participants. Our aim simply, was to enhance understanding of the importance of risk management, risk pricing and capital provisioning in banks in the region and to do this in the context of the emerging Basel 2 capital standards.

We also wished to consider what further capacity building measures, if any, would be needed if the banks and regulators across the region are to implement Basel 2 - by the time it will become effective - possibly in late 2006.

Sponsorship was provided by a number of Australian public and private institutions, and the intellectual input provided by the BIS, the ADB, regulators from the APEC region, academics - some are here at this forum (my colleagues Professor Dietrich, Dr. Parrenas and Dr. Hong) - and bankers from the region and representatives from a number of international advising groups and rating agencies.

Approximately 90 bankers and regulators from the region attended.

A detailed report and an executive summary and recommendations arising from the symposium are available on ABAC's website and I understand a summarised report is being prepared by PECC.

The following are my personal views on what were the main "high level" findings of the symposium

- on the implementation and objectives of Basel 2

- banks and regulators in the region are working to implement Basel 2; there is broad understanding that Basel 2, if fully implemented, would provide greater stability to regional banking systems and improve efficiencies;

- while the essential goal of both the standardised and the internal risk management approaches is to strengthen the prudential base of banking activities through a more calibrated approach to risk management (including for operational risk as well as market and credit risk), those banks which elect to adopt the internal risk management approach should enjoy a particular benefit because it will enhance their capacity to manage and price risk and to use capital in a more efficient way;

- (the minimum capital requirements of Basel 2 are dealt with under the First Pillar)

- banks - with international operations - are likely to adopt the internal risk management approaches envisaged under Basel 2 - while smaller local banks are likely to go along with capital adequacy standards similar to those in place under the Basel Accord of 1988;

- how the capital requirements work out in practice and just how much benefit is gained through the more efficient use of a bank's capital will become apparent with experience as Basel 2 is implemented;

- Pillar 3 seeks to impose greater market discipline on banks through more effective disclosure requirements on information they provide about their operations; Pillar 3 should provide markets and depositors with data relevant to judging the credit worthiness of banks; the discipline this imposes should be an incentive to banks and other deposit taking institutions to ensure they follow best practices in risk management;

- the challenges for banks and for bank regulators

- the symposium showed that *banks* and *regulators* in the region have quite different levels of capacities to implement Basel 2; these differences arise from a number of reasons - they include:

    - the availability or lack of it, of time series data on which risk experience can be based;

    - the use, or lack of, of sophisticated risk management tools that are now available from market sources;

    - banking cultures - those economies with a culture of relationship banking have generally not developed the analytical tools that go with more sophisticated models of risk analysis;

    - the quality of governance structures; banks with strongly developed and transparent governance structures have at the core of those structures the management and pricing of risk and the management of capital; (the relationship between governance and effective risk management is a crucial issue for a number of emerging markets - both at the industry and regulator level);

- differences in IT and human resource skills were also noticeable - and quite closely linked to the first point above;

- it is noteworthy that while there will be somewhat different approaches to risk based capital, pillars 2 and 3 of Basel 2 will require new approaches by banks and regulators in all economies; pillar 2 will involve greater co-operation between banks and regulators as Basel 2 is developed and then bedded down;

- and because there is some national discretion on the treatment of risk, national regulators will need to liaise closely with the banks they supervise and with other regulators in the region to ensure that differences in approaches do not cause regulatory arbitrage across borders;

- the challenge for governments

- there is a clear need for governments in the region to review the resources of their regulatory agencies - to ensure that agencies do have the skills base necessary to implement Basel 2;

- there is a fairly straightforward choice; as economies move to adopt Basel 2 to provide greater stability to banking sectors andgreater efficiencies in the use of scarce capital - then regulatory agencies will need to be properly equipped to the effective implementation of the new accord;

- co-ordination with the Bank for International Settlements will be required so that regional issues are fully understood and taken into account as details of the Basel 2 approach are further developed; in particular,

    - regional governments and the BIS should consider lower risk weights for lending to SMEs where lending is secured, properly priced and where the enforceability of securities is certain under local legal systems; immediate changes should be made to lower risk weights in the lead up to the Basel 2 accord;

- finally, further capacity building proposals to enhance regional financial security

I would like to close with a few comments on further capacity building.

Perhaps one of the most important message from the Sydney symposium is that the implementing Basel 2 creates many challenges. I know that a number of agencies and institutions in the region acknowledge this fact and are working to put measures in place that will ensure that this region can go forward confidently to implement Basel 2.

There is ongoing work to develop regional infrastructure that will be necessary to support the implementation of Basel 2, in particular the development of credible rating agencies that are necessary to give effect to the market disciplines that underpin Pillar 3. It is vital that work be continued with a high degree of urgency, as well as work associated in developing data on lending activities and on risk modelling techniques.

Another important message from Sydney is that the skills base in APEC is more than adequate to implement Basel 2. The challenge is to bring them together effectively to impart knowledge and practices to people and institutions that need them. This of course requires co-ordination and funding.

I should note that ABAC is proposing further important capacity building initiatives - and which would aim to involve public and private partnership in the field of risk management in financial institutions - both in regulatory agencies and in commercial banks in the region.

I strongly commend that PECC and ABAC continue to work co-operatively in this work and build on the foundations established by both groups at the highly successful capacity building symposium in Sydney in May.

May I again thank PECC for the opportunity to address this Forum.