Zeti Akhtar Aziz: Cross-border challenges in implementing Basel II in emerging economies

Keynote address by Dr Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia, at the Public-Private Dialogue Session of the 7th SEACEN Conference of Directors of Supervision of Asia Pacific Economies, Kuala Lumpur, 4 August 2005.

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Dr. Subarjo, Executive Director of the SEACEN Centre,
Mr. Karl Cordewener, Deputy Secretary General of the Secretariat of the Basel Committee on Banking Supervision,

Distinguished Guests,

Thank you for the invitation to speak at this 7th SEACEN Conference of Directors of Supervision of Asia Pacific Economies organised by the SEACEN Centre in collaboration with the APEC Business Advisory Council, the Asian Bankers' Association and the Pacific Economic Cooperation Council. This event is of particular significance as it brings together the regulators and practitioners from the banking industry, to exchange ideas and share experiences on the operational and policy issues involved in cross-border banking, in particular, with respect to the implementation of Basel II. The participation of regulators and industry players from Latin America will, I believe further enrich the discussions. It is in our common interest to resolve these issues expeditiously, as the implementation date of 2007 for G10 countries approaches.

Ladies and Gentlemen,

In most emerging markets, the banking sector forms the key component of the financial system that drives the economy. In Malaysia, despite the increased significance of the domestic capital market, the banking sector continues to be the predominant source of financing in our financial system, as it evolves to offer more innovative financial solutions to meet the more sophisticated needs of customers and investors. The increasingly complex nature of their operations have had a significant impact on their risk profile over the years. The domestic financial environment has also become more competitive, following an intensification of the liberalisation and deregulation process. Domestic banking institutions have now also ventured beyond our domestic borders. Increasingly, supervisory attention is therefore directed towards ensuring that a robust risk management framework is put in place to support such business expansion and growth strategies.

Against this background, the call for improvements in risk management through the adoption of Basel II and the discussions on the effectiveness of supervisory arrangements on cross-border banking and financial activities are most relevant. The case of the BCCI in the early 90's and Baring in the mid-90's have also brought to the fore the gaps in supervisory oversight activities and highlighted the need for greater cooperation between home and host supervisors. Similarly, the arrangements for cross-border activities involving either international branch networks or the operation of subsidiaries is a subject of much discussion within supervisory circles, particularly with respect to its implications on supervisory cooperation. While there may be differences in the operational arrangements and in the nature of activities undertaken by global players in emerging markets in Asia and Latin America, the significance of their presence in the financial systems in both regions makes this dialogue session most relevant and timely. In Malaysia, foreign banks' account for almost 30% of the total assets of the banking industry. In the context of cross-border banking, the local incorporation of all foreign-owned banking institutions' branches in 1994 has contributed towards the strengthening of Bank Negara Malaysia's supervisory oversight over the activities of foreign-owned banking institutions in Malaysia. The capital and resources dedicated to support the domestic subsidiary operations reflects the commitment of the foreign-owned banking institutions in the country. In addition, it has also facilitated the assessment of the financial soundness of local operations of foreign banks. While the merits of different operational arrangements are a matter of much debate, particularly in terms of business flexibility, the subsidiary structure of foreign-owned banking institutions in Malaysia has facilitated the consistent application of rules and regulations by Bank Negara Malaysia to the entire banking system.

The increasing significance of the foreign institutions, along with the different operational structures were key factors that influenced the design of the early cross-border supervisory framework. This is detailed in the Basel Concordat, that outlined the principles for supervision of foreign banks by home and host authorities, issued by the Basel Committee of Banking Supervisors (BCBS) in 1983. The concordat recognised the greater roles of host supervisors for supervising foreign banks that operate via locally-incorporated subsidiaries. Some home country supervisory in fact referred to the host supervisor as the banks' "intermediate home supervisor".

The framework also recommended a high level of reliance by host supervisory on the works undertaken by the home supervisors in their oversight and monitoring of the soundness of the foreign banks' branches in their jurisdictions. These important principles have become the foundations for the current cross-border supervisory framework and have been the basis for the formulation of the High-Level Principles for the Cross-Broader Implementation of the New Accord issued in 2003. The Principles have sought to further reinforce the responsibilities of home supervisors in conducting consolidated supervision of financial conglomerates and the greater expectation on host supervisors in the supervision of individual subsidiary banks in their country.

The new capital accord is yet another significant development that would challenge the robustness of the cross-border banking framework and principles. The real test would be in translating the principles into detailed policies and action plans that are both sound and practicable. The main challenge in applying the new accord uniformly across the globe is, indeed the complexity of the framework itself. While the underlying intention of the framework to promote sound risk management and best practices is not in question, countries, particularly the emerging markets, are at different levels of readiness to cope with the extensive changes and potential implications of Basel II. Given the different stages of development and levels of market sophistication, applying Basel II, that is designed fundamentally based on parameters and experiences drawn from developed economies, may not be appropriate without some customisation to better reflect the situation in the emerging markets. The low liquidity in some markets and the higher level of market volatility in most emerging markets may not be adequately captured in the underlying assumptions within the Basel II framework. It is therefore important to emphasise that such constraints and the need for some customisation must be well understood and acknowledged by foreign banks operating in emerging markets. In essence, the discussions on the cross-border implementation of Basel II will contribute towards avoiding the imposition of "one size fits all' solutions, and minimising the potential adverse implications of the differences in approaches in addition to avoiding the unnecessary duplication of efforts and investments.

Ladies and gentlemen,

In many emerging economies, Basel II is seen as an important catalyst to accelerate the introduction of best risk management practices within the banking sector in the medium and longer term. While best practices that have been adopted by global banks have even surpassed the expectations of Basel II, this is not the case for most domestic institutions. In many emerging markets where the banking system is still highly fragmented, promoting the adoption of these practices throughout the entire industry will indeed be a challenge. Such efforts would therefore need to be implemented within the agenda of the overall financial sector development programme in the individual countries. It is within this context that Malaysia has chosen to adopt a flexible timeframe, underpinned by four key implementation principles:

- First, for capacity building measures to be implemented;
- Second, within these capacity building efforts, the emphasis on the enhancement of the risk management framework for all banking institutions;
- Third, to emphasise on strong business justification instead of regulatory mandate in the adoption of the more advanced approaches; and
- Finally, to enhance the supervisory methodology to assess the internal models and the advanced risk management systems.

The rigorousness of the analytical process under Basel II will certainly be demanding for banking institutions. It is equally demanding from the supervisory perspective to develop an appropriate response and assessment framework on these processes. Instead of over focus on validating the detailed quantitative and statistical procedures, supervisory attention would need to ensure that the analytical processes are undertaken to support decision making, and not merely to meet regulatory expectations. Supervisors also need to undergo early training to identify the relevant issues when undertaking the supervisory assessment. This underscores, the importance of efforts to accelerate supervisory capacity building efforts, particularly in the development of specialised supervisory skills to conduct model validation. While emerging market economies may have different timelines and priorities, rigorous training programmes need to be simultaneously pursued to ensure that the supervisors are able to fully understand and interpret the qualitative materials, and at the same time, are able to comprehend the broader supervisory issues and concerns.

Ladies and Gentlemen,

The benefits of Basel II cannot be fully realised if emerging countries do not have the necessary foundation for effective implementation. In reality, some developing and emerging countries still need to develop a more efficient and comprehensive legal, accounting, regulatory and market infrastructure. The challenge for the emerging economies is therefore to place high priorities towards establishing and strengthening the fundamental infrastructure. Without the proper foundations in place, this could pose impediments to the implementation of Basel II, in addition to inhibiting the proper implementation of cross-border regulations and the effective conduct of consolidated supervision.

In emerging countries where the necessary infrastructure is already in place, supervisors need to look beyond the state of the current financial landscape, in the context of the globalisation of financial services, and integration with the international landscape. Against this backdrop, the appropriate regulatory framework for the banking industry, in particular, the future of cross-border supervisory arrangements, needs to be articulated. In this regard, it is also important to recognise that the challenge of cross-border banking in the context of the increased significance of international banks has far wider implications.

Ladies and Gentlemen,

The effectiveness of cross border arrangements would be easier to achieve when there is a greater consistency in the regulatory rules and standards as well as supervisory practices among the home and host supervisors. The new capital accord was therefore intended to accelerate the convergence process with respect to the adoption of international standards for capital adequacy in the global environment. In reality, however, total convergence cannot be expected given the varying levels of sophistication between developed and emerging countries. At any point in time, differences in rules and standards can be expected to exist. Our main task will be to find areas where convergence can be accelerated. There may also be room for greater mutual recognition of supervisory assessments among fellow supervisors that could avoid duplication of efforts and resources that could contribute towards reducing compliance costs to the banking institutions.

While we deliberate on the complex issues relating to cross-border implementation of Basel II, supervisors and banking institutions operating in emerging markets also need to take into account the broader implications of Basel II on the economy as well as the access to financing for specific economic sub-sectors, such as the small and medium size enterprises (SMEs). The highly risk sensitive framework could indeed have a potential adverse impact on bank lending behaviour. There has to be continuing discussion between supervisors and the banking institutions on the broader supervisory issues and the effectiveness of regulatory and supervisory framework that could mitigate such potential adverse implications. Basel II is only one component of prudential regulation, and hence must not be viewed in isolation. In this context, the suitability of other rules such as the provisioning framework and the stress testing practices must also be discussed with a view for future enhancements.

Ladies and gentlemen,

While we engage in the intricacies of implementing Basel II we should not loose sight of the ultimate objective of maintaining financial stability. This dialogue is most important in providing a forum for the exchange of views and the sharing of experiences. Indeed, the outcome of the discussions should be escalated to a higher level of policy deliberation so as to further accelerate the progress in detailing the issues relating to the cross-border implementation of Basel II.

On that note, I wish all of you for a stimulating and productive discussion.

Thank you.