Zeti Akhtar Aziz: Basel II implementation and the development of Asia's financial system – experiences, challenges and regional cooperation

Keynote address by Dr Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia, at the 4th SEACEN/ABAC/ABA/PECC Public-Private Dialogue for the Asia Pacific Region, Kuala Lumpur, 18 August 2008.

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It is my pleasure to be here today, to speak on the occasion of this Public-Private Dialogue organised by the SEACEN Centre in collaboration with the APEC Business Advisory Council (ABAC), the Asian Bankers Association (ABA) and the Pacific Economic Cooperation Council (PECC) on the development of Asia's financial systems and the implementation of Basel II.

The implementation of Basel II across the Asia Pacific region is occurring at a time of heightened risks, during a time in which our economies and financial systems are confronted with significant challenges and increased uncertainties. As the underpinnings of Basel II are concerned with enhancing the responsiveness to risk by banking institutions, there are enormous expectations that Basel II will stand up to the test of capturing the complexities and the more uncertain direction of risk in the current environment. There is also enormous interest in assessing the pre-emptive capabilities of the framework to anticipate the direction of risk and thus ensure the provision of adequate capital buffers for such risk. The sharing of experience on the implementation of Basel II in this region and the greater engagement between the supervisory and financial communities will provide further insights to these issues. The ultimate objective of Basel II is to achieve more resilient banks, and thus preserve the broader financial stability.

In the Asia Pacific region, thirteen countries have adopted the standardized approaches under Basel II for credit and operational risks. A number of countries have also either already adopted or announced plans to adopt the more advanced approaches by 2010 or earlier. Malaysia adopted the standardised approach this year and has recently issued a concept paper detailing the parameters for the implementation of the more advanced approach to be adopted in 2010.

The global economy has entered a period of greater uncertainty, with a number of developments that are taking place in some of the developed economies having destabilising implications on the global economy. The international financial markets continue to be in turmoil, triggered by the developments in the subprime market in the United States and resulting in the tightening of liquidity in the credit markets. The impact of these developments on the financial position of financial institutions has affected the functioning of the financial markets and the financial intermediation process. This has required interventionist policies to contain its systemic implication. In addition, the global economy has been through a period of high commodity and energy prices which has not only translated into higher inflation but has also contributed to dampening economic growth.

While the Asian region has experienced robust growth in the first half of 2008, the regional economies will be affected by these developments. Although growth is expected to moderate, most economies will continue to see a reasonable growth performance. The region will, however, continue to face inflationary pressures arising from high commodity and energy prices. This is however, expected to recede with the substantial correction that has recently taken place following the slower pace of global growth.

The Asian region is expected to weather this challenging period with the growing intra-regional trade and the expansion of its economic links with Eastern Europe and Russia, the Middle East and Latin America. At the same time, increased infrastructure spending in several of the large economies will provide further support to domestic demand. In addition, the strengthened economic fundamentals of the Asian economies, including the high level of reserves, low external debt, strengthened financial systems and improved fiscal position, will allow the flexibility to better manage the risks to the economy and the financial systems.

In this environment, the implementation of Basel II presents a powerful lever for banks to significantly enhance both their long term resilience and their competitive advantage. It promises greater financial stability through the closer alignment of risk with capital. To realise the full benefits from the implementation of Basel II, its multi-faceted dimensions need to be well understood and well integrated with the financial structures, institutional practices, and supervisory systems. Emerging markets in particular will need to ensure that supervisory interpretations of the framework are contextualised to the local conditions, and the preconditions for its effective implementation are adequately developed to avoid the potential market distortions.

At the institutional level, Basel II provides a unique opportunity for banks to integrate risk considerations with their business strategies. Indeed, several leading financial institutions have successfully taken Basel II beyond the narrow and mechanistic risk applications to a more strategic implementation of the framework across the organisation. Such institutions have leveraged on the upgraded risk infrastructures that have been established for Basel II to create competitive advantages through the application of new business and management tools. This enables the risk function to have a central role in forming strategic moves into new markets or products. In the process, this will ensure that the strategies are aligned with the bank's risk appetite and policies.

The benefits of Basel II cannot be achieved with just a strict regulatory compliance approach. While Basel II serves as a powerful catalyst to reposition the role of, and the attention to, risk management in banking institutions, significant efforts need to be directed at strengthening the financial structure, corporate governance, risk management and data capabilities within the banking institutions. The approach adopted by Bank Negara Malaysia has been for these efforts to complement and reinforce the positive outcomes of Basel II. These are important preconditions for, and not automatic outcomes from the adoption of Basel II.

In the wake of the sub-prime mortgage crisis in the United States, several aspects of Basel II have attracted attention. Among them has been the use of ratings in the regulatory framework and whether this has unintentionally discouraged investors from performing their own due diligence. The underestimation of risk for structured credit securitisations has now come under greater scrutiny. There has also been increased debate over the cyclicality impact of Basel II. The effectiveness of the supervisory review process in ensuring that additional capital buffers are provided by banks for risks not fully captured under Pillar 1 of the framework has also been the subject of this review by authorities.

The relative importance of these issues will be different for different countries, depending on the stage of development of the financial markets and the banking system, as well as the supervisory structure that is in place. Among Asia Pacific countries, experiences with the implementation of Basel II have been varied.

For emerging economies, Basel II has arguably a more far reaching impact. This is on account of several factors. Firstly, many emerging economies continue to depend heavily on the banking system to finance economic activity. With a few exceptions, commercial banks are the main providers of credit in most emerging economies, accounting for an average of 90% of total credit. This produces a higher correlation to the economic sectors where the implications on the banking system could result in significant disruptions to credit supply which could in turn affect economic activity.

Secondly, the more advanced approaches of Basel II are calibrated to the environment of the G10 countries, with significant acceleration of capital charges as the probability of default ratings deteriorate. To the extent that this inappropriately amplifies economic cycles by inducing the systemic misperception of risk in emerging economies, this can exacerbate a credit crunch during periods of weak economic performance.

Thirdly, the anticipation of lower regulatory capital requirements and hence, a competitive cost advantage, provides a strong incentive for banks especially in the developed countries to move towards the more advanced approach under Basel II. This could result in an uneven competition between the domestic and international foreign banks operating in the domestic financial system. Capability gaps in the adoption of the more onerous approaches under Basel II may place domestic banks at a competitive disadvantage in such countries.

These considerations have meant that for many emerging economies, the translation of the Basel II framework to suit the local environment needs to be approached carefully. The Basel II text provides a range of options which can be considered by national supervisors to re-balance the calibration of Basel II to reflect the local environment. It is also important that Basel II is implemented as part, and not in isolation of, the overall financial sector development programme. This has been Malaysia's approach.

The highly fragmented banking system and relatively weak risk management systems within the domestic financial institutions which prevailed in Malaysia prior to the financial restructuring and reforms that were undertaken from 2001 would have rendered the implementation of Basel II extremely difficult, if not impossible to achieve without risking disruptions to the intermediation process. The financial reforms that were undertaken to strengthen the underpinnings of our banking system are therefore instrumental in facilitating the smooth transition to the adoption of Basel II in Malaysia without adverse market outcomes.

In the more recent period, the Asian region as a whole has made significant strides towards strengthening market structures and institutional arrangements for financial stability. Two developments deserve mention, in view of their important contributions towards mitigating some of the concerns surrounding Basel II for emerging economies.

First, in the decade following the Asian crisis, the emerging economies in Asia have extensively developed their bond and equity markets. Measured in terms of market capitalisation, East Asia's equity markets have more than trebled since 1997. The bond markets in the East Asian region have also seen significant growth during this period with significantly improved liquidity conditions in these markets. There is therefore now a more diversified structure in the financial system.

Second, within Asia, the regional cooperative framework has been substantially strengthened to support financial sector development, surveillance, crisis management and capacity building. An important achievement within the EMEAP process has been the establishment of a Monetary and Financial Stability Committee, or MFSC, which is charged with the mandate of facilitating greater regional collaboration in preserving monetary and financial stability as well as in the development of regional financial markets. Since its establishment, the MFSC has exceeded expectations in terms of the commitment towards supporting regional monetary and financial surveillance, and in advancing efforts to institutionalize cross-border crisis management and resolution arrangements.

These developments will contribute towards reducing any procyclical impact of Basel II and facilitating over time, refinements to the risk parameters that are more appropriate to local and regional experiences. The continuation of such efforts at the national and regional levels will reduce the prospects for potential disruptions in the regional financial systems.

One of the most important consequences of Basel II lies in the effect that it will have in sharpening the focus on corporate governance in banking institutions. While there has been considerable attention focused on the quantitative implications and operational aspects of the Basel II framework, there has been less attention given to the corporate governance dimensions associated with its implementation.

The expectations on the board and senior management oversight are significantly higher under Basel II. The board of directors is expected to ensure that a sufficiently strong risk control framework is in place before banks can adopt the more advanced approach. Boards and senior management must have a sound understanding of the risk profile of the respective banking institution and ensure that it holds sufficient capital that is commensurate with that profile. This is reinforced by the greater attention being accorded by supervisors to the risk management control functions within the banking institutions and how they are effectively governed. Improved market disclosures under the third pillar of the framework further subjects the banking institutions governance practices to closer market scrutiny.

These developments have challenged governance practices that may have been tolerated in the past, but which would be grossly inadequate to provide the oversight that is demanded in today's far more complex business environment. Such practices have included vague reporting of risks to the board, boards that are disengaged, and boards that have no or little expertise in risk and financial matters. Boards and supervisors need to confront these issues with firm resolve. This will entail the more rigorous scrutiny of board members and senior management, both prior to their appointments and on an ongoing basis. Boards need to also assert themselves more actively in advocating and driving risk reforms, and demanding the appropriate level and amount of information from management that would enable the oversight responsibility to be discharged effectively.

In many respects, Basel II remains a work in progress. As we continue to ponder its broad and complex dimensions, platforms such as this for open and active dialogue between public and private interest groups are important to provide further insights on the many issues that will provide the direction forward for the wider and effective global implementation of Basel II.

On that note, I wish you all productive and successful discussions. Thank you.