Rasheed M Al-Maraj: Basel II and risk management

Address by His Excellency Rasheed M Al-Maraj, Governor of the Bahrain Monetary Agency, to the Institute of International Finance: Basel II & Risk Management - Meeting International Standards, Manama, 30 November 2005.

* * *

Mr. Chairman, Excellencies, Ladies and Gentlemen:

It is a pleasure to be with you here today, and to have this opportunity to contribute to this topical symposium. My own personal thanks go to the organisers, the Institute for International Finance, and to the sponsors, Gulf International Bank and Arab Banking Corporation, for making this event possible.

I should also like to welcome those of you who have taken time out from busy year-end diaries to attend today's event – especially those who have travelled from overseas.

Basel II, as you need no reminding, constitutes the most significant change to banking regulation in nearly twenty years. Its impact so far, however, has probably been less felt in the Gulf region than in the G10 countries, where extensive implementation efforts have been taking place for some time. The situation in the Gulf, however, is now rapidly changing, as the strong turnout today I think demonstrates.

I should like, therefore, to use today's opportunity to set out in high-level terms the BMA's approach to Basel II implementation and how it relates to the BMA's other regulatory initiatives. I will also touch on what I see as some of the key challenges posed by Basel II, not only for GCC regulators, but also for the regional banking industry. In doing so, I will avoid touching on some of the more detailed implementation issues, which will be covered later this morning.

The BMA has endorsed the implementation of Basel II and is now working closely with the industry to apply it to the whole of Bahrain's banking sector. We are aiming to implement Pillars 2 and 3 first, during 2007; Pillar 1 will be implemented at a later stage, from 2008 onwards. We currently expect that most locally incorporated banks will use the standardised approach for credit risk - only a handful have expressed an interest in using the IRB approach. For our part, we have said that we will only offer the foundation IRB approach, to start with at least.

The above approach reflects our view that Basel II represents a significant improvement over Basel I, in terms of its better alignment of regulatory capital with risk, its emphasis on risk management and supervisory review, and its requirements on disclosure. It also reflects the fact that Bahrain hosts a large and dynamic banking industry, comprising international as well as local and regional players, and that their expectations are that Bahrain should move towards Basel II.

Finally, the above approach also reflects our view that a realistic and measured implementation of Basel II is essential, if it is to succeed without creating additional risks to the banking system. Basel II is clearly a much more complex and sophisticated framework than the original Capital Accord, and its successful implementation will require not only a strong supervisory infrastructure to be in place, but – for many banks - more sophisticated risk management and comprehensive data capture to be developed. For this reason, we remain sceptical at this stage that the necessary preconditions for implementing the advanced IRB and operational risk measurement approaches will exist by 2008.

Many of the BMA's recent enhancements in supervision will help prepare the groundwork for effective implementation of Basel II. For instance, our development of a risk-profiling methodology for bank licensees, to help better focus our supervisory efforts and provide for a more systematic assessment of key risks in an institution, is essential in my view to the successful implementation of Pillar 2. As part of our Basel II preparations, we will be developing this system further to incorporate assessments of banks' capital assessment processes and to ensure more effective implementation across both on-site and off-site supervisory directorates.

Our on-going efforts at strengthening corporate governance in banks, and our support for the recent development of a credit reference bureau in Bahrain, will similarly help underpin the implementation of Basel II.

Nevertheless, the fact remains that Basel II represents for the Gulf region as a whole a major implementation challenge. Even where risk-based supervision has already been introduced, moving to a system of individual capital requirements, set by regulators through the Pillar 2 review process, will require significant improvements in internal processes, staff training and resources, if the whole system is to work effectively and in a manner that carries credibility with the industry, the rating agencies and other supervisors.

Supervision, in short, will have to become even more pro-active and risk-focused, and will become more resource-intensive.

Equally, significant challenges exist for banks. Boards will be required to demonstrate that they have in place effective processes for capital adequacy assessment and management. Many GCC banks, particularly the smaller entities, have much work to do in this area to ensure that such frameworks are properly embedded in their organisation. Further efforts need to be made to link capital planning to risk management in a comprehensive manner. And many boards need to engage in such issues in much more detail; some will need to revisit their mix of skills and experience.

Furthermore, banks will also be required to implement a comprehensive range of disclosures under Pillar 3. Although banks in Bahrain are already subject to fairly extensive disclosure requirements, the Basel II requirements are even more detailed. For many banks, this will pose challenges in terms of reporting systems; for some, it may also require a shift in corporate culture.

In short, Basel II represents more than simply a technical compliance exercise. It will require major changes in the way that we operate as supervisors, and in the way that banks and their boards manage their business. Without such changes, the benefits of Basel II will not be realised.

I should like to turn now to some of the wider implications of Basel II for the Gulf region. Many of the concerns voiced over its competitive and macro-economic impact are based on the assumption that there is a direct relationship between regulatory capital requirements and the pricing and supply of bank lending – in other words, that regulatory capital requirements determine banks' behaviour.

In fact, the evidence suggests that although there is some impact, that regulatory capital is not usually the key determinant. Actual capital held by banks, for instance, is often significantly in excess of regulatory minima: in Bahrain, commercial banks on average maintain a capital adequacy ratio of over 25%, significantly in excess of the BMA-imposed minimum of 12%.

Some banks also assume that the more sophisticated credit risk approaches offered under Basel II inevitably lead to lower regulatory capital requirements. In reality, of course, the impact of the different possible approaches is dependent on the quality of the loan portfolio concerned. The more sophisticated approaches, because they measure more accurately the underlying economic risks involved, in fact impose higher capital requirements for poorer quality loans than the standardised approach. Even where they offer regulatory capital savings, banks often overlook the systems and data costs involved in implementing the more sophisticated approaches.

And finally, some comments are based on the assumption that the current Basel I regime, the status quo, is the valid yardstick by which to measure these changes. Thus, the move away from the simple risk weighting of bank exposures at 20% may indeed lead to higher cost of funds for some banks – but to the extent that the existing approach does not adequately discriminate between the different risk profiles of borrowers, the change in regulatory treatment is clearly an improvement.

Bearing these points in mind, I believe that many of the concerns expressed over the competitive impact of Basel II are somewhat over-done. At the very least, the issues involved – and the impact of any changes to regulatory capital requirements - are not always as straightforward as they may first appear.

In short, therefore, the main impact of Basel II is more likely to be to move regulatory capital requirements closer to banks' actual risk assessments when lending to emerging markets, rather than lead to material changes in pricing or availability of funds.

Similarly, Basel II will not necessarily favour foreign banks over domestic ones. Banks operating mainly in lower-rated markets will, it is true, on average be required to hold under Basel II more regulatory capital relative to banks operating in higher rated markets, including a higher capital buffer to match the higher volatility inherent in their business. But the regional experience here is that local banks already are relatively well capitalised – again indicating that actual risk assessments, rather than regulatory capital, are the key driver.

These comments, of course, only touch on the surface of what is a complex subject. But the message that I wish to leave today is simple. It is that Basel II has the potential to bring about significant improvements in both the quality of supervision and banks' risk management. For that reason, it is important to the financial services industry in this region that we implement it wholeheartedly, in a manner that brings about these improvements.

Ladies and gentlemen, thank you for your patience.