Baboo R Gujadhur: Preparations for implementation of Basel II

Introductory remarks by Mr Baboo R Gujadhur, First Deputy Governor of the Bank of Mauritius, at the Seminar on Basel II, organised by KPMG, Mauritius, Port Louis, 25 – 26 May 2006.

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Mr. Wilfrid Koon, Senior Partner
Colleagues from KPMG Mauritius & South Africa
Distinguished Guests
Ladies and Gentlemen

Good Morning. This is just a short speech to get you started on the 2-Day Seminar on Basel II organized by KPMG, Mauritius. I must say at the outset that I am very pleased with KPMG's initiative to host this Seminar, which comes as no surprise being given that the firm is closely associated with the banking sector as auditors of banks. But the firm also needs to be commended for being the first among the auditing firms to organize a Seminar on Basel II for our local banking industry and for the audit profession.

First, a few words to set out the reasons for Basel II. The Capital Accord of 1988, now referred to as Basel I, was a major step forward in so far as it embodied the principle that regulatory capital requirements should be based on risks being taken by each individual bank. Important as it was in this regard, Basel I with its rather crude method of assigning fixed risk weights to particular assets, failed to capture the responsiveness of capital requirements to risk. In a world that became increasingly prone to a serious risk of systemic failure, as illustrated by the East Asian crisis and other subsequent events including the LTCM crisis, a more risk-sensitive and comprehensive framework for assessing bank capital adequacy was called for, especially for large internationally active banks involved in complex transactions.

After many years of discussion and several rounds of consultation, including with non G-10 countries, the Basel Committee came up with a new framework of principles for supervising the largest and most complex banking institutions. This has become known as Basel II. The core objective of Basel II is to promote the stability of the financial system by setting out the parameters on which to base the safe and sound operation of banks.

By definition, financial intermediaries are here to take different levels of risk which they manage differently from each other. Banks remain at the heart of this system of financial intermediation, whether at the individual country or international level. As such, their safety and soundness has implications for financial stability, for consumers of financial services, for banks across the board, for regulators and for entire economies. In very simple language, Basel II sets out therefore a rigorous framework tying the amount of capital which a bank is required to maintain with its specific risk measurement and risk management capabilities in as much as capital is seen as the last line of defence a bank has recourse to in the event of unexpected loss from risk-taking.

Even though Basel II was intended originally to provide a capital adequacy framework for internationally active banks, it was clear that, for diverse reasons, a number of countries and banks of various sizes and importance, would eventually embrace its principles for determination of capital adequacy. Several options – the Simple Standardized, the Standardized, Foundation and Advanced approaches – have accordingly been formulated in the menu of options available to accommodate a progressive adoption of Basel II. One of the direct impacts of Basel II adoption will be the wide scale use of quality information, data warehousing and credit risk modelling with a view to improving risk management by banks.

Whichever approach is adopted, the regulator and the external auditor as well as Board and Management of banks, all have a duty to exercise oversignt over the processes of capital determination and, hence the precise risks being taken necessitating specific capital charges. In this context, a system of consistent regulatory practices has to be aligned with the way banks are run and managed and, in this sense, Basel II creates the scope for regulators to adapt over time to innovations taking place in the banks and the markets. Unless they apprehend fully concepts underlying processes for the estimation of Probability of Default (PD), Loss given Default (LGD), Exposure at Default (EAD) and the parameters employed to calculate risk of loss based on these concepts, inadequacies will surface up since the supervisory validation process will not be up to the mark in such a case.

Conscious of this factor, we have been earnestly raising at the Bank of Mauritius regulatory capabilities to meet this challenge. I would like to say in this context that we have a fully motivated and competent professional team of regulators at the Bank who have been receiving for the last year and a half the necessary training to deliver effectively on this assignment.

The key role that regulators have to play under Pillar 2 and the importance of public disclosure and accountability under Pillar 3 have generally not received the attention they deserve in the Basel II context. It is absolutely necessary to re-emphasize the critical importance of these two pillars in the Basel II implementation process. We are conscious that a whole process of prudential re-adaptation is called for in this respect by both banks and regulators. I may add that we are well on course, fully aware that Basel II is more than a simple framework for fixing an amount of capital consistent with the specific risks taken by a bank.

In fact, Basel II is expected to create a whole range of positive spinoffs. Among others, it will help put in place a wider framework for supervision and regulation to be conducted on a consolidated basis. Supervision will become increasingly more risk focused and that, not with respect to Basel II implementation alone, but along with a re-focussing of other prudential rules as set out in the Basel Core Principles. Moreover, a system is expected to evolve out of Basel II that will enable intervention on the markets much before a crisis sets in because the whole framework is intended to avoid having to take action before any wide scale financial distress is at the doorstep. Care will also be taken to ensure that costs of regulation and supervision do not weigh down on the benefits of efficient private market operation in the implementation of the associated regulatory rules. All these will add value and, hopefully, lighten the overall burden of financial regulation while promoting overall financial stability at the same time. We have therefore to look into a framework of benefits and market efficiencies to be gained beyond ordinary Basel II considerations. Those benefits will emerge after Basel II becomes part of the reality and gives rise to a new thinking about what may be called a more even level playing field than what prevails cur rently at the national and international levels .

It is for these reasons and to be really effective that the Bank of Mauritius has adopted, together with banks, a consultative and participative approach for Basel II implementation. The target date for implementation has tentatively been set for beginning 2008. Much work has been done already at the level of the Basel II Implementation Committee. Proposal drafts on work done have been circulated for views and comments from the industry as a prelude to progressive Basel II implementation in the form of guidelines issued to the industry. It is not intended to impose any specific Basel II approach but banks are being encouraged from the start to go for an approach – such as the Internal Ratings Based Approach – by which they will effectively add value now and in the longer term to the inherent capabilities of their institutions. All this is being done without losing sight of the investments banks are making or have already made to progress towards that goal by first adopting the simpler approaches of Basel II.

I hope I have given you a broad background in these introductory remarks to set the stage for the Seminar. I am confident that close cooperation by various stakeholders and specialized resource persons including creditors, regulators, risk management strategists, financial analysts and credit risk modelers, will go a long way to make for the efficient and productive implementation of Basel II in Mauritius. To that end, this Seminar represents an important contribution and I take the opportunity to praise KPMG once again for taking the initiative.

I thank you for your attention.