# Baboo R Gujadhur: Challenges and solutions to implementing internationally compliant and domestically robust banking regulations in emerging economies

Introductory remarks by Mr Baboo R Gujadhur, First Deputy Governor of the Bank of Mauritius, at the Workshop on "Challenges and Solutions to Implementing Internationally Compliant and Domestically Robust Banking Regulations in Emerging Economies" in collaboration with the Commonwealth Secretariat, Balaclava, 6 – 7 April 2006.

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Professor Avinash Persaud
Mr. Percy Mistry
Miss Cheryl Bruce, Commonwealth Secretariat
Members of the Board of BOM
Distinguished Guests
Colleagues and Friends
Good Morning

My first duty is to welcome you all this morning on behalf of the Bank of Mauritius which is co-sponsoring this Workshop together with the Commonwealth Secretariat. I hope you have an excellent stay in our midst and that you will take away by the end of the Workshop some novel ideas on the issue of banking regulation, with specific reference to the implementation of Basel 2 in small and emerging economies.

I would like to extend a special welcome to the Commonwealth Secretariat who have accepted to co-sponsor this workshop along with the Bank of Mauritius. The Commonwealth Secretariat, as you know, have always held the interests of their members at heart and their participation in this event is a testimony of their commitment to the advancement of Commonwealth countries. Our friends from the region and ourselves stand to benefit from the experience the Commonwealth Secretariat has acquired from its exposure to a wider range of countries at different stages of development.

### From Basel 1 to Basel 2

This workshop comes at an opportune time, when the regulation and supervision of banks is undergoing a vast amount of change. Change, as you know, is often viewed with apprehension and is frequently met with resistance. It is true that change is accompanied by threats against those who are satisfied with the status quo. But we have to recognise that change brings along new opportunities and promises. It usually provides an impetus to unleash new potentials. In a situation of changing circumstances, success embraces those who not only adapt to change, but who also position themselves as agents of change. In fact, we should evolve so that change becomes our second nature.

The financial system in different countries has been evolving for many centuries to match the demands of the real sector. However, the pace of change has been much faster and more global during the two last decades. Propelled by wider access to education and knowledge, advance of technology and intensification of competition, new financial products and services, with varying degrees of sophistication and complexity, have made their way to the markets and on the balance sheet of banks. Doubt has been expressed in certain very serious quarters as to whether the sum of the risks taken by financial agents in this regard the world over is fully contained.

Banks play a prime and vital role in a financial system. A stable banking system is thus a pre-condition for a stable financial system. The importance of a stable financial system for the long-term growth of an economy cannot be over-emphasised. I recognise that we are still some way off from devising a framework for financial stability which is as comprehensive as that for price stability, but no one can deny the importance of a system for providing credit to business that is fair, efficient and reasonable. We cannot also deny the importance of an efficient and resilient payment system for a timely and reliable flow of funds through an economy. The importance of continued public confidence in a banking system, held together in a stable environment by an efficient control of risks taken, is also widely endorsed. It is in attempting to secure a higher level of overall financial stability that the Basel Committee on Banking Supervision (BCBS) has advanced the stage from Basel 1 to Basel 2, both of which are focussed on the amount of capital that banks should hold as a safeguard against risks taken.

## Stepping up the regulatory framework

This is an audience that is knowledgeable about the reasons prompting the shift from Basel 1 to Basel 2. I do not therefore propose to dwell on this issue, except for drawing your attention to the fact that the concepts underlying the first Capital Accord of 1988 in respect of banks have evolved considerably to embrace a wider and more differentiated set of techniques for risk identification and measurement in the determination of the amount of capital that a bank should carry in relation to those risks. Moreover the approach of Basel 2 is principle-based and flexible. It provides amongst others for a wider range of concertation among banks, their supervisors, analysts and market participants in the process of risk assessment and is far superior to the ticking-off compliance driven culture of past practices.

The complex implementation that Basel 2 entails should not be seen in isolation in the area of banking regulation. It is in fact part of a series of actions initiated at the international level since the late 1990's to overhaul financial supervision and banking regulation in particular. The scale of the Asian Crisis of 1997 brought to the fore the notion of "macroprudential surveillance". The overall aim was to get regulators from several jurisdictions together to devise the means to safeguard national and international financial systems, identify systemic flaws, promote governance and set out financial stability as an explicit goal of financial regulation. By September 1997, the BCBS presented its 25 Core Principles for Effective Banking Supervision. The Core Principles have since then become the very foundation of modern banking regulation. The final objective behind all this effort to strengthen banking supervision is to avoid market failure, which can have vastly disruptive effects on the functioning of entire economies and can spread out to wider regions or impact adversely on the global economy if not attended to in a timely manner.

The direct impact of these international regulatory developments has been felt very closely by the industry in Mauritius. The Bank of Mauritius has issued a series of guidelines over past years on a wide range of subjects covering IAS 39, Corporate Governance, Internal Controls, Liquidity and Operational Risks Management, Public Disclosure and Outsourcing of Financial Services, to name but a few. A visible intensification of our onsite and offsite inspections of banks over several years has led to enhancing the regulator's understanding of the precise framework in which banks actually operate. It has also led to a higher degree of appreciation by banks of the objectives behind supervision.

The amount of trust and confidence that this interactive process has generated between the two sides will no doubt have its own positive impact on the ongoing implementation of Pillar Two of Basel 2. Better mutual understanding between the two parties, regulator and banks, will also ward off the risk of over-regulation. Besides, several forums exist for the purpose of concensus building between the Bank of Mauritius and the banking sector on major policy issues. This existing collaborative plan should assist in Pillar 2 implementation more effectively. Given also that the banking sector of Mauritius accounts for over 70% of total financial assets of the country, we cannot underestimate the relevance of applying sound and timely rules and principles towards maintaining the safety and stability of the banking system in the general economic context of the country. However, to be productive, those rules and principles have to be adapted to the ultimate objective sought by bank regulation to strengthen the domestic banking system. They should not merely reflect decisions taken in other contexts for other countries and in different market circumstances, or not have direct bearing on the realities of banking practices in Mauritius.

## Country-specific issues

We have in Mauritius our own banking environment and specific banking culture. Of the 19 banks that have been licensed, a couple of banks only account for a dominant share of the domestic banking market. Many of the other banks are oriented towards providing almost exclusively global financial services to international markets. Side by side with a few other locally owned banks, that have a relatively small share of the market, affiliates of the world's largest banks are also present in our jurisdiction. In general, the overall style of bank management has improved positively over the years under the impact of our guidelines to the industry, bringing it closer to best international practices. Nevertheless, we have a number of structural and historical factors going into Mauritian banking which need to be dealt with according to local specificities.

Given this situation, it could represent a considerable effort on the part of some of our banks to invest in the major IT project that Basel 2 actually represents in terms of its complex risk management systems and database management. On top of the high level of technological architecture, Basel 2 involves cost of investment in human resources and skill development across the entire institution for effective risk profiling. It goes without saying that outright implementation costs are significant. Given the structural and other factors of the banking system of Mauritius, pragmatic regulatory decisions will be called for to justify additional costs to be incurred by individual institutions in their specific situations.

At the end of the day, the test of adopting Basel 2 will lie in the extent to which it pays off to embrace the comprehensive risk control culture advocated particularly with reference to the Internal Ratings Based (IRB) approach which appears to be the ultimate objective of Basel 2. In other words, moving to the Basel 2 approach should be coupled with enduring tangible benefits to individual banks. Neither time nor resources should be wasted by an artificial adoption of international norms just for the sake of moving on alongside other countries. In this regard, we have to be careful to put our banks in fair competition with each other while sticking as closely as possible to the essence of the International norms underlying Basel 2. As a result of adopting Basel 2 in its appropriate form, our financial architecture should come out stronger and the country should also have reasonably priced access to international capital markets.

**Basel 2 implementation: choices to make**

In view of these considerations, it is of no use to fiddle with the rules or to focus on the arithmetic of risk management with a view to minimizing the amount of capital that each bank is eventually required to maintain. There is also no point in adjusting the scaling factor to “get it right” with the same objective. This is not the guiding principle of the new Capital Accord. Pillar two of Basel 2 advocates dialogue between banks and well trained regulators, able to apply the relevant judgment on the choices that have been exercised by each bank to quantify risks in their portfolio and hence to determine the commensurate amount of capital to be maintained as a buffer against those risks. Moreover, Pillar 3 emphasizes transparency in the capital allocation process through the provision of full information to analysts and market participants to enable the latter to judge whether the bank is adequately capitalized, given the nature of the risks taken by it. Pillars 1,2 and 3 cannot therefore be viewed in isolation from each other.

However, as it is usually the case for rules and codes of universal application which transcend the original purpose for which they were initially formulated, not least in those jurisdictions that were expected to be the first ones to embrace it, there are difficulties of implementation. Issues have cropped up about the reasonableness and practicability of the ratings system inherent in the Standardized Approach. This factor has been highlighted specifically in environments in which smaller banks adopting the simpler approach of Basel 2, have no alternative to abiding by the system of ratings for their customers whereas there is no supportive borrower rating culture in these environments and it is unlikely that it would be so in the near future. This is the case for a jurisdiction like Mauritius. Issues have also been raised about competitiveness implications of Basel 2 adoption in mixed environments In this case, with certain banks adopting the simpler approach, the capital charge is expected to be higher for such banks as compared to other larger banks which go for the more sophisticated IRB models to allocate a lesser amount of capital on their lending to the same customers. The debate is whether the IRB capital advantage will price the blue chip borrowers completely out of reach of banks adopting the simple approach. If so, the structural impact of a shift in this direction would be far from negligible. Cross-border coordination issues for banks operating in distinct environments has become another issue in so far as banks do not want to be the disadvantaged due to differences in supervisory practices and approaches in different jurisdictions in which they have operations. This has raised the question as to whether there is effectively a level playing field and how far it can be achieved. Issues have also been raised on the assessment of Loss-Given-Defaults (LGD’s) in the downturn phase of the economic cycle, the efficiency of supervisory validation and the quality of stress testing. These problems will have to be sorted out to avoid unwarranted fears and suspicions. More importantly, while Basel 2 advances the platform for risk management more comprehensively than ever before, it is not free from some practical problems that need to be addressed.

We have to be realistic and patient. Given the increasingly complex transactions in which banks are continuously engaging in search of markets, a risk management system like Basel 2 is consistent with the primary objective of the bank regulator, which is to incorporate those risks into capital regulation with a view to making the whole banking system safer and more stable. We cannot expect a huge system like Basel 2 to be implemented without the normal teething problems. The difficulties of adaptation of the model to the practical situation prevailing on the ground in different environments are expected to spin off solutions. These solutions should not thwart financial sector development or introduce excess compliance costs out of keeping with the expected benefits. I repeat therefore that it would be reasonable for Mauritius to join the mainstream of Basel 2 implementation provided that, as a positive spin off for adopting Basel 2 in an acceptable form, banking practices over here become more solidly entrenched and bankers find full expression in their primary job of risk taking through a hands-on approach to their activities rather than outsourcing judgment to third parties. The judgment of the seasoned banker, capable of identifying and quantifying the risk he is taking on, is a significant value addition that we should not jettison by moving on to a purely ratings based assessment of risks as advocated in the simple approach. This is why the Bank of Mauritius and banks are discussing in detail the practicalities of Basel 2 implementation since last year and progressing the agenda on a concensual basis.

Finally, I would like to state that we have adopted an open attitude in this respect in Mauritius. No specific Basel 2 approach is mandated to any bank, irrespective of its size and complexity of its transactions. Inevitably, banks will need to invest in more risk management systems responding to their present and foreseeable needs. Nothing is, in my opinion, more precious and worthwhile for a bank than maintaining and developing a deep and intimate in-house knowledge of its customers for the purpose of identifying the distinct risk each one of the customers represents. With Basel 2, this kind of knowledge has to be objective and systematic, and drawn up into a reliable database so that the information can be utilized, to the satisfaction of the regulator, for mitigating risks and defining the capital requirement on a case to case basis. This goalpost has already been set and we need to reach it in the most cost-effective manner, preferably keeping pace with other jurisdictions.

I know that Professor Avinash Persaud and Mr. Percy Mistry have delved into the issues concerning Basel 2 at a deeper level, having had knowledge of how things are moving in the Commonwealth and other countries. I trust that they can enlighten us more fully about the direction we can practically take in our specific context of a small and emerging economy.

It is therefore my pleasure to leave the floor to them to throw light on how best the regional economies can deal with the new challenge that the implementation of Basel 2 represents and I invite you to participate actively in the exchange of views due to take place over the next couple of days. I know that discussing about banking risks in the beautiful setting of this tourist resort is not the ideal thing to do but the trade-off may be well worth the while for the short duration of the Workshop.

Thank you for your attention.