

BASEL II IMPLEMENTATION ISSUES, CHALLENGES AND IMPLICATIONS

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The implementation of Basel II is a subject which has gripped a lot of interest both internationally and within Pakistan. Different efforts are underway within the country and across the globe to ensure an effective adoption of this new international regulatory and supervisory architecture.

In my remarks this morning I would like to briefly talk about the significance of ‘risk management’ underlying this framework. I would then like to discuss the important contributions of this architecture, and finally conclude with the issues, challenges and implications pertaining to its implementation. I would also like to touch briefly on where the region and the world is in the adoption of Basel II.

It has to be acknowledged at the outset that one cannot dispute the inevitability of risks, and different types of risks, in bank operations. With growing complexity of operations and product innovations, financial institutions have progressively become more exposed to a diverse set of risks. These risks stretch from credit risk to interest rate risk, liquidity risk, foreign currency risk, strategic risk, compliance risk, reputational risk, country risk and operational risk. The menu continues to become larger with each passing day, and with the developments in financial markets. These risks stretch quite far and deep, and have the inherent potential to significantly undermine the viability of the financial and corporate system, as well as that of the concerned institutions. There is a very high cost associated with what we believe are the *uncalculated* risks. These arise largely because of a number of issues, ranging from the inadequacy of internal controls and inadequate use of Information Technology, to the weak professional management of the institutions.

Such a large and diverse portfolio of risks gives a vivid description of the complexity of risk management as a subject. Yet these risks are far from being independent and require a holistic approach for their mitigation and management. It is both the financial institutions' and the regulators' responsibility to achieve an optimal management of these risks. We have an intrinsic interest in the financial health of each institution because all these institutions together define the financial stability, smooth functioning of the payment system, and eventually promote economic growth.

The past two decades have witnessed significant developments in the field of risk management. While financial institutions, dominated mainly by the large banking organizations, have invested heavily in strengthening their key internal processes to manage and measure risks, bank supervisors have been equally upto the task of devising more responsive and sophisticated solutions to the emerging challenges.

Let me highlight the fact that the entire process of development of the theoretical and practical literature on banking regulations and supervision owes its origin to the Basel Capital Accord which was introduced around 20 years ago. We all need to thank this innovation because it has served the banking industry well in the two last decades or so. But with the advent of the Asian financial crises in particular, and a number of other crises, the Latin American, the Russian, etc., the banking industry as a whole has come to recognize that Basel I fails to properly align capital with the actual risk profiles of the banks. It has created a wide gap between regulatory and economic capital and there are perceptions governing the dead-weight cost of regulations that have gotten stronger with the rapid pace of innovations. This cost is now impeding the efficient functioning of markets. This has laid the foundations of a very long-drawn process for Basel II, which recognizes the perceived shortcomings of Basel I and progressively addresses its inherent weaknesses, while gearing the risk management framework for the emerging financial engineering and innovation.

Basel II Accord, first of all, aims to align banks' capital with their basic risk profiles. It is very elaborate and far superior in terms of its coverage and details. It exploits effectively the new frontiers of risk management. It seeks to give impetus to the development of a sound risk management system which hopefully will promote a more efficient, equitable and prudent allocation of resources. It is perceived to be the harbinger of the future disposition of bank

supervision, and an evolutionary path for the banking industry. It is a product of a long, arduous, exhaustive consultative process. Not only has the Bank for International Settlements (BIS) produced a voluminous document which has been revised several times, incorporating comments of the various stakeholders, but every jurisdiction in the world has produced an equivalent amount of documentation to define the ground rules for its own implementation.

In my view, what is important to acknowledge is that Basel II has fundamentally altered the conventional rule-based and reactive approaches to designing a regulatory framework, to a superior and relevant regulatory and supervisory mechanism which is today more comprehensively assessing the various types of risks which I have mentioned and is inherently proactive. There are three pillars of this architecture. The first pillar refers to the minimum capital requirement, which includes an acknowledgement of the variety of risks and treatment of those risks. The second pillar is the supervisory review, and the third, market discipline. All the three pillars complement and mutually reinforce each other.

I would now like to turn to discussing briefly where I think some of the important regional economies are in terms of their preparation for Basel II before I conclude by discussing the issues and the challenges for its implementation.

Let me first talk about Pakistan. Whereas the State Bank of Pakistan has chalked out a roadmap for the transition of the banking system to this new capital regime, we intend to, like so many other economies, first adopt the standardized approach to credit risk and operational risk from January 1, 2008 and then move forward with the adoption of the internal ratings based (IRB) approach from January 1, 2010, subject to due diligence of the banks with international presence. Once SBP is satisfied that commercial banks have the appropriate models and risk management capacities, permission will then be granted for them to proceed with the IRB approach.

With respect to this game plan, the first phase of a parallel run involving relatively simple approaches has already taken off from July 1, 2006 and will continue for one and a half year. Similarly, the second phase for the adoption of advanced approaches will begin in January 2008 and will last for two years. The transitional period is expected to provide the banks and the supervisors, hopefully ample time to fine tune and strengthen their systems, and hone their technical and human resource capabilities. Among others, we rely on IBP to help in this process.

IRB approaches present an incentive to all banks, including Pakistani banks, to economize on capital. The large banks are expected to become more inclined towards this. However, as I stated earlier, State Bank would like to ensure adequate preparedness of the industry before we endorse the move towards IRB, and before we declare victory on this important subject.

All other countries of South Asia like India, Bangladesh, Sri Lanka etc. have issued their plans along similar lines. There are, of course, some differences regarding the pace and sequencing of the timetable depending on financial conditions and the type of banking activities in these countries. East Asian countries, including Malaysia, Indonesia and the Philippines, which are broadly implementing initially the simple approaches followed by a gradual transition to IRB approaches, have adopted their own course, depending on the prevailing situation.

I know also that the extent of adherence to the existing regulatory framework differs from country to country in these regions. What is, however, different from the South Asian and some of the middle income East Asian economies, is that some of these economies, such as Japan, Hongkong, Taiwan, Singapore and Korea have large financial sectors, given their state of development, and have proceeded with a swifter adoption of IRB approaches, almost consistent with the implementation schedule of Basel II. But again, the process of implementation is dependent on the state of technology prevalent in the banks in these countries. China has been pursuing a very cautious and steady approach in respect of Basel II, and it plans to put in place first of all International Accounting Systems and then a robust risk management system before it graduates to Basel II.

Let me now turn to the issues, challenges and the implications of Basel II. In some senses Basel II is a revolution in regulation and risk management. According to the KPMG international whitepaper, depending on its current risk management processes, size, customers, portfolio and markets, a particular bank is likely to experience varying effects of Basel II on at least four levels, namely internal processes, customers, businesses and global interaction. However, it is not just the banks that will be impacted in the Basel II environment. I believe this accord would also affect the behavior of a number of other industries, including credit rating agencies, external auditors, banks' customers, regulators and finally the corporate sector at large.

What are some of the key challenges pertaining to the Basel II Accord ? The list that I am about to cover is by no means an exhaustive one. First of all, I would like to underscore that there is an absolute need to instill a well functioning, integrated and efficient risk management system at the macro level by the supervisors and by the institutions. Second, we need absolute accuracy and reliability of information. Third, we need asymmetry in supervision; we need to recognize that the markets are imperfect. Fourth, industries face pro-cyclicality which needs to be recognized and due consideration needs to be given to incorporating this phenomenon. Also, there are serious implications for access to finance for certain sectors, groups and the disadvantaged segments of the population, given that there is going to be a huge operational cost for the banks and the regulator with the implementation of Basel II. And lastly, there will be cross-border challenges for not only Pakistan but a number of other jurisdictions, including the developed countries.

Let me first briefly touch upon the risk management aspect. I think it would be fair to say that there has been, as I said, a revolution led by innovation in the risk management field. Not only have we identified, quantified and developed various models in risk management but we have also nurtured the aspect of risk management in a number of institutions all over the world. So I don't see it as being an impossible task for economies. There are complications in its implementation where there are inherent weaknesses of different types. We all know that the world has suffered repeatedly from the accumulated huge portfolio of non-performing loans. And the non-performing loans would be a reality even if we were to absolutely eliminate the vested interests from the banking system which encourages willful default, a factor quite familiar to us. Defaults are inevitable because of the conventional corporate risks as well as the business cycles that industries face. What is important in going forward is to be able to define and capture these risks effectively, and to appropriately weigh these risks and make effective provisions. It is really in this context that Basel II defines and lays the ground rules for risk management.

Banks all over the world have been more cautious in their credit appraisal and monitoring system and in assessing the gaps in their risk management systems. I think the most important factor in positioning ourselves effectively is education, which alone will help us to understand what the risk management architecture is all about.

Let me now talk briefly about the second item. The success of Basel II depends exclusively on the accuracy and reliability of good quality data. We need adoption of the

international financial accounting and reporting systems. We need to assess the risks accurately. And there has to be intellectual honesty in reporting all this. Besides the internal assessment of the reliability of information from a regulator's point of view, the requisite comfort will be achieved only if an independent agency is able to do a due diligence of the company and its inherent risks. Within Pakistan there are only two credit rating agencies and I am not sure that with the universe that they capture, whether we are well positioned to go forward in even adopting the standardized approach effectively. In addition to the credit rating institutions, we need to exploit more effectively the role of the auditors of the borrowing entity. It has to be acknowledged that the data stream currently available is not fully comprehensive to serve our requirements. So it is not just about developing information flows; it's about changing the quality and the timely reporting of this data.

Another important aspect of reliability is business continuity planning and sophistication of the IT resources, both in the State Bank as well in the banking industry. And again, we need to cover a lot of ground here.

The third item which I mentioned is asymmetry of supervision, which occurs when different market participants are regulated by separate supervisors. This makes it difficult for us to maintain comparable levels of vigilance and quality of objectives in policy formulation. The asymmetric regulatory regime can be within the country, for example between banks and securities firms, as well as at cross-border levels. The Basel Accord provides an excellent opportunity for developing common standards. Yet it requires much closer cooperation, information-sharing and coordination of policies. In many developing countries only the banks are required to comply with Basel II, and not the other financial services providers. This carries the risk of promoting regulatory arbitrage. In the context of Pakistan, it is important that the coordination of policies at the regulators' level i.e. SECP and SBP, be pursued actively. This will be part of our deliberations with our co-regulator.

Let me now talk about the fourth item, i.e. imperfect markets and the challenges they pose. The functioning of the risk assessment systems of banks is clearly affected by the nature of innumerable types of distortions in the markets. In Pakistan, like everywhere else, there are several problems that can create these distortions. These can pertain to the dominance of large players, or they could be related to the high asymmetry of information or the lack of market depth and so on and so forth. Price manipulation by significant market players can also distort the true

market value of the securities portfolio. To make any meaningful assessment of market risks and encourage market discipline, market imperfections have to be first of all recognized and then it is the job of the policy-makers to ensure that it puts in place a legal and regulatory framework which could minimize these distortions. Clearly the banking sector has a role to play in this regard as a responsible citizen of the financial services industry itself. The regulator also has to do a lot of work in this area. It has to be capable of assessing the price risk and identifying situations in which market values of portfolios have been over- or under-stated by the regulated institutions through price manipulations. In this context, market surveillance by the regulator needs to be enhanced, an area which is clearly a shortcoming currently.

The fifth item relates to business and economic cycles and their behavior. The basic criticism on Basel II from all quarters is related to pro-cyclicality. The new accord makes the business cycle in an economy much more pronounced. It can create problems for policy-makers and also for economic stability. The arguments suggest that in times of recession as the borrower's credit risk increases, as measured by either of the approaches, the banks will curtail lending, while in a booming economy they will expand lending. The proponents of Basel II, however, have argued that under the new accord the deterioration of a portfolio should begin to be reflected in a bank's capital adequacy itself at a much earlier stage and no further deterioration should ideally occur in the capital adequacy ratio when it is recognized as an accounting loss. Several options have been proposed for this purpose. For example, discretionary powers granted to supervisors under pillar II, such as the ability to demand a buffer of additional capital during a business cycle expansion, is one way of addressing pro-cyclicality. Another is to adjust the value of the probability of default in the internal ratings approach or advance approaches which draw on the historical trend analysis of the business cycle. Whatever we do, we have to somehow come to grips with this phenomenon.

The sixth point is how does Basel II introduce complications for access to finance. This is an area where we have to be careful because there is a lot of scope to enhance funding to the desired sectors and to specific groups of individuals which are currently under-served. First of all it has to be recognized that the banks do have to enhance business and coverage in these vulnerable sectors and vulnerable segments of population. So will this mean that they would require higher capital allocation for assuming what has got to be a higher credit risk? Yes, of course, but this will clearly and hopefully not be a deterrent in encouraging credit flows to the small businesses and poor segments of the society, because we have to somehow accommodate

this through better credit appraisal and credit vigilance rather than by adding excessive capital. One aspect which has been clearly underdeveloped in this architecture is how should the credit scoring mechanism be adopted for the small companies? Some advancement has been made in this area in Latin America, and SBP will have to actually look at this area quite closely. I am not advocating a fundamental deviation from Basel II, but rather proposing to find a robust and a workable solution to what I believe is a daunting problem.

Another aspect that I will touch upon is the operational cost of Basel II. As we know, the installation of the risk assessment system, the cost of the IT system, hiring of new, technically more competent staff, etc., entails a heavy cost for banks as a pre-requisite for the adoption of Basel II.

In Europe, the cost of Basel II implementation was estimated to be over US\$ 15 million for some large jurisdictions alone. It is this phenomenal cost which has deterred the United States; it is still deliberating on how to adopt Basel II and has declared that it will adopt a variant of Basel II for its own banks.

Finally, my last point is about the cross-border challenges and with this I would like to conclude. The challenges discussed so far become more pronounced when we have free cross-border capital flows. One of the main areas of concern which has been studied extensively, relates to the higher capital requirements in the advanced countries due to the flows that they have towards the developing countries. The conclusion derived from the empirical evidence was that there will be a decline in the banking flows from international centres to the developing countries because of the higher risk perception of their financial systems, and lack of appropriate rating and risk management systems. If not effectively addressed, this will be clearly a deterrent for the western economies to actually send flows to these jurisdictions.

The issue surrounding cross-border flows pertains to the difficulty in information-sharing across sectors and across borders. Lack of complete accessibility to information or sharing poor quality information will restrict the credit flows from banks of developed countries into the emerging economies. The most basic step is to ensure that no matter what the stage of development is vis-à-vis Basel II implementation, we should at least ensure accurate information disclosure in accordance with the rules defined in pillar III. This would help, along with the

regulators' strong approach to this architecture, in building the confidence level of the foreign donors and the banks.

In my recent meetings with various banks, I have observed that they are taking some important initiatives with respect to the implementation roadmap of Basle II. But clearly the quality and level of these initiatives varies from institution to institution. Large banks that today have more resources, thanks to high profitability, are moving forward progressively. The small banks clearly do not have the capacity and will have to benefit from the learning and the architecture being developed by the large banks which they can adopt with some modifications to suit their requirements.

In conclusion, I would like to urge banks to make speedier and concerted capacity building measures for training human resources in targeted fields. IBP and NIBAF will have to transform themselves to actually come up to the challenge of the requirements of Basel II. Banks will have to develop internal risk models and advance risk management systems. But most importantly, I implore banks to strengthen their internal control systems, which are generally substantially weak. We also have to encourage better coordination with our fellow regulator of the securities market. We have to bring in more competition in the credit rating business and in the auditing field. Simply put, we have to set new standards and work hand in glove with the financial industry.