

Bandid Nijathaworn: “Implementation of Basel II and IAS” from a regulator’s perspective

Keynote address by Dr Bandid Nijathaworn, Deputy Governor of the Bank of Thailand, at a meeting hosted by the Thai Bankers’ Association and organized by the Bankers Association of the Philippines and ASEAN Bankers Association, Bangkok, 4 October 2007.

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Distinguished Participants,

Let me first thank the Thai Bankers’ Association for the invitation to give today’s keynote address, on the *“Implementation of Basel II and IAS” from a regulator’s perspective*. Looking at the agenda, the meeting in the next two days will dwell into a number of important regulatory issues. Therefore, to help set the stage for the discussion to follow, I would like to take this opportunity to speak on the Bank of Thailand’s perspective on the implementation of Basel II and the International Financial Reporting Standards (IFRS), looking in particular at the benefits from such adoption, the progress we have made on implementing the two standards, and the challenge and adjustments that need to be made for a successful implementation.

Ladies and Gentlemen,

Recognizing that today’s global financial system has become increasingly complex and interdependent, a number of organizations around the world have been working on improving international standards to ensure sound risk management and disclosure by financial institutions. Among these, Basel II and IFRS are undoubtedly the most important recent efforts.

As an international framework for capital adequacy, Basel II is designed to ensure soundness and stability of the global banking system. Improved from Basel I, Basel II provides guidelines for maintaining capital for more comprehensive types of risks. Under Pillar 1, as you know, banks are required to maintain minimum capital for operational risk in addition to market and credit risks as previously required. And on top of the minimum capital, additional capital may be recommended by national supervisors under Pillar 2 for risks not covered by Pillar 1.

Because Basel II will be imposed on a wide range of financial institutions with different sophistications, the framework offers several approaches to calculate minimum capital, ranging from a simple factor multiplication approach to model-based methodology. Obviously, we as supervisors, expect complex financial institutions to adopt the model-based methodology for a better measurement and assessment of risk.

One important point I would like to stress here is that Basel II should not be viewed as merely a capital calculation methodology. Rather, it should be seen as a principle-based guideline for sound risk management. This is because Basel II’s advanced approaches are derived from the best banking practice. It is, therefore, a vehicle for better risk management. Banks in emerging markets, including here in Thailand, should, therefore, take advantage of this opportunity to improve their operations.

From the perspective of financial information, it is also necessary for banks to produce good quality financial statements so that stakeholders will be well-informed, and a sound judgment on their financial status can be made by the market. Good quality financial statements typically contain comparable and reliable information, which depends in turn on the accounting standards being used. In this respect, IFRS can help ensure that financial reporting is prepared under accepted principles that convey a true and fair view of the financial position.

For the banking sector, the most important accounting standard is the IAS 39 because it deals specifically with financial instruments. The standard assures that financial instruments are correctly recognized and measured in the financial statements, to reflect the true financial position and performance, as well as the related risk exposure. Under IAS 39, there is important change to the accounting for derivative transactions, in which banks need to mark-to-market and record all derivatives on their balance sheets, as well as classify them as held for trading, unless they are used as hedging instruments. Previously, all derivative transactions are kept off the balance sheet, and hence from the recognition of external stakeholders or even bank management. IAS 39, therefore, brings off-balance sheet items into the spotlight. Apart from IAS 39, commercial banks also need to comply with the accounting standards concerning financial instrument's presentation (IAS 32) and disclosure (IFRS 7), which require banks to present their financial statements in an appropriate format, and to disclose information sufficiently regarding financial instruments and risk.

Ladies and Gentlemen,

The Bank of Thailand has taken a careful timing to implement both standards in Thailand. Similar to many economies in the region, commercial banks in Thailand will start maintaining capital according to Basel II by the end of next year, and by the end of 2009 for banks with the advanced approach. IAS 39, on the other hand, will be fully enforced by the Federation of Accounting Professions in the beginning of 2010. However, the Bank of Thailand has already adopted some parts of IAS 39, namely the impairment of assets since December last year, and we are now considering adjusting the related regulations to be in line with the concept of IAS 39.

For Basel II, preparations on the supervision side started a number of years ago. The Bank has set up several internal working groups to study the guidelines and its suitability to the Thai market. Staff were sent abroad for training on Basel II implementation. Experts from other supervisory authorities and consultants were invited to hold seminar and training on the underlying concepts, applications, and supervision issues. The drafting of the Thai version of Basel II has been quite involving. During the drafting, the Bank of Thailand carefully studied other countries guidelines and consulted with other supervisors to gain insights on the suitability of Basel II to the Thai financial system.

As a result, we have made some necessary adjustments to the guideline taking into consideration its practicality. Banks in Thailand have been consulted in the process so that the guideline does not impose extra unnecessary burden. At this time, we have mostly completed Basel II's key guidelines with only a few remaining issues. This includes finalizing Pillar 1 – namely, Minimum Capital Adequacy Return Form, and the Recognition of External Credit Assessment Institutions and the Mapping Process Under the Standardized Approach (SA).

On the commercial bank's side, our assessment shows that the preparation for Basel II implementation is on track. In terms of capital impact, based on end of June data for 2006, our quantitative impact study shows that the BIS ratio for the whole industry is expected to decline approximately by 1.5 percentage point. This means Basel II implementation will not have a major impact on the Thai banking industry.

At this time, while most of our banks have decided on using the SA for calculating minimum capital, they are fully aware of the need to improve the database to support a more advanced risk management process. Reflecting this, larger banks are in the process of developing advanced internal rating systems to be fully compliant with Basel II advanced approaches in the near future. By the end of this year, banks in Thailand will also begin parallel calculations of the required capital under Basel II. And we, at the BOT, are keeping a close watch on this progress with keen interest.

Regarding the implementation of IFRS, I have to say the readiness amongst Thai commercial banks and foreign bank branches do vary a great deal. Foreign bank branches, especially European banks, are better prepared to implement the IAS 39 and IFRS as they

are more familiar with the new accounting principles. This is because they get the supporting systems, as well as knowledge, from their head offices. Thai commercial banks, on the other hand, are studying the implications and the context of the new accounting standards, and are preparing their IT systems with the help of external consultants.

In terms of regulation, as I already noted, the Bank of Thailand has begun implementing IAS 39 for the impairment of assets or NPL since December last year. By June this year, commercial banks have set an additional provision of about 90 billion Baht, with their BIS ratios remaining comfortably well above the minimum requirement at 14 percent. We at the BOT are studying the remaining issues of IAS 39 pertaining to supervisory policies and financial impacts on the banking sector. And our policies on components of capital and related reports are scheduled to be prescribed by the end of next year.

Ladies and Gentlemen,

Implementing Basel II and IFRS has been a challenging experience. For Basel II, the most difficult issue is arguably going to be the application of the principles embedded in Pillar 2 where supervisors have the ability to require banks to hold capital in excess of the minimum. Since the amount of required capital has a direct impact on business performance, it is therefore quite a challenge for supervisors to be requiring banks to hold different amounts of additional capital.

For accounting standards, the most recent challenge is the accounting methods for sophisticated financial products, such as CDO and structured notes, in which differences in financial assets' classifications can result in different financial impacts. For example, held-to-maturity classification conceals profit or loss until maturity, while trading classification charges profit or loss to financial statements in every accounting period. The interpretation for a suitable classification relies significantly on the intention of bank management as well as on the judgment of external auditors. The importance of this issue, as we know, has reemerged more demandingly following the sub-prime crisis in the US.

Another practical challenge in implementing both standards is the use of complex financial models to measure risks in banks' portfolio. In order to confidently use the models, there must be sufficient data, appropriate risk measurement techniques, and a rigorous validation process. At present, the most important concern is the lack of data. For example, for credit risk measurement, a certain amount of data on default is required. Such data typically are not readily available, and this is also the case here in Thailand.

In addition to the lack of data, the IAS 39 also allows the use of fair value for all financial assets and liabilities, or the Fair Value Option. Although this concept is attractive, there are still many concerns from a regulatory point of view. The Fair Value Option may be inappropriately used and may result in unreliable financial information. For example, when a bank applies the Fair Value Option to its liabilities and is downgraded, the yield for its liabilities will increase to reflect the increased risk. Consequently, the mark-to-market value will be lower than the original value, and the gain is recorded as profit. Therefore, it seems unreasonable that banks can record profit in a difficult period by applying the Fair Value Option to their own liabilities.

Ladies and Gentlemen,

My last point is that Basel II and IFRS will undeniably bring some fundamental changes to the business of banking.

First, banks may need to rethink their operations and strategies on account of the expected greater involvement of third parties. The point here is that new regulations allow banks to use financial models to estimate required capital and fair values of assets and liabilities. This means banks can take advantage of the lower capital requirements by offering cheaper or more cost efficient products to their customers. However, to develop financial models requires a certain amount of data and know-how which a single bank may not have. So, to

overcome this difficulty, banks may have to seek support for additional credit data from peer banks, rating agencies, or the credit bureau.

Second, banks must increase their knowledge base regarding risk management techniques, especially on risk modeling. Going forward, a good internal rating system is key to business expansion and growth. To do so, banks can initially seek support from external consultants to transfer the know-how on risk management. But, in a longer term, it will be necessary for banks to have their own staff and expertise to work as specialists on internal rating system and risk modeling.

Lastly, I would like to stress the importance of coordination and cooperation in implementing the two standards. We at the BOT have always sought comments and views on our policy statements, and on the implementation plan from both local and international entities. Within Thailand, comments were sought from the Stock Exchange of Thailand, the Federation of Accounting Professions, private consultants, rating agencies, external auditors, the Foreign Banks' Association and most importantly the Thai Bankers' Association.

On the commercial bank side, a Basel II Implementation Working Group has been set up by the Thai Bankers' Association and the Bank of Thailand. Through this working group, I encourage banks to share Basel II implementation experience so that common issues can be resolved more effectively. Any common concerns, on the other hand, can be passed on to the BOT for consideration. And if necessary, the BOT is ready to act as a mediator to voice the concerns to the appropriate international channels. As a result, where possible, banks in Thailand are now pursuing a coordinated effort for a better implementation of Basel II. Such effort can be as close as forming an alliance to pool the necessary data for model development, or as loose as sharing the costs of training and seminar similar to the one we are having here today.

I should now end my talk. It has been a pleasure to share with you a regulator's perspective on the implementation of Basel II and IFRS. I hope my remarks and observations have been useful. We are traveling on an important and challenging path towards achieving a robust and resilient financial system, and steady progress is being made. You, as a key stakeholder, are also an important part of this journey.

I wish the rest of the seminar great success and accomplish its objective, and be interesting and educating to all.

Thank you very much.