SAARCFINANCE Regional Seminar on Basel II Enhancements (i.e. Basel III) and Policy Response in SAARC Countries; April 11, 2011

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Ladies and Gentlemen

It gives me great pleasure to welcome SAARC delegates on a topic currently on the minds of all banking regulators, i.e. the Basel Accord Enhancements. I hope that during the proceedings of this seminar, the understanding of Basel enhancements and their expected impact would be clarified significantly; and it will also provide an opportunity to benefit from each others' experiences.

As we all know the Basel Committee's landmark initiative on "international convergence of capital measurements and capital standards" commonly referred to as Basel I started way back in 1988 and we are gathered here to deliberate on the third version of the same as published in December 2010 and commonly referred to as Basel III. This reminds me of the pre-Socratic Greek philosopher Heraclitus (535 – 475 BCE) who is famous for his doctrine of change being central to the universe, as stated in his famous saying, "Everything changes and

nothing remains still .... and ... you cannot step twice into the same stream". This centuries old doctrine has proved itself time and again and is true for the financial sector as well. Three years ago (2008) at this very place we were talking about a new Basel II accord and now again we are here for yet another enhanced version i.e., Basel III. The speed with which changes are taking place, suggests that going forward continuous updation will be the only way out to minimize the chances of recurrence of crisis as recently witnessed.

Basel III framework is essentially the Committee's response to the recent global financial crisis (GFC), and the principal goal is to enhance bank and banking sector resilience to unexpected shocks and thereby promote financial stability. The GFC highlighted the vulnerability of the financial institutions arising out of excessive leverage, opaqueness of innovative products, and too much reliance on inter-bank market for liquidity management. In the United States, we were faced with a dysfunctional financial sector/ system and a virtual collapse of the Capital Markets where only the bluest of Blue Chip companies could access the market for their funding needs. We witnessed massive bailout and Federal support programs to ensure adequate liquidity was available. In the U.K., Northern Rock become a victim of both a

liquidity crunch and regulatory failure. The new Basel enhancements mainly focus on improving quality and quantity of core capital, and in addition introduce liquidity standards.

A key feature is the combination of firm specific and macroprudential measures to address extreme cyclicality and systemic risk. Following are some of the main components of the new framework which are aimed at protecting against the types of internal and external shocks banks and banking systems often face, regardless of the state of development or complexity.

1) **It substantially raises the quality and quantity of capital, with a greater focus on common equity. With tangible common equity (TCE) which comprises paid up capital and retained earnings (minus intangibles) there would be an improvement in capital quality to better absorb losses from shocks which could emanate from anywhere.**
2) **The crisis has shown that balance sheets were being leveraged, but the risk-based framework failed to fully or adequately capture this dynamic. Recognizing this problem, the Basel Committee has now introduced a simple, non-risk based leverage ratio to**

supplement the risk-based capital requirement that captures risks arising from total assets.

3) **It introduces two types of capital buffers. The conservation buffer is oriented to absorb losses not only in normal times, but also during times of economic stress. Additionally the countercyclical buffer takes into account the dangers of rapid credit growth, which might be particularly relevant for emerging economies.**
4) **Finally, beyond the need for more and better capital to absorb unexpected losses, the crisis highlighted the risk of poor liquidity management. As such another feature is the introduction of Liquidity buffers: for instance, banks must hold a sufficient position of high-quality liquid assets to allow them to survive a whole month's loss of access to funding markets.**

Some policy makers and market participants have shown concern over this proposed reform agenda on the grounds that if banks are forced to hold stronger capital and liquidity buffers, lending will be choked off, damaging the fragile global recovery. However, the long transition period as proposed by the committee provides banks with ample time to move to the new standards in a non-damaging fashion and as such the impact on economic growth is likely to be mild. Furthermore, it is

envisioned that these modest costs and special structural actions will be benefited by the significant gains that the new policy is likely to deliver in the form of less frequent crises, and possibly lower risk premia across the board.

After this broad overview of Basel III, I would like to give a brief overview of some of the main steps now being taken by SBP to improve the soundness and stability of the banking sector in Pakistan, thus providing a platform for a smooth transition to international best practices. Over the years, our banking sector has witnessed a significant change from a wholly government owned structure to the majority being privately owned. This shift was one of the main factors which led to improved performance of the overall banking sector, which is evident in increased ROA and ROE of the banking industry here, and the high growth in banking assets. Moreover, we opened up our banking industry to foreign investors which provided benefits such as new sources of capital, funding, know-how and competition. As such, this has helped the domestic banks to compete with foreign banks who possessed well established systems & controls, thus improving the overall soundness of the total banking sector and promoting competitive environment.

We implemented the Basel II capital accord in 2008. It helped in enhancing the quality of risk management by tying regulatory capital more closely to institutions' underlying risks and by requiring strong internal systems for evaluating credit and other risks. Under Pillar I we have adopted simple approaches and we feel that in the area of advances, our banks still have a lot to do to improve the IT systems and data capturing requirement. The crucial element of our Basel Accord implementation policy is the extensive interaction with our banks. The adoption of Basel II and prospectively of Basel III demand further enhancements of systems and expertise that can only be achieved gradually and with regular two-way feedback between the SBP and the banks.

SBP has also addressed Pillars II and III. It has provided guidance on ICAAP (Internal Capital Adequacy Assessment Plan) to facilitate Pillar II (Supervisory review process) implementation in banks. Regarding Pillar III (market disclosure) banks' disclosure requirement, through published financial statements and other regulatory reports have been much expanded and thus strengthened over the years.

In the broad area of Risk Management, which ultimately feeds into the Basel implementation, SBP has put in place detailed guidelines for banks, namely on Risk Management (issued in 2003) Internal Control (2004), Country Risk (2004) general policy framework (2007) and Stress testing (2005). In addition, we issued guidelines on internal credit rating system (2007) and by September 2010, 90% of corporate borrowers were internally rated by banks. This has gradually started improving the risk management practices at all banks under our oversight and will also help the banks which would opt for advance approaches in future. Moreover, we have constantly been refining our regulatory and supervisory oversight through set of prudential regulations and other related instructions. For example stress testing guidelines have been revised extensively and would be implemented in forthcoming months. This is in line with Basel III framework which provides for a bigger role for stress testing in the determination of capital buffers under Pillar 2.

We maintain a strong on-site inspection department which has helped us in timely identifying issues in banks especially those pertaining to the actual level of non-performing assets on banks' books, thus allowing us to also take timely remedial action. This may take the form of requiring

banks to promptly meet the provisioning requirement and take other necessary measures we suggest as appropriate.

Keeping in view the increasing reliance on IT systems, most of the large banks have either already shifted to or are in the process of shifting to new core banking application which will specifically cater to the future technology related requirements. However, there is still a lot to be done to further improve the IT systems as well as the procedure for capturing data so as to better enable our banks to meet the minimum data/ information requirement necessary for the effective implementation of the Basel capital accord "advance approaches" in a proactive and disciplined manner.

Because of our highly focused and strict banking supervision policies and oversight, the banking sector of Pakistan enjoys a healthy capital adequacy ratio of 14% (aggregate). This is a remarkable achievement given the fact that for last two years the sector has faced a sluggish economic environment and a marked rise in overdue loans. It now appears that most banks have sufficient capital buffers to manage moderate shocks in Credit and market risks.

I would also like to refer briefly to the preliminary analysis my team conducted regarding the impact of Basel III changes. It is our view that the majority of the banks will meet the new capital regimen as well as the liquidity standards comfortably. However, SBP will continue to work with those banks who may face some problem in achieving the standard promptly.

On the international scene it is clear that with the passage of time, national boundaries are no longer barriers on the activities of lenders, borrowers, investors and intermediaries. However, this global financial integration has its own risks and costs. In the absence of a global financial regulator, it proved difficult in the recent crisis to ensure the safety and soundness of globally active financial institutions; and as such governments had to step in to bail out their respective institutions. However, these "contagion" concerns can be minimized if we can keep local problems from turning global. This will require both strengthening and harmonizing financial supervision across borders. Moreover, keeping in view the continuous upgrading of banking regulations and the challenges of adopting advance approaches, there is a need to have frequent interaction and cooperation among the regional countries. This will help us all if we can openly share our knowledge

and experiences at regional forums such as this and also collectively devise ongoing and future strategies for region specific issues which may pose potential risks for each of our banking sectors.

During the course of this seminar, I urge you to please actively engage in sharing of ideas and mutual learning experiences you have had, and I hope that you all will look forward to more such events at the SAARC level in the future

Thanks.