Abdulrahman A Al-Hamidy: Risk strategies for Basel III compliance and beyond – extracting business value from regulatory change

Speech by His Excellency Dr Abdulrahman A Al-Hamidy, Vice Governor of the Saudi Arabian Monetary Agency (SAMA), at The Institute of Banking/Moody's Analytics Symposium, Riyadh, 30 November 2011.

* * *

Distinguished Participants,

I am pleased to be here today to share my thoughts on "Risk Strategies for Basel III Compliance and Beyond". Given the lingering global financial crisis with ongoing impact on a number of economies and financial markets, this is a relevant and timely subject to deliberate upon.

I appreciate the efforts of the Institute of Banking and the Moody's Analytics to organize this Symposium for the benefit of the bankers and supervisors in the Kingdom. I have seen the list of topics to be covered today and the impressive list of speakers and I am confident that all of you would greatly benefit from the discussions.

The world today has not yet recovered from the global financial crisis that started in 2007. While the governments, central banks, supervisory authorities and international organizations have been working hard to revive and revitalize financial markets and financial institutions in many advanced markets, the recovery has been slow. Following the financial crisis the lessons learned exercise had attributed the main causes to include a long period of easy monetary policy that fueled accelerated economic growth accompanied by lax and light supervision in a number of advanced markets. Consequently, one of the key response from the authorities was to develop the BASEL III Reforms Package that aims to strengthen global supervision of international banks and banking systems.

While the global banking supervisors have been working hard to improve banking supervision, the financial crisis has mutated into a fiscal crisis in some markets in Europe, once again threatening the viability of some global banks and causing the risk of contagion to other financial institutions and markets. Consequently this drives home the lessons that strengthening banking supervision alone is not sufficient and that prudent fiscal and monetary policies are essential for a sound and resilient banking system.

Before I talk about Basel III, I would like to revisit the evolution of the Basel II framework which was published by the Basel Committee in June 2004 with a tentative full implementation date of 1st January 2007. Consequently in 2007 a pertinent question was that why did Basel II fail to prevent the financial crisis. The response was that apart from its slow and uneven implementation in the advanced markets, Basel II was a flawed standard that had failed to address some of the major supervisory weaknesses. These included the lack of a common definition of quality of capital, no limits on leveraging, no common standards for liquidity and a failure to recognize the excessive market risks embedded in trading and derivative transactions that had risen very sharply among the major banks. Therefore, Basel II would have not done the job it was required to do.

This brings me to the Basel III which not only addresses the shortcomings of Basel II but goes far beyond by introducing a variety of new concepts which have raised the bar in terms of global supervisory standards. Some of these concepts emerged from the various lessons learned exercises that were carried out following 2007, while others are a product of serious research and reflection by the global banking supervisors. Basel III has introduced some fundamental reforms such as elevating the status of Common Equity capital as the key component of Core capital. It also has introduced the concept of a conservation capital buffer and even more importantly an additional countercyclical buffer on top of the minimum capital requirements. Also Basel III has recognized that liquidity is as important if not even more important than capital for safety and viability of banking institutions. It has recognized that there must be limits on leveraging by financial institutions so that bankers are restrained from excessive risk taking.

Basel III also has taken a serious and perhaps a much needed closer look at risks in trading and investment activities and particularly for derivatives and off balance sheet transactions. In July 2009, as an interim measure, Basel Committee had issued a document addressing the market and trading book weaknesses in Basel II for immediate implementation. This document is known as Basel II.5. Basel III goes much further with refinements in areas such as counterparty credit risk, Credit Value adjustments, etc. These measures should enhance the risk management, governance and supervision of such activities as securitizations, re-securitizations and credit derivatives.

Also at the conceptual level there is far greater emphasis on stress testing by banking institutions for various risks. Banks are required to develop stress scenarios and demonstrate their ability to cope and survive under stressful situations. Basel III also requires supervisors to use stress testing at the systemic level.

One related area of major concern that has kept Basel Committee very busy is the enhanced supervisory regime for Global Systemically Important Financial Institutions(G-SIFIs). These institutions will be subject to a more stringent, sensitive and effective supervisory regime and will also face a higher capital charge in form of common equity capital. They are already subject to supervisory colleges and to the emerging requirements of stronger resolution regimes. There is already an informal consensus that these rules will be equally applied to Domestic SIFIs.

I do not want to delve into many details on these measures which I am sure will be covered by various speakers today. I just want to make a fundamental point that the Global supervision is reverting back to fundamental values of prudence, conservatism and simplicity. These are the same values that SAMA has always espoused and maintained and therefore for us the transition to Basel III raises no major concerns nor poses major challenges.

Let me now highlight some challenges to be globally faced by banks and supervisors in implementation of Basel III:

- Firstly, Base III has substantially raised the quality, quantity and international consistency of capital and liquidity. The new rules are aimed at strengthening of capital and risk management in banks. This may require banks to inject high quality fresh capital, preserve existing capital by limiting the payout of dividends and bonuses, realize efficiency gains, and mobilize liquidity from new sources in certain jurisdictions to meet additional capital and liquidity requirements. This would be a major challenge for some internationally active banks, particularly under present market conditions;
- Secondly, internationally active banks facing major capital shortfalls will have to revisit their business strategies on global presence and expansion plans. They might be required to take some tough decisions on exiting from certain locations or considering merger and consolidation of their affiliates and subsidiaries;
- Thirdly, implementation of Basel III will require banks to assess their existing capacity on estimation of additional capital and liquidity requirements. This may also require some banks to make additional investment in systems and procedures to build-up their capacity;
- Fourthly, new capital and liquidity rules are conceptually and technically very demanding. This will require banks and supervisors to undergo extensive trainings to learn these new concepts and techniques;

- Fifthly, given the scarce availability of qualified human resources, banks and supervisors will face the challenge of attracting and retaining staff with appropriate skill sets;
- Sixthly, meeting the additional regulatory requirements relating to Basel III implementation will require banks to reassess their existing regulatory reporting and compliance structure to ensure its adequacy. This is important given the extended transitional timeline for implementation, during which some banks are required to participate in quantitative impact studies while others will have to prepare for full implementation within specified timeline. We also have to keep in mind that new rules are still evolving in certain areas based on the results of quantitative impact studies and thus may require further adjustments in the current regulatory requirements;
- Lastly, and the most important step to be taken by banks, is adopting the robust governance structure that best suits their business model and risk profile. The Board of Directors should have a clear understanding of their role in corporate governance and be able to exercise sound and objective judgment about the affairs of the bank. The senior management should ensure that the bank's activities are consistent with the business strategy, risk tolerance/appetite and policies approved by the board. This is the cornerstone on which any effective risk management framework, sound incentive structure and robust governance arrangements must be built.

In order to give you our perspective of implementing Basel III, I would point out that our Banking Control Law (BCL) already provides for a clear definition of capital and also provides for legal capital, liquidity and leverage ratios and limits on large exposures. The BCL also allows SAMA to introduce appropriate and relevant international standards such as those emanating from the Basel Committee or the Financial Stability Board. Over the years, SAMA has proactively introduced international standards and best practices in Saudi Arabia to ensure that the Saudi Banks are well managed, adequately capitalized and effectively governed. This is also reflected in the safety and soundness of individual banks and the resilience of the overall banking system.

In line with its stance, SAMA was among the first group of non Basel Countries at that time to introduce Basel I framework in 1992 and the Basel II in January 2008. While Basel I was crucial for the introduction of the concepts of risk sensitivity of banks' assets and tier-1 and tier 2 capital, Basel II introduced us to the concepts of internal risk rating systems and risk modeling. From SAMA perspective the greatest value in introducing Basel II was the significant progress that banks have made in four areas. Firstly, with the introduction of the Internal Capital Adequacy Assessment Plan(ICAAP), they have improved their capital planning process. ICAAP requires banks to align their business plans with their risk appetite and risk profiles in projecting their capital over the medium term. The second area of improvement is on other Pillar 2 risks including interest rate, liquidity, FX, strategic, technology and reputation. All banks have developed methodologies to identify, quantify, manage and allocate capital to such risks. These were risks for which no capital was required earlier. A third area is stress testing where Saudi banks have made good progress. This allows them to know their risk tolerance and resilience in times of stress. Finally, the introduction of Pillar 3 has strengthened the disclosure of Saudi banks to high international standards.

This brings me to an important natural question. What does Basel III mean for Saudi banking system? Well let me assure you that our preliminary analysis is that the transition to Basel III in the Basel agreed time frames should be smooth. Saudi banks already maintain a high level of core common equity capital. The average following the introduction of Basel III has been about 17%, of which around 85% is core common equity. Similarly Saudi Banks maintain a high level of liquidity which has averaged over 30% over the past two decades. SAMA already requires banks to keep conservation buffers above the minimum and has introduced stringent stress testing requirements. Banks are making good progress in all areas.

SAMA has already started the Basel III implementation process by publishing its plans, introducing relevant prudential returns and providing guidance to banks. As a part of implementation plans, SAMA has conducted quantitative impact studies on selected banks, started capacity building within SAMA as well as the banking industry, and formed technical groups comprising of supervisors and bankers to deliberate on technical issues and seek industry feedback to facilitate smooth implementation. Our multi-pronged strategy to implement Basel III is focused on the following areas:

i. Setting the regulatory requirements for banks essentially based on the Basel Committee's rules and international best practices on implementation of Basel III;

ii. Conducting impact studies and collecting data from banks to assess the impact of new capital and liquidity rules on Saudi banks;

iii. Providing guidance to banks on regulatory and technical issues to facilitate the implementation;

iv. Reviewing the plans of banks for implementation and holding bilateral and industry-wide meetings at various levels to track progress on implementation;

v. Arranging and/or coordinating training programs and other capacity building initiatives for supervisors as well as bankers to enhance their understanding of technical issues. We are also actively participating in various international meetings, conferences and forums to keep ourselves updated on international developments;

vi. Implementation of various other standards of BCBS and FSB, besides Basel III. These includes, inter alia, the FSB Principles and Standards on Compensation, BCBS Principles on Stress testing, plans to introduce rules for D-SIFIs, etc. In many areas, the new rules are equally applicable to the branches of foreign banks operating in Saudi Arabia;

vii. Review and updating of SAMA regulatory requirements in other related areas. SAMA's regulatory initiatives are aimed at protecting the interest of depositors and consumers of banks, besides ensuring the safety and soundness of banks.

In conclusion, I would say that in the aftermath of the global financial crisis, the financial landscape has changed substantially and still continues to change at a rapid pace. In order to cope with the challenges ahead, the supervisors and central banks are required to have better management of systemic risks through coordination and cooperation in global standards and policies. We believe that Basel III when fully implemented will contribute significantly in managing the systemic risks and strengthening of global financial system. However, this will require substantial investment in systems and human resources as well as strengthening of governance and risk management frameworks. But this does not mean that we should excessively rely on advanced risk methodologies and models, and undermine the role of sound professional judgment and common sense. In practice, the use of quantitative risk models have proved much more effective when coupled with judgment and institutive thinking. We have been emphasizing upon our banks the value of strengthening risk management frameworks and methodologies along with requiring their boards to institute a strong corporate governance culture to manage the banks effectively. We at SAMA are also actively monitoring the new developments both globally and in domestic markets, and are fully geared to ensure stability of our financial system.

I wish you a fruitful symposium!