David Opiokello: Basel II and its impact on financial services in Uganda

Address by Mr David Opiokello, Acting Deputy Governor of the Bank of Uganda, at the opening of the 6th East African Banking School, Kampala, 3 July 2006.

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Background

I am pleased to speak to you this morning at the 6th East African Banking School Annual Seminar. Since launching the Banking School, the Annual School is increasingly becoming a prestigious regional event for bankers and all other key players in the financial services sector. This is yet another commendable contribution towards capacity building and harmonization efforts within the financial sector of the East African sub-region. It is incumbent upon all of us stakeholders to continuously review the standards set by the school to ensure that we not only maintain but strive to improve them going forward.

On behalf of Governor E. T. Mutebile, the Patron of the Uganda Institute f Bankers, I would like to formerly welcome the invited resource persons in their respective capacities and all distinguished participants.

The subject I was asked to speak on namely "Basel II and its Impact on Financial Services is a complex one and I wish to state from the outset that the implementation of Basel II remains very much "work in progress". Briefly, the Basel Committee on Banking Supervision ("the Committee") issued a Revised Capital Adequacy framework which is widely called Basel II in June 2004. This framework has been endorsed by the Central Bank Governors and Heads of Banking Supervision of the G-10 countries. The Group of Ten (G-10) is made up of eleven (11) industrial countries namely; (Belgium, Canada, France, Germany, Italy, Japan, The Netherlands, Sweden, Switzerland, United Kingdom and United States). The committee believes that the revised framework will promote the adoption of stronger risk management practices by the banking industry worldwide.

The New Accord is designed mainly for internationally active banks and is to be implemented as of year end 2006. However one year of impact studies or parallel calculations has been allowed for the most advanced approaches to be implemented as of year end 2007.

The committee recognizes that the adoption of Basel II may not be the first priority for the non-G10 countries. Furthermore the IMF and World Bank are of the view that future financial sector assessments will not be conducted on the basis of adoption of or compliance with the revised capital framework. Rather, assessments will be based on the countries performance relative to the requirements of the Committee's Core Principles for Effective Banking Supervision.

Experiences across the region and especially developing countries indicate that most countries are still at the stage of sensitization and trying to incorporate market risk under Basel I. As we progress towards the implementation of this new capital framework, success will require that bank regulators, the banking industry and other relevant parties engage in a continuous and frank dialogue on its costs and benefits. As you are aware Basel II is one the activities, which is being reviewed at regional level under the auspicious of the Monetary Affairs Committee. Our proposed implementation target date is 2010.

Bank of Uganda in this direction recently circulated a Basel II impact assessment questionnaire to all supervised banks and credit institutions. I am happy to report that varied responses have been received from the banks and credit institutions and are still being analyzed so as to come up with a Basel II activity plan.

Impact on financial services

Basel II is a comprehensive framework for improving bank safety and soundness for three reasons.

1. It closely links the regulatory capital requirements with the bank's risk profile.
2. It improves the ability of supervisors and financial markets to assess capital adequacy

3. It gives banking organizations stronger incentives to improve risk measurement and management.

The Impact of Basel II on financial services can best be reviewed by looking at its three elements or Pillars.

Pillar 1 - The Minimum Capital Requirements or Risk Focused Regulatory Capital Requirements

Pillar 2 - The Supervisory Review Process

Pillar 3 - Market Discipline

Under Pillar 1: The treatment of credit risk reflects more accurately the risk reducing effects of guarantees, derivatives and other risk "mitigants" through substitution and on balance sheet netting due to application of different risk buckets depending on risk category of the borrower. This will give incentives for banks to hedge credit portfolio risks.

The incorporation of operational risk under pillar 1 is also a significant step, which recognizes operational failures that banks should seek to minimize.

In addition, strong capital helps banks to absorb unexpected shocks and the minimum regulatory capital that accurately reflects the bank's risk profile provides more effective triggers for prompt corrective actions.

Under Pillar 2: Banks will 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, concentration risk and other risks which are not captured under pillar 1. The expanded information will improve the quality of both the Supervisors 'and individual Banks' assessment of capital adequacy.

Under Pillar 3: Banks will be required to disclose to the public the new risk-based capital ratios and more-extensive information about credit quality of their portfolios and their risk measurement and management practices. Other disclosures include: corporate structure, market risk disclosures for standardized and Internal Models Approaches, disclosure for operational risk measurement, interest rate risk and foreign exchange risk. Such disclosures are expected to encourage banks to be more transparent to financial markets which should then promote market discipline.

Uganda's preparedness

The key element that countries should consider before moving on to Basel II is whether a good baseline supervisory system is in place. That is, whether the Basel Committee's Basic Core Principles, including its preconditions – have been complied with. For Uganda, the answer to this is in the affirmative. Yes, we have a good baseline supervisory system in place.

The major milestone that enabled Uganda to move towards full compliance with the Basel Core Principles was the enactment of the new Financial Institutions Act (FIA, 2004). In addition Bank of Uganda fully shifted to the risk based supervision approach since January 2003. The FIA, 2004 allows BOU to prescribe higher on-going capital requirements for a specific financial institution if the supervisory review process reveals existing risks that warrant such increases which is in line with Pillar 2. The FIA, 2004 also outlines some disclosures including a prescription for the form and content of the annual accounts which provides a good ground for Pillar 3 under the New Capital Accord. Many aspects and possible effects of Basel II have been debated at various levels, including its potential effects on banks' costs and on the competitive positions.

Such costs include: Revamping the IT Systems and or acquisition of new Systems, training costs for staff and additional staffing needs, insufficient historical data, time consuming transitions, Internal models and risk quantification costs and disclosure overload.

As to whether these associated costs will be transferred to the beneficiaries of financial services remains a subject for research and discussion within the sector.

Thank you!