ROADMAP FOR THE IMPLEMENTATION OF BASEL II IN PAKISTAN

Introduction

Basel Committee on Banking Supervision (BCBS) finalized the New Capital Adequacy framework commonly known as Basel II in June 2004. This new capital adequacy regime offers a comprehensive and more risk sensitive capital allocation methodology for major risk categories. Basel II framework comprises of three parts referred to as three pillars of the Accord; Pillar I, which is about minimum capital requirement, prescribes the capital allocation methodology against credit and operational risks. The capital requirement for Market risk remains the same as envisaged under Basel I in 1996. The risks, which are not captured under pillar I, are covered in pillar II. Pillar II of the New Accord outlines the supervisory review process of the capital adequacy of banks. It require banks to establish a robust risk management framework to identify, assess and manage major risks inherent in the institution and allocate adequate capital against those risks. The supervisor has to review the adequacy of risk management function and capital allocation mechanism against major risks including those that are not covered under pillar I i.e. Liquidity Risk, Concentration risk, Interest rate Risk in Banking Book etc. and ensure it commensurate with the size and nature of business of the institution. The pillar 3 of the Accord sets out disclosure requirement depending upon which particular approach of Pillar I the institutions adopt for calculating Minimum Capital Requirement (An Overview of Basel II is attached as Annexure I).

The New Capital Accord is not mandatory even for the member countries of the BCBS. However, there is consensus among member countries to adopt Basel II standardized approach by the end of 2006 and advance approaches by 2007. Among Non Member countries Basel II is expected to be adopted by most of the economies in 2008 or later on.

Why Basel II?

The Basel I had a number of flaws. For instance, it provided “one size fit all” approach and did not differentiate between assets having less risk and assets having higher risk. There was no capital allocation against operational risk as well as no consideration was given to other risks such as concentration risk, liquidity risk etc. The new accord has risk management embedded in it; so it will be a driving force for bringing improvement in risk management capabilities of banks. Basel II provides incentive to banks having good risk management and punishes those that are not managing their risk profile appropriately by requiring higher capital.

On the basis of foregoing and keeping in view the global response towards Basel II, SBP has, in principle, decided to adopt Basel II in Pakistan. The ensuing pages outline a proposed Roadmap for the implementation of Basel II in Pakistan. While preparing this Roadmap, the State Bank has conducted a survey to assess the existing capacity of the banks and their financial position to meet additional capital requirement. The plans of other countries for adoption of Basel II have also been reviewed. Efforts have been made to draw a realistic timeline so as to give banks sufficient time to prepare themselves for meeting the requirement of Basel II.

Timeline for Basel II Implementation

The capital allocation under Basel II is more risk sensitive and comprehensive and its implementation would result in improved risk management at banks. Nevertheless the implementation of New Accord is by no means an easy task especially in countries where risk management in banks is at its infancy stage. The proposed implementation plan has been prepared on the basis of;

a) Feed back obtained from the banks
b) Assessment of financial impact derived from quantitative Impact Study carried out by Banking Supervision Department
c) Implementation of Basel II across various countries, especially in developing economies.

Before discussing the proposed roadmap it would be important to discuss the results of above-mentioned studies.

a) Feedback from Banks:

In Order to obtain feedback from all banks regarding Basel II implementation and to assess the level of their preparedness, a survey on Basel II was conducted in July 2004. All banks/DFIs were invited to give their views by responding to a detailed questionnaire

The most important question asked was when should the Basel II be implemented in Pakistan. Figure 1 shows the responses to that question. It was quite encouraging to note that not a single bank/DFI disagreed with the implementation of Basel II. 13 banks representing 49% of total banking assets recommended to implement Basel II from 2008 whereas 17 respondents representing 43% of banking assets recommended 2007 as Basel II implementation date. Regarding which specific approach for Minimum Capital Requirement (Pillar-I) be offered, most of the banks were of the view that standardized Approach would be suitable initially. One of the prerequisite for Basel II implementation is that the institution should have a robust risk management setup capable of effectively managing all major risks that the institution is exposed to. Most of the banks claimed that they have in place risk management setup at least for major risk categories. The banks that claimed to have partial risk management setup lacked operational risk management

Figure 1

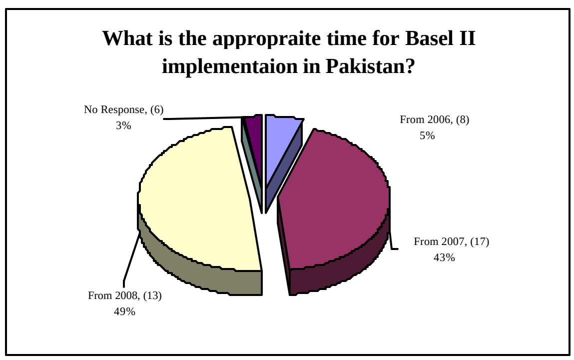
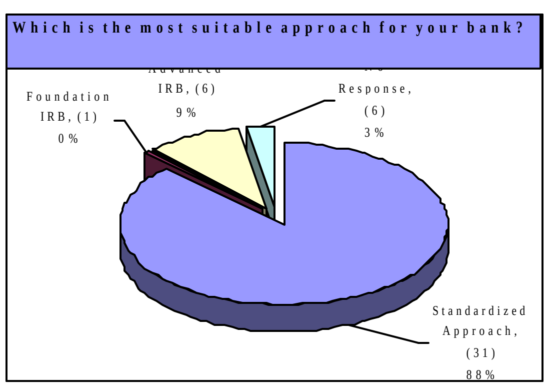


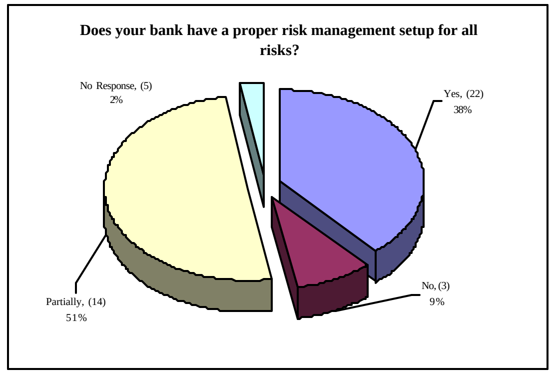
Figure 2



function (figure 3). It has, however, been observed that most of the banks have not given any consideration to Basel II in their current operating plan, nevertheless all banks have shown their intention to include it in their next operating plan..

b) <u>Quantitative Impact Study.</u>

Figure 3



In addition to the above-mentioned survey, the State bank also conducted a quantitative impact study (QIS) of Basel II (Standardized Approach) based on data as of 31.12.2003. The study was based on the assumption that there would not be any major variation in the capital requirement of banks against their credit risk as in absence of external ratings most of the loans will fall under the category of un-rated claims and attract 100% risk weight.

The capital requirement under Basel II of individual banks was therefore calculated by adding capital charge for market risk and operational risk. It was observed that there would not be any significant increase in required capital and most of the banks will be able to meet capital requirement under Basel II rules. It may be worth mentioning here that the study did not take into account the impact of increased Paid-up Capital requirement of Rs 2 billion in compliance of which some of the banks have to increase their paid-up capital.

<u>Transition towards Basel II</u>

Keeping in view the results of survey, QIS and the global implementation of Basel II, the transition towards Basel II in Pakistan would be as follows:

- Banks would be required to adopt Basel II as under:
    1) Standardized Approach for credit risk and Basic Indicator /Standardized Approach for operational risk from 1st January 2008.
    2) Internal Ratings Based Approach from 1st January 2010.

  (Banks interested in adopting Internal Ratings Based Approach for capital requirement against credit risk before 1st January 2010 may approach SBP for the purpose. Their request will be considered on case-to-case basis)

- To ensure smooth transition to Basel II there would be a parallel run of one and half year for Standardized Approach and two years for IRB Approach starting from 1st July 2006 and 1st January 2008 respectively.
- Banks' internal plans for Basel II implementation shall be reviewed and continuously monitored by the State Bank during the pre-implementation period as well as during parallel run.

<u>Actions Required by SBP</u>

On the part of SBP the implementation of Basel II require following activities to be accomplished.

General.

1) Ensuring the establishment of Basel II Implementation units at each bank.
2) Communicating the Basel II implementation plan to Banks.
3) Drafting and issuance of circular/instructions laying down the parameters for adopting Basel II

Pillar 1-Minimum Capital Requirement

Standardized Approach

1) Preparing eligibility criteria and rules for recognition of External Credit Assessment Institutions (ECAIs)
2) Recognition of ECAIs and mapping of the ratings with the appropriate risk weight.

Internal Ratings Based Approach.

3) Devising requirements relating to Internal rating system design and minimum conditions of eligibility for use of these ratings for IRB approach
4) Validation of banks' systems with respect to Basel II implementation.

Pillar 2 - Supervisory Review

1. Capacity Building at SBP as well as in banks.
2. Deciding on the range of actions and standardizing them for different scenarios in case a bank is not meeting in whole or in part different aspects of capital adequacy as emerged during the supervisory review process.
3. Carrying out a specific exercise to review as to whether banks have a process for assessing their overall capital adequacy in relation to their risk profile and a strategy for maintaining their capital levels

Pillar III- Market Discipline

1. Reviewing existing disclosure formats and comparing them with the disclosure requirements under Basel II.
2. Preparing / drafting new formats for disclosure by banks in order to meet the minimum disclosure requirements under Basel II.

The detail of the actions required along-with the time frame for their completion is given in the attached table 1.

Table 1-Action Plan

	Activity/Action	Description	Date of Completion
1	Finalization of Implementation Plan	Preparation and finalization of the Roadmap after consultation with the stakeholders for implementation of Basel II.	31.03.2005
2	Communicating the implementation plan to Banks	After the approval of this road map, the plan to implement Basel II in Pakistan will be communicated to the banks. The communication will include; o Timeframe for the adoption of Basel II. o Minimum requirements for the adoption of various approaches for credit and operational risk. This communication will enable banks to devise their internal plans and would gear up their efforts.	31.03.2005
3	Designation of coordinator at each bank	? To serve as a focal point for coordinating activities internally and communicating with SBP. ? The coordinator could be CFO or Head of RM or Head of Credit.	31.05.2005
4	Banks to submit their individual plans containing specific approach (Standardized or IRB) they intend to adopt and their internal plans with respect to such implementation.	However the banks intending to adopt advance approaches will be subject to SBP's validation /approval.	30.06.2005
5	Approval of individual plans by SBP.	Finalization of specific approach to be adopted by each bank.	30.09.2005
6	Preparing eligibility criteria and rules for recognition of ECAIs	The eligibility criteria will be used for short listing of rating agencies	30.06.2005

7	Recognition of ECAIs and mapping of the ratings with the appropriate risk weight.	? Inviting applications from the interested rating agencies. ? Assigning the risk weight for their particular ratings.	30.09.2005
8	Capacity Building at SBP.	Organizing various learning sessions.	2005-2008 (on-going)
9	Capacity building in banks	PBA to take lead.	2005-2008 (on-going)
10	Preparation and issuance of instructions/Circular	Issuing detailed instructions to banks for implementation of Basel II.	31.12.2005
11	Parallel run of Basel II	? Banks to continue meeting the existing MCR. ? Simultaneously to calculate capital adequacy on the basis of Basel II	01.07.2006 to 31.12.2007

Pillar II- Supervisory Review Process

12	Prompt Corrective Measures by SBP	Deciding on the range of actions and standardizing them for different scenarios in case a bank is not meeting in whole or in part different aspects of capital adequacy as emerged during the supervisory review process.	31.12.2005

Pillar III- Market Discipline

13	Reviewing existing disclosure requirement for banks with respect to Basel II and assessing the gaps.	Compare the existing disclosure requirements with those required under Basel II and identify what additional discloser would be required by banks	30.09.2005
14	Preparing / drafting new formats for disclosure by banks in order to meet the minimum disclosure requirements under Basel II.	To be prescribed along with proposed circular to be issued by SBP for implementation of Basel II.	31.12.2005

Annexure I

Overview of Basel II

The new Accord (Basel II) is based on three mutually reinforcing pillars. The First pillar is about minimum capital requirement. This part of the Accord outlines the level of capital required by the bank against credit, market and operational risk based on the risk profile of the organization. The primary objective is neither to raise nor lower on average regulatory capital for banks however the capital requirements for a specific bank may increase or decrease depending upon its own risk profile. A bank's capital ratio will be calculated by dividing the total capital by the sum of risk-weighted assets of credit risk, market risk and operational risk.

Credit Risk

The calculation of capital requirement against market risk remains unchanged, however the methodologies provided for capital against credit risk are more elaborate and risk sensitive. The Accord gives a hierarchy of 3 alternative approaches for the purpose that vary in terms of sophistication, and adoption of a particular approach depends on the risk measurement capabilities and robustness of the systems in place in a bank. A Standardized Approach will be available for less complex banks for the credit risk calculation. This approach builds upon the 1988 Accord (risk weights determined by category of borrower) with risk weights based on external credit ratings (with un-rated credits assigned to the 100% risk bucket).

Banks with more advanced risk management capabilities, which can meet rigorous supervisory standards, can make use of an Internal Ratings-Based ("IRB") approach. Under this approach the risk weights are derived from risk components: Probability of default (PD), Loss Given Default (LGD), Exposure at Default (EAD) and Maturity. The calculation of the risk components is based on internal ratings assigned by the bank to individual exposures. The IRB approach differs substantially from the standardized approach in that banks' internal assessments of key risk drivers serve as primary inputs to the capital calculation. However, the IRB approach does not allow banks themselves to determine all of the elements needed to calculate their own capital requirements. Instead, the risk weights and thus capital charges are determined through the combination of quantitative inputs provided by banks and formulas specified by the Committee. The IRB approach is further categorized into two variants: a foundation version and an advanced version. Under the foundation approach, banks will develop their probability of default ("PD") for each rating grade while loss given default ("LGD") and exposure at default ("EAD") estimates will be based on supervisory values with a standardized treatment of credit risk mitigation. Under the IRB advanced approach, banks can use their own LGD and EAD estimates and will have greater flexibility in the treatment of collateral guarantees and credit derivatives. The formulas, or risk weight functions, translate these inputs into a specific capital requirement.

Operational Risk

The New Accord introduces for the first time a capital charge for operational risk. The framework presents three methods for calculating operational risk capital charges in a continuum of increasing complexity and risk sensitivity. These methods are the Basic

Indicator approach (a fixed percentage of gross income amount), Standardized approach (sum of a certain percentage of bank's income in each business line) and Internal Measurement approach (Statistical measure of banks operational loss based on its historical loss data)

Pillar – 2 Supervisory Review Process:
This pillar is based on the principle that capital adequacy is not just a compliance matter and it is equally important that the bank should have a robust risk management framework. The pillar 2 has two key elements

a. A firm specific internal assessment and management of capital adequacy.
b. Supervisory review of this internal capital assessment and the robustness of risk management processes, systems and controls.

Four key concepts of supervisory review have been identified through which supervisors can ensure that each bank has sound internal processes in place to assess the adequacy of its capital and set targets for capital that are commensurate with the bank's specific risk profile and control environment:

Principle 1: Banks should have a process for assessing their overall capital in relation to their risk profile and a strategy for maintaining their capital levels.
Principle 2: Supervisors should review and evaluate banks' internal capital assessments and strategies as well as their ability to monitor and ensure their compliance with regulatory capital ratios. Supervisors should take appropriate supervisory action if they are not satisfied with the results of this process.

Principle 3: Supervisors should expect banks to operate above the minimum regulatory capital ratios and should have the ability to require banks to hold capital in excess of the minimum.

Principle 4: Supervisors should seek to intervene at an early stage to prevent capital from falling below the minimum levels required to support the risk characteristics of a particular bank and should require rapid remedial action if capital is not maintained.

An important element of pillar II is that the risks against which there is no capital charge in pillar I (interest rate risk in banking book, concentration risk, liquidity risk etc) shall be covered under pillar II and the supervisors are required to assess whether these risk are being actively managed and the bank is holding adequate capital against these risks.

To facilitate supervisors' monitoring of interest rate risk exposures banks must provide the results of internal measurement systems expressed in terms of economic value relative to capital using a standardized interest rate shock. If supervisors determine that a bank is not holding capital commensurate with the level of interest rate risk they must require the bank to reduce its risk or hold a specific additional amount of capital or both. Supervisors will pay particular attention to sufficiency of capital for those banks whose economic value declines by more than 20% of the sum of Tier 1 and Tier 2 capital as a result of a standardized interest rate shock (200 basis points).

Pillar 3 Market Discipline:

Bolstering market discipline through enhanced disclosure is a fundamental part of the New Accord. Effective disclosure is essential to ensure that market participants can better understand banks' risk profiles and the adequacy of their capital. The New Accord provides detailed guidance on the disclosure required for each of the methodology given in pillar I.