Zeti Akhtar Aziz: Enhancing the soundness of the banking sector - The New Capital Accord

Keynote address by Dr Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia, at the Risk Management Seminar on the New Capital Accord (Basel II), Kuala Lumpur, 15 April 2004.

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Distinguished guests,

Ladies and Gentlemen,

It is my pleasure to welcome you to the Risk Management seminar on Basel II organized for the directors and senior management of banking institutions. The objective of this seminar is to promote greater understanding of the impending changes to the international capital adequacy regulation. Given the importance of the subject and its implications on the banking industry, it is important for the industry to understand the intentions and the challenges arising from these changes so that the necessary action may be taken in a manner in which the benefits to be derived from it can be maximised. While there has been global acceptance of the broad principles of the new accord, differing implementation approaches are being adopted by different countries. I will take the opportunity to discuss the new Accord from our perspective and the approach that will be adopted for Malaysia. This seminar will provide you with the opportunity to engage in discussions on the issues concerning the new Accord.

Philosophy and objective of capital regulation

A well functioning and efficient banking sector is vital to the economic growth process. The banking institutions perform the important intermediation function of mobilizing funds to finance productive activities. This intermediation process needs to be performed in an environment of financial stability. Therein lies the importance of confidence and soundness of the financial system. Banking business inherently involves risks and these risks need to be rigorously managed. In an environment of heightened uncertainty and increased volatility, this needs to be reinforced with the development of a more robust and resilient banking system. Hence the importance of prudential regulations to ensure the soundness and stability of the financial system.

An important component of prudential regulation is having a sound capital framework that measures risks accurately and allocates adequate capital to the risks. The current capital accord issued in 1988 has served as the international benchmark for capital adequacy assessment for banking institutions. While it has achieved the desired results in terms of developing more well-capitalized banking institutions globally, the rapid developments in the financial markets over the years, including the growth of off-balance sheet financing such as asset securitisation have rendered the broad-brush measurement of the existing accord to be less effective.

Risk and risk management - the need for new accord

New institutional structures and evolving market practices have reduced the effectiveness of the existing accord. While the basic categorization of risks have not changed significantly, the ways in which risks present themselves have changed quite substantially. With the introduction of new products and more complex financial transactions enabled by technological innovations, risks can be disaggregated and rebundled in new ways. Similarly, the advances in financial engineering and improved expertise have allowed the introduction of new hedging instruments to facilitate risk management. Significant enhancements have been achieved in the measurement of market risk where the use of internal value-at-risk models is fast becoming the industry standard.

The advances in the quantitative approach to the management of market risks have also expanded to the areas of credit as well as operational risks. Despite the significant data constraints, new research has strengthened the theoretical foundation for internal credit and operational risk modeling. The development of new hedging instruments such as credit derivatives has also increased the use of credit risk transfer mechanisms within the financial system, thus promoting more active credit portfolio risk management. Key developments have also taken place in the area of operational risk. The experience of large corporate failures due to fraud and lapses in internal controls has focused greater attention on improving operational risk management in banking institutions. This has prompted the need for banking institutions to provide capital for operational risk and to put in place a more integrated risk management framework on an enterprise-wide basis.

The essence of the new accord

Ladies and Gentlemen,

The efforts of the BIS to introduce an enhanced framework for capital adequacy regulation through Basel II is in the context of these developments. The accord seeks to bring into greater alignment the more advanced concept of capital management into the regulatory equation. The assessment of capital adequacy needs to look beyond the computed capital ratio. The new Basel Accord therefore comprises **three pillars**. The first pillar provides a minimum capital measurement framework for credit and operational risks. In essence, the regulatory capital requirement is aligned more closely with the actual degree of underlying risk that the banking institution faces. It provides the capital measurement that has three options with different levels of complexities for both credit and operational risks to better reflect actual risk. The second pillar focuses on strengthening the supervisory process, particularly in assessing the quality of risk management in the banking institutions. The supervisory process aims to provide the mechanism to ensure that other risks such as concentration risks and market risks in the banking books being managed. Under such an environment, prudent lending such as that characterized by a high degree of portfolio diversification, could justify lower capital requirements. The third pillar specifies minimum disclosure requirements on capital adequacy to enhance market discipline.

Despite its relatively more complex architecture, the implementation of the new framework provides a number of options and flexibility to banking institutions. This is to ensure that the approach adopted reflects and is commensurate with the nature of risk-taking activities and the level of sophistication of individual institutions. In adopting the **standardized approach** for credit risks, the credit exposures are weighted based on recognized external credit ratings. However, for large banking institutions with businesses which are highly complex, the more advanced approaches, that is, the **foundation or advanced internal rating based (IRB)** approach may be more appropriate to reflect their actual risk profile. Similarly, there are three alternative approaches that may be adopted in allocating capital for operational risks, that is the basic indicator approach, the standardised approach and the advanced measurement approach.

The objective of the new framework is to emphasise on the need for refined measurement of risks, more efficient capital management and the adoption of sound risk management practices that will ultimately contribute to greater financial stability. This will be complemented with efforts to enhance the corporate governance framework, the robustness of the internal control systems, and to introduce greater transparency and market discipline. Within the context of these developments is the importance of the ability of the board members and top management of banking institutions to assess risk from a broader perspective and its strategic impact on the institution.

In view of the significant implications of this new capital framework, Bank Negara Malaysia has been directly involved in the consultative process through regional forums to ensure that issues and concerns of the emerging markets are considered by the BIS in designing the new accord. We are pleased to note that many of these issues have been taken into consideration.

Motivation for migration to the new accord

The adoption of the new accord is consistent with building strong risk management capability. The enhanced risk management practices required by the new accord not only can result in greater capital savings but becomes vital as the domestic banking system becomes increasingly competitive and integrated with the global marketplace. Effective and efficient decision making is enhanced with relevant and timely information supported by more quantitative analysis. This can be achieved through having a more robust data architecture and information system, integrated processes and enhanced information flow and reporting. Having a robust risk management framework would also allow banking institutions to better assess the marginal contribution of existing as well as new business lines to the institution’s overall financial performance. This would allow for more-informed decision-making, thus contributing towards greater competitive advantage.

Moving forward, there will be increased expectation for more efficient use of internal resources. A more enhanced and integrated risk management framework, and the adoption of a risk adjusted performance management model would serve to further facilitate shareholders' activism and drive greater efficiency among banks.

Risk management however does not operate in a vacuum or in isolation and it should not be viewed merely for the purpose of regulatory compliance. Priority should be given to ensure that the risk management framework is well-aligned and well-integrated with the strategic business directions of the banking institution. The benefits of refined risk quantification and more robust risk management should be translated into improvements in business operations and more effective functioning of the institutions. This will in turn ultimately bring benefits to the consumers and the economy at large.

Implementation challenges and considerations

Ladies and Gentlemen,

Given the complexity of Basel II, the ability to comply appears to be the main concern within the banking community. This is truly a major undertaking with respect to the IRB approaches or the internal rating based systems. The resources involved and data constraints are often cited as the two main challenges in implementing the IRB approach, particularly for banks in the emerging markets. At this stage, data on default and credit migration for certain market segments is too limited to facilitate any meaningful analysis. It is therefore recognized that some lead time would be needed for banking institutions to produce a robust and meaningful validation of internal estimates of probabilities of default and loss given default. However, this does not mean that banks should wait until all the requisite data is in place. Banks can initiate work to establish the framework for analytical functions.

While the industry survey conducted by Bank Negara Malaysia revealed a strong preference among Malaysian banking institutions to adopt the IRB approach, many had indicated the need to further strengthen their business case and undertake more comprehensive gap and impact analysis. This is indeed a critical process. Of importance is to be able to extract the benefits out of the new accord. This would however, take time even for large and internationally active banking institutions that have made substantial enhancements over the years.

Standardised approach offers benefits with much less complexity

While capital savings from the adoption of the standardized approach may be relatively lower than the IRB approach, the benefits to be gained under the standardized approach are still considerable compared to the current accord. It includes the lower risk weights to be assigned to the mortgage portfolio, which would be reduced from 50% currently to 35% under the standardized approach. Similarly, substantial capital savings could be generated from lending to small and medium enterprises (SME) that would qualify as retail exposures where the risk weights would be lowered from 100% to 75%. The potential impact of lower risk weight for this sector under the standardized approach could result in greater participation by banking institutions in this market segment.

Bank Negara Malaysia's initial estimates on the impact of the standardized approach indicated that benefits would be derived by individual institutions in terms of capital savings. However, improvements in a number of areas such as loan identification systems as well as collateral management systems would result in higher capital savings for credit risks under the standardized approach. Continuous calibration would be required to ensure that banks under the standardized approach would continue to maximize capital savings for credit risks in view of the requirement for an explicit capital charge for operational risk under the new accord.

While the IRB approaches promise greater capital savings in the longer term, the adoption of the standardized approach in the transition is considered a more pragmatic option even for some internationally active banking groups. Under the IRB approaches, banks would need to reach an agreement with the regulator in the countries they operate on the robustness of group internal estimates and validation. The standardized approach is therefore seen to provide the breathing space for a smooth transition to IRB approaches while at the same time allowing banking institutions to avail themselves of the benefits of capital savings.

Different approaches are adopted by regulators

Ladies and Gentlemen,

While there has been global acceptance of the broad principles of the new accord, differing implementation approaches are being adopted by different countries. In some countries, regulators have opted for the accord to be applied to all institutions while in others selected banks are being mandated specific approaches. Some other regulators have given greater flexibility for banks or have extended the timeline for the implementation of the new accord. These reflect the different considerations and priorities accorded by the various regulators in their policy agenda. In essence, the decision by national regulators are based on a number of common factors, namely, the stage of industry development and market infrastructure, the size and types of institutions involved, the regulatory philosophy and priorities, as well as the economic environment. Of importance is to ensure that the implementation of the new accord is consistent with the overall agenda and objectives for the financial sector to facilitate growth and economic expansion.

Implementation principles for Malaysia

In Malaysia the appropriateness of the new accord is being assessed in the context of our own objective to develop a more effective and resilient banking system that is best able to serve the nation. In view of the significant and special role of the banking sector in the economy, a well-capitalised banking system has always been a priority in the regulatory framework. In this context, the principles advocated by the new accord are consistent with our regulatory philosophy that encourages capacity building and enhancing risk management.

Effective Basel II implementation strategies would be premised on the industry having the correct understanding of the new framework. To implement the required changes, it is therefore vital that the management of banking institutions understands the principles of the new accord. One common misperception is that the recognition of financial collateral under the new framework will encourage more collateral-based lending within the banking sector. This is a simplistic conclusion given the stringent minimum standards for the recognition of such financial collaterals before banks can qualify for the capital savings. Moreover, the potential capital savings under the new framework is not from the recognition of financial collateral, but rather from the much lower risk weights attached to higher rated loans.

Indeed, the real benefit to be gained under Basel II environment comes from improved standards of loan underwriting and more accurate quantification of risks that can subsequently translate into enhanced performance. Acceptance of collateral is only to mitigate loss severity should a default take place. In an increasingly more competitive marketplace, the emphasis is on maximizing risk-adjusted returns on capital and maintaining an optimal asset portfolio that reflects the risk tolerance level of the institution. In such an environment, overemphasis on collateral is certainly not viable.

Ladies and Gentlemen,

Bank Negara Malaysia will adopt four key principles in the implementation of Basel II in Malaysia:

Firstly, the need to accommodate capacity building efforts, with strong emphasis on gradual enhancement to risk management framework for all banking institutions;

Secondly, a more flexible timeframe that allows capacity building measures to be implemented;

Thirdly, an emphasis on strong business justification instead of regulatory mandate for the adoption of IRB approaches; and

Finally, an enhanced supervisory methodology to assess internal models and advanced risk management systems.

Malaysia will adopt a two-phased approach for Basel II

These principles would be implemented in a two-phased approach. The first phase will begin in January 2008 where all banks will adopt the standardized approach for credit risks and basic indicator approach for operational risks. Banking institutions would be required to submit to Bank Negara Malaysia *parallel calculation of capital adequacy on a monthly basis for one year prior to the implementation of the standardized approach*.

In Phase I, Bank Negara Malaysia may also allow banking institutions to remain on the current accord if they intend to adopt the Foundation Internal Rating Based (FIRB) approach, instead of the standardized approach. However, Bank Negara Malaysia would require a submission of business case justification as well as a blueprint for implementation that has been approved by the Board of Directors of the banking institutions concerned. These banking institutions would be expected to have undertaken a comprehensive gap and business impact studies to justify their roll-out plans. In this regard, a broad guideline on the required processes and expectations will be issued to facilitate the process.

Banking institutions intending to adopt the FIRB approach are expected to do so by January 2010. This is when the second phase of implementation will commence. These institutions will be required to submit to Bank Negara Malaysia parallel calculation of capital adequacy on a monthly basis for one year prior to implementation. However, during the second phase, banks on the standardized approach will not be mandated to migrate to the FIRB approach. For purposes of regulatory validation and approval, Bank Negara Malaysia would expect that all parameters and assumptions used for the FIRB approach will be based on local data inputs.

Conclusion - capital is key, but not the sole factor to ensure soundness

Ladies and Gentlemen,

Despite the increased sophistication of the regulatory capital framework and internal economic capital model in banks, *capital remains the last line of defence*. Capital regulations will have to be complemented with prudent banking that includes enhanced underwriting standards, effective internal controls and risk management, as well as strong corporate governance. In achieving your future goals and aspirations, significant benefits can be derived from Basel II provided that your institutions undertake the necessary efforts to align your strategy and business orientation with the new standards. Your interest, participation and decisive actions on the new accord are therefore important in positioning your institution in this increasingly competitive and more dynamic environment.

Thank you.