

Roadmap for managing Basel II implementation issues for Asian Banks **- D. Ravishankar, MD, Risk Solutions, Standard and Poor's**

Implementation of the new capital adequacy framework has been a long and exacting journey in most of the jurisdictions, and so is the case with Asian Banks.

Basel II is very good news

“Basel II Framework”, offers a new set of international standards for establishing minimum capital requirements for the banking organisations. It capitalises on the modern risk management techniques and seeks to establish a more risk-responsive linkage between the banks’ operations and their capital requirements. It also provides a strong incentive to banks for improving their risk management systems. The risk sensitiveness is sought to be achieved through the now-familiar three mutually reinforcing Pillars. The Pillar 1 stipulates the minimum capital ratio and requires allocation of regulatory capital for credit risk, market risk but and operational risk. The Pillar 2 of the framework deals with the ‘Supervisory Review Process’ It requires the banks to develop an Internal Capital Adequacy Assessment Process (ICAAP) which should encompass their whole risk universe – by addressing all those risks which are either not *fully* captured or not *at all* captured under the other two Pillars. The Pillar 3 of the framework, Market Discipline, focuses on the effective public disclosures to be made by the banks, and is a critical complement to the other two Pillars.

Basel II is a long way away

One-third of the Asian banks are at various stages of implementation of Basel II and it is possible within the country; several banks may adopt several approaches for implementations. Japan has permitted mega banks to prepare for AIRB approach and whereas in Korea, the regulator provides a roadmap for AIRB for those banks who are complying with FIRB approach by 2008. Hong Kong & Taiwan regulators are also busy with guiding banks for FIRB approaches. All banks in India are provided guidance for preparing for Standardised approach for credit risk management and Basic Indicator approach for operational risk. The regulator in China provided guidance for the mega banks to go for AIRB approach by 2010. Other countries like Indonesia, Sri Lanka & Philippines are also preparing for Basel II. We expect the final implementation by all banks in Asia can go beyond 2015.

Having a Strong foundation – Pillar I

The Pillar 1 provides a menu of approaches, from the simplified to the advanced ones, for determining the capital charge for each of the three categories of risks. The credit risk mitigants used by the banks have been specifically recognised to provide appropriate capital relief. In addition, each country regulator will have country specific norms. In case banks select to go with Standardised approach for credit risk and Basic Indicator approach for operational risk, it would be better to have architecture for advanced approaches to avoid any efforts duplication.

Basel II leaves to banks the choice between three approaches for quantifying the regulatory capital for operational risk. First, the *Basic Indicator Approach* (BIA) defines the operational risk capital as a fraction (15%) of the gross income of the institution, thus explicitly assuming that operational risk is related to size. Second, the *Standardized Approach* (SA) slightly refines the BIA, as it calculates the operational risk capital on the basis of gross income split per business. Here, the regulator distinguishes among different operational risk levels according to the type of activity performed. Finally, under the *Advanced Measurement Approach* (AMA), banks are free

to develop their own model for assessing the regulatory capital that covers their operational risk, with a confidence interval of 99.9%.

We believe that a strong foundation needs to be put in Building an implemental roadmap – a) Building capacities & capabilities and b) Having a right architecture for credit, market & operational risk

Beyond Pillar I

The second pillar of the New Accord provides for supervisory review of banks' capital adequacy and their internal assessment processes. National supervisors will be responsible for evaluating and ensuring that banks have sound internal processes in place to assess the adequacy of their capital and to evaluate their risks and can impose additional capital requirements.

Basel II promotes market discipline through enhanced disclosure requirements for banks, e.g. regarding the risk measurement methods used. This increased transparency should give market participants a better idea of a bank's risk profile and its capital cushion. Pillar III is intended to be a complement to the minimum capital requirements and the supervisory review process.

The need for validation framework

Validation is essentially concerned with assessing - or evaluating - the predictive ability of a bank's risk estimates and the application of those risk estimates within its credit processes and business practices. A robust credit risk framework should exhibit the following characteristics:

- Risk assessments should be predictive though, where possible, grounded on historical experience.
- Risk assessments should be forward looking.
- Levels of risk should be appropriately discriminated or differentiated
- Risk should be accurately quantified.
- The framework should encompass robust end-user processes that are consistently applied in practice.
- Additional robust independent oversight and control processes should be in place to ensure compliance as intended, including the production of validation conclusion reports to Senior Management. As part of this, monitoring and review processes should be in place, facilitating the timely identification of any material divergences from expectation, the analysis of such divergences and (if appropriate) the consequent evolution of the internal rating system.
- Validation is conducted consistently with the bank's credit risk governance framework

Dealing with cyclicity / business cycles

The linking of capital adequacy and credit ratings, as envisaged by Basel II, is not unproblematic. As a rule, ratings are downgraded during periods of recession. Banks will thus need more capital during crisis periods. This means that banks are likely to cut bank on lending and/or will be forced to increase interest rates for clients. In turn, this will have a negative effect on the competitive environment for the companies affected. The potential adverse overall impact on the real economy could ultimately lengthen and deepen a recession. The phenomenon (or fear) that higher capital volatility will tend to reinforce economic cycles is referred to as procyclicality. As long as there are business cycles, credit ratings will always change over time. The key issue is that under the New Accord's sensitivity to credit ratings this will drive capital changes. The proposed system will require significantly more capital when companies are downgraded. In

essence, "banks will have to choose between raising more capital during recessions or reducing the amount of lending that they do. Among the Basel II proposals for dealing with the procyclicality issue are stress tests, which are a good way of understanding how much capital might be needed in a scenario. However, they will not eliminate the potential for procyclicality under Basel II since all scenarios will tend, like minimum capital, to vary over the business cycle. It has been argued that dynamic provisioning could mitigate procyclicality, with provisions being built up in good times in order to enhance the resources to cater for default in bad times.

Understanding the requirements for regulatory approval

The banks should consider the expectations of the regulator for approving their IRB application. As part of the overall implementation schedule, the bank should include broadly three steps:

- a) Filed tests / QIS 5 – the bank should assess the overall impact of Basel II on capital and simultaneously prepare the QIS spreadsheet along with the feedback for the questionnaire and self-assessment gap analysis.
- b) Parallel calculations – Assessing the impact of Basel II in adopting IRB / AMA from inception
- c) Application for approval – the regulator will conduct onsite / offsite assessment for judgement whether the bank's satisfy the requirements

Dealing in cross border consolidation methods

Basel II will reinforce structural change and the associated process of consolidation and concentration. Consequently, more merger and acquisition (M&A) activity can be expected. Unsophisticated banks facing a potential increase in their capital charge could be bought by more sophisticated banks. The New Accord will thus provide a significant incentive to domestic consolidation, whereas the discretion of national supervisors when implementing Basel II will put some strain on cross-border mergers. Enhanced disclosure on risk and capital position through Pillar III requirements is another likely driver of M&A activity since it helps potential buyers to screen targets.

Promotion of Home-Host Co-operation

We expect enhanced cooperation between regulators to lead to an eventual reduction in the regulatory burden on banks without any increase in risk to depositors or to the financial system. Nevertheless, we believe that certain refinements or extensions to the principles are necessary and focus should be on the following key elements:

The supervisory relationship should focus, to the greatest extent possible, on the consolidated group rather than levels below that. A) The Pillar 2 dimension in home/host relationships needs to be elaborated. B) An acknowledgement of the role the supervised group itself can play in identifying the most efficient role of the supervisors C) The need for a greater emphasis on the relationship between supervisors themselves, notably the increased use of colleges of supervisors.