Marion Williams: Basel II – implementation of the New Capital Accord in Barbados

Remarks by Dr Marion Williams, Governor of the Central Bank of Barbados, at a conference on Basel II, Bridgetown, 10 July 2006.

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It is indeed a pleasure for the Central Bank of Barbados to host a conference on Basel II to an audience which includes both domestic banks and banks in the international financial services sector. Today is therefore a good opportunity to emphasise the similarities in the kinds of risks financial institutions face as we in the jurisdiction cope with new regulations which are being introduced in regulatory frameworks around the world.

Over the last several months, banks have been receiving a number of guidelines originating from the Central Bank of Barbados in preparation for the migration to Basel II. We have been in constant contact with commercial banks on their feedback on these proposed guidelines. However, it is very timely that we should meet. There is a lot to talk about and a number of areas to be clarified. I trust that by the end of our meeting over the next two days, we will be closer to fine-tuning our road map for the implementation of Basel II.

The panelists you will hear over the next two days will take us a long way toward our goal. We thank them in advance for their assistance.

I will start with a little background on Basel II but before doing so, let me first take the opportunity of thanking the Bankers' Association and BIBA for their financial contribution to the lunch which you will be enjoying today and tomorrow.

For many years, it was clear to international supervisors and regulatory entities that Basel I was not satisfactory for evaluating the increasing diversified and complex nature of risks in the financial system.

The increasing complexity of banking systems had made Basel II inadequate. Basel I provided, for example, a static measure of default risk. It was found that an 8% capital ratio, which it required, was generally insufficient to protect banks from insolvency. A modeling approach reflecting actual assessment of variable default risk and the changing risk profile of individual credits seemed more appropriate. In the Caribbean, regulators had been for some time been increasing that ratio.

There was no recognition of term structure of credit risks in Basel I. Capital charges were set at the same levels regardless of the maturity of the credit exposure. However, we know that default risk is greater the longer the exposure.

There was not enough differentiation of the level of risk in different currencies or national markets or different types of commodities. There was limited recognition of – and standards for – collateral use, limited recognition of offsets, with respect to long and short risk positions and there was lack of recognition of portfolio diversification effects.

It is also argued that the weakness of Basel I had the potential for mispricing of credit risks, and the risk of providing a false sense of security because of reliance on a simple ratio. It led to compliance checking rather than the evaluation of internal risk management practices. It was therefore advisable to transition to a technically more sound risk-based approach.

Basel II, by more closely linking regulatory capital requirements with bank risks, provides a comprehensive framework for improving bank safety and soundness. It allows supervisors and financial markets to assess capital adequacy, by giving banking organizations stronger incentives to improve risk measurement and management. The framework encompasses three pillars: risk-focused regulatory capital requirements, supervisory review and market discipline.

In addition, the opportunity was taken to explicitly analyze new types of risks – market risks – which had already been introduced in 1998 and operational risks.

Quantitative impact studies in most jurisdictions have tended to show that the more sophisticated the system of credit risk assessment, the less capital is needed. Such studies have not yet been done for the Caribbean but this is the result of most studies.

One lesson we have learned through repeated instances of financial instability around the world is that financially and operationally weak financial institutions have been a key contributing factor to nearly every crisis. Adequacy of capital can forestall crises and allow time for remedial action. Thus, enforcing sound capital requirements is at the heart of maintaining a strong system.

The first pillar of Basel II is minimum capital requirements for regulated financial institutions. Minimum capital requirements will be derived by examination of credit, market and operational risks. In addition, the measurement of credit risk will be fine-tuned substantially.

Under Pillar 1, the risk sensitivity of minimum risk-based capital requirements is much greater than under the current Accord. This greater sensitivity would be achieved by linking each banking organization's capital requirement to measures of credit and operational risk, as determined by risk parameters estimated by each organization.

However, Basel II offers options. There are three possible approaches to evaluating credit risks, three to evaluating operational risks and a number of options for evaluating market risks.

The second pillar is supervisory review of the process of setting minimum capital requirements. Some have argued that the first priority should be to attempt to fully implement Pillar 2, which emphasizes the role of the supervisory authority, as judgement is an important element of Basel II. Full implementation of Pillar 2, would impose a significant enhancement in Basel Core Principle compliance.

Under Pillar 2, a bank would be required to maintain a capital cushion above the regulatory minimums to capture the full set of risks to which the bank is exposed. These include liquidity risk, interest rate risk, and concentration risk.

The third pillar of Basel II is market discipline. The idea is that market forces ought to supplement supervisors' oversight of financial institutions. In this way, banks learn from investors how their risks are perceived, and supervisors learn from the market as well.

The keys to market discipline are informational transparency and well-functioning financial markets. Sound accounting systems are necessary for informational transparency. These issues are important and can make a difference to how investors evaluate firms' capital positions.

Under Pillar 3, banks will be required to disclose to the public the new risk-based capital ratios and more-extensive information about the credit quality of their portfolios and their practices in measuring and managing risk. Such disclosures should increase transparency and improve market discipline.

There are several approaches to measuring credit risk. The standardized approach and the Internal Ratings Based approach, either Foundation or Advanced. The standardized model of Basel II relies on impartial actors to assist in the calculation of regulatory capital. Here, I make reference to the external credit assessment institutions.

The higher the penetration of rating agencies and the more confidence there is in the workings of the rating market then the more attractive the approaches become relative to the new Accord.

The internal ratings based approached relies on the banks' skills and the banks' judgments but requires more input from the organization. Basel II also sets standards for risk measurement and management and for related disclosures that will give banks ongoing incentives to improve their practices.

The proposal appears to be complex but this is mainly a question of familiarity. It would not have been appropriate to continue to assess complex matters with simple approaches which do not grapple with all the issues.

Commercial banks will desire to avoid unnecessary regulatory costs. We will be discussing with banks over the next several weeks which methodology they will be using. While we would wish banks to exercise preference, this may not always be possible in the light of the cost of overseeing too many systems at the same time. It may therefore be necessary to fine-tune our approach further to economize on resources.

There were a number of areas of Basel I which we needed to make sure were in place before moving on to Basel II. One of these was the market risk amendment. Because we are a fixed exchange rate regime, and up to 5-7 years ago banks dealt principally in the local market, this aspect did not seem too important, since we felt we knew the local market. However, increased regional and global activity of international banks required that we put in place the 1998 Market Risk Amendment.

Accordingly, early this year this was circulated to banks. The basic structure of the Market Risk Amendment regarding the treatment of market risk has been retained; and the definition of eligible capital remains. The Committee also retained the general requirement for banks to hold total capital equivalent to at least 8% of their risk-weighted assets.

The revised Framework provides a limited degree of national discretion in the way in which each of these options may be applied, to adapt the standards to different conditions of national markets. The Central Bank of Barbados has reviewed these areas of national discretion and will be circulating its guidance on these to the industry shortly.

Operational risk is a new area now included in the regulation of banks.

The Basel Committee defines operational risks as:

> "The risk of loss resulting from inadequate or failed processes, people and systems from internal and external events".

Recent developments, including advances in technology, high profile operational loss events, greater use of outsourcing arrangements and the sheer size of some institutions have propelled the need for a strong operational risk culture.

No significant operational loses in the sector have been reported in Barbados, but the Central Bank requires that all licensees, regardless of size, implement an effective framework of policies and processes to identify, assess, monitor and control or mitigate operational risks as part of an overall approach to risk management.

Areas that should be captured in any operational risk management programme include:

a) internal fraud;

b) external fraud;

c) employment practices and workplace safety;

d) clients, products and business practices;

e) damage to physical assets;

f) human losses;

g) business disruption and systems failures;

h) execution, delivery and process management; and

i) legal risk.

Consistent with the Guideline on Corporate Governance, the Board of Directors (Board) and Senior Management are responsible for developing an appropriate risk management environment within each institution. Indeed, the Board is ultimately responsible for the effective oversight of the licensee's operational risk management framework.

Barbados hosts a myriad of domestic branches of internationally active banks incorporated in different jurisdictions. A challenge for us as the local supervisor is therefore the harmonizing of the different national treatments by different supervisors into a common interpretation, both regionally and internationally. Co-operation between regulators will be essential.

Supervisors in the host jurisdiction will therefore need to be involved in validating risk management techniques adjusted by the home supervisor. In this regard, the Basel Committee has issued a set principles to govern the home host relationship so as to limit the risk that different or inconsistent supervisory processes will be burdensome or redundant for both banks and supervisors.

The issue of materiality is especially troublesome here as the significance of a particular subsidiary may be immaterial to the home regulator but extremely significant to the host jurisdiction. The host jurisdiction may not be able to rely on the home regulator to ensure that the specifics of his jurisdiction are captured.

Memorandums of understanding between regulators in developed countries and those in the developing world must be worked out and an informal relationship between the international home regulator and host regulator in developing countries will be important.

In the Caribbean, the larger institutions which already have ratings have used the well-known rating agencies. However, the recent establishment of a regional rating agency has the potential for filling the vacuum in terms of broad-based ratings of banks' corporate clients. Supervisors will no doubt observe these rating agencies in operation before giving their approval for use of regional ratings as the basis for credit assessment in supervisory reviews. In this regard, international comparability and appropriate mapping will be important.

Significant legal and regulatory changes are required in order to implement Basel II. Some amendments are already in train and others need attention. They include:

- The legal framework surrounding the perfecting of loan security. Issues such as the enforceability of guarantees, the standards for registration of loan security.
- The impact of local bankruptcy laws.
- The legal protection of banks against main categories of operational risk.

  (fraud, IT failures and similar risk)
- The power of the supervisor to require different capital ratios based on a risk assessment.
- Enforcement powers for the supervisor before the suspension or revocation of licenses.
- Confidentiality, where secrecy rules that could impact on consolidated supervision of information exchange.
- Rules that would inhibit the public disclosures required under pillar III.
- Inclusion of legal requirement for supervisory validation and approval for the use of specific models, processes and products.

Other obligations relate to areas such as stress testing. In the case of stress testing, the supervisor is required to issue guidance to banks.

The history required for qualification for IRBs will tend to extend the time for implementation. The requirement that banks have a credible track record of internal ratings or at least 3 years, broadly in line with the minimum requirements articulated by Basel II suggests that implementation time for most banks in the Caribbean of an Advanced IRB approach will be some time off, since three year track records of ratings are not now available without some spade work. To construct them retroactively could undermine their accuracy and dependability.

This requirement for historic data could also delay implementation of the Advanced Approach. For example, in the case of calculations of probability of default, the length of the underlying observations must be 5 years.

By recognizing a wider range of credit risk mitigants, the new Accord has taken into consideration developments in the financial system used by banks and PSEs to mitigate risk. This is particularly helpful for countries which have official business guarantee schemes and export credit agencies.

There are a number of areas in which training of both supervisors and banks will be required. Also, the level of detail required by Basel II will require greater manpower and skills in banks as well as in the office of the supervisor.

Also, the requirement for parallel reporting to implementing the advanced IRB approach could have some cost and manpower implications for banks.

Competition for trained staff will place tremendous pressures on the banks' and the supervisors' ability to attract and retain staff of the highest calibre. Already, commercial banks are poaching our staff as soon as we train them and we may have to call a truce as it can affect our ability to meet our targets for the introduction of Basel II.

In 2004 it was announced that the Bank would implement the new standard from 2009. It is expected at minimum the simpler approaches will be adopted by institutions by the 2009 deadline – however, the domestic banks are expected to move to transition to Advanced IRB by 2012. Discussions will be necessary with the Head Offices of banks with respect to their plans as some international banks may wish to go to Advanced IRB before that date. We welcome that as long as the Central Bank is involved in the validation process.

The Bank has made significant progress to date. A lot of work has been done. It is like an iceberg – you can only see the tip but there is a lot going on below the surface. This includes:

a) the drafting of market risk and operational risk guidelines;

b) the preparation of position papers on the Areas of National Discretion; and

c) the issuance of a consultant paper on Pillar III.

The original plan identified three main projects to be fast tracked. The three main projects identified were:

a) the administration of a Quantitative Impact Study in conjunction with regional regulators;

b) adoption of the 1998 Market Risk Amendment; and

c) amendment of the legislative Framework as part of wider domestic and regional legislative reforms.

The Market Risk Amendment has been completed and will be circulated to commercial banks shortly. Some of the legislative amendments are in train and we are co-ordinating our approach to the Quantitative Impact Study with the rest of the region, but we have already done a Preliminary Survey.

Bahamas is the only country in the region which seems to be ahead of Barbados on implementation and their deadline is 2010. We will therefore need to accelerate the implementation process if we are not to be forced to adjust the date.

In developing a programme to advance the implementation of the project we need to focus on the adequacy of training resources for Basel-related activities and the capacity of existing technology to manage and assess data.

Indeed it may be necessary for us to encourage commercial banks to train their staff simultaneously, if we are to be properly equipped. Basel II is not, however, for all banks. We will be issuing guidelines to the smaller banks in the international financial services sector in this regard.

Generally speaking however, Basel II will require supervisory bodies and banks to work smarter and to use their resources more efficiently, as it places significantly higher burdens on supervisory agencies.

We will need the cooperation of all involved.

Thank you.