

Basel II Deployments in Asia-Pacific: Who's Ahead?

Now that the final rules have been set, Basel II implementation is not too far down the road. But will the capital accord really have a global impact? **Dr. Dean Jovic** examines the progress Asian banks have made on their Basel II projects and discusses the challenges they will face along the path to compliance.

Published in June 2004 by the Basel Committee after nearly six years of work, the New Basel Capital Framework¹ (commonly referred to as Basel II) has been designed to enable financial institutions across the globe to more accurately determine their capital requirements and to simultaneously improve their risk management capabilities.

To its credit, the Basel Committee created the new accord only after lengthy deliberations that included extensive input from financial institutions, industry associations, consultants, technology vendors and other regulatory bodies worldwide. But will the new capital accord have a truly global impact? More specifically, how much progress has been made, to date, on Basel II rollouts in the Asia-Pacific region?

Various surveys² indicate that Australia's and Singapore's banking sectors are leading the Asia-Pacific region in terms of Basel II implementations. The thorough preparations of banks in these regions and the reasonable implementation timetables set by their national regulators (the Australian Prudential Regulatory Authority and the Monetary Authority of Singapore, respectively) are the main factors driving their advanced progress.

The banking systems in Australia and Singapore are generally viewed as being well developed and advanced, exhibiting sound pre-conditions for Basel II implementation. However, though Australia's four main banks³ are expected to comply with the advanced approaches (i.e., the internal ratings-based approach [IRB] for credit risk and the advanced measurement approach [AMA] for operational risk), a number of issues still must be resolved prior to the successful deployment of the capital accord.

Australia's relatively poor default and recovery data, for example, is one potential stumbling block standing in the way of Basel II deployment. This data is needed to calibrate the rating system that will generate reliable estimates for recent probability of default (PD), loss-given default (LGD) and exposure-at-default (EAD) at a given financial institution. So there is a fear that the low number of recently observed defaults in Australia is unrepresentative of the

true default nature of banks in this country; consequently, there is also a fear that such a data flaw could cause banks to produce minimum regulatory capital levels that are insufficient to cover full economic cycles.

The surveys also indicate that Hong Kong, Japan and South Korea are making reasonable headway while other countries — such as Thailand, Taiwan, Malaysia, the Philippines, Indonesia, India and China — are less advanced in their Basel II preparations. The countries that

are lagging a bit behind favor a more gradual and phased implementation of Basel II, which is comprised of three pillars (Pillar I, Pillar II and Pillar III).

According to one of the most recent surveys,⁴ the general level of Basel II preparedness in the Asia-Pacific region is widely diverse. The majority of banks surveyed (245 participants from 12 Asian countries) indicated that they are either in the early implementation stages



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of their overall Basel II compliance program or have not yet started the work at all. About one-fifth of those banks have not yet decided which of the Pillar I approaches will be used for credit and operational risk. Moreover, one-third of the institutions cannot yet estimate their overall Basel II implementation costs.

With respect to implementing Pillar II and III requirements, more than 80% of the banks surveyed have not started or are only at an early deployment stage. From a technology and data standpoint, meanwhile, almost two-thirds of institutions have not completed their planning for the IT infrastructure required for Basel II. However, on a positive note, more than 60% of banks set a high or very high priority on the development of an economic capital allocation and management framework.

The bottom line is that, apart from the most advanced countries such as Australia and Singapore, a vast amount

of Basel II implementation work still remains to be done.

Nevertheless, despite scarce skills and expertise or other obstacles, Asian banks should be able to live up to the challenge of implementing Basel II via raising the awareness of senior management, rigorously planning and executing project steps and getting help (where necessary) from outside IT vendors and consultancy companies.

Basel II Implementation: Key Success Factors in Asia-Pacific

Our own experiences — stemming from our involvement in many Basel II and risk management projects as well as from numerous conversations we’ve held with financial institutions and regulators in the Asia-Pacific region — indicate that there are a number of factors that jointly can explain the level of preparedness of financial institutions in a specific jurisdiction. We would divide these factors into three broad categories: institution specific, market driven and regulatory driven.

In terms of institution-specific factors, one of the most important characteristics is the size of an institution relative to the domestic market and the degree of involvement in international or cross-country business activities. Larger institutions tend to have a higher level of sophistication and expertise in the area of risk management practice, as well as more advanced information technology infrastructures.

In addition, if an institution is among the top three or five banks in a specific country, the probability is higher that the local regulator will expect the bank to act as a “role model” and achieve compliance with the more advanced approaches of Basel II.

Other institution-specific factors include the pre-Basel II risk management history of a firm — e.g., was the organization’s asset liability management (ALM) practice compliant with Basel’s 1997 and 2004 best practice papers on interest rate risk management? And has liquidity risk management been practiced in line with the respective BIS guidance paper?

From a market-driven perspective, intense international or domestic competition is likely to produce incentives for

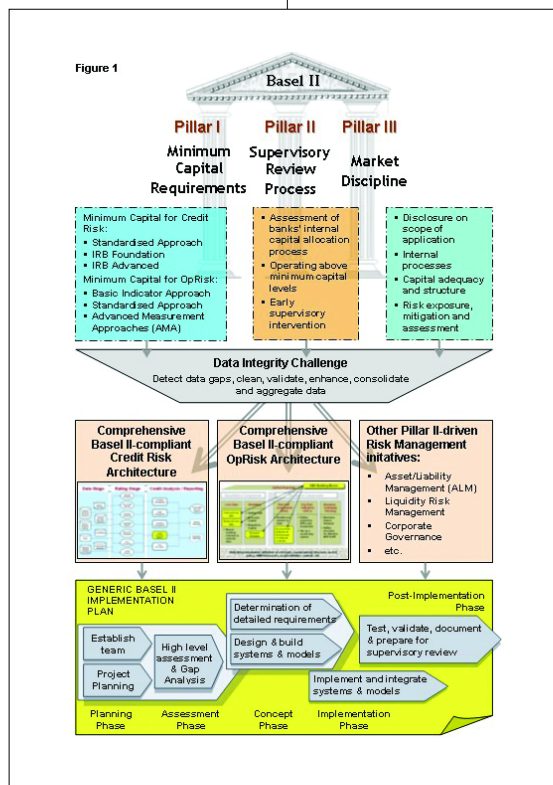
a more ambitious implementation of the risk management framework; competition will also usually have a positive effect on the sophistication of an institution’s Basel II implementation.

Last but not least, there is the “regulatory guidance” factor. The level of regulatory pressure is not really tied to the Basel Committee’s proposed deadline for the implementation of the capital accord. Rather, banks are rightly more concerned about the Basel II requirements of local regulatory bodies.

Examples of important Basel II “milestones” that could be driven by local authorities include the following: (1) the

national regulator has announced a time plan for Basel II implementation with an explicit deadline for compliance; (2) the national regulator has asked the country’s major institutions to comply with Basel’s more advanced approaches for credit and operational risk (e.g., Advanced IRB and AMA, respectively); and (3) the national regulator has requested the submission of an implementation plan from the country’s largest firms — or, alternatively, from all supervised institutions.

Needless to say, such actions by regulators will immediately raise awareness and a sense of urgency within financial institutions and will also lead to a higher commitment in terms of planning and performing the actual Basel II project work.



Global Challenges

Worldwide, banks are facing multi-dimensional challenges when implementing their Basel II projects. The first dimension calls for the strengthening of existing internal processes — especially credit risk and operational risk management — while simultaneously solving data integrity issues.

The second challenge is to achieve regulatory compliance by meeting the Basel II requirements for all three pillars of the accord: i.e., the capital calculation approaches (Pillar I); the supervisory review process that emphasizes features like validation, stress testing or economic capital (Pillar II); and the external disclosure of risk information (Pillar III).

Leveraging Basel II installation efforts — via building more sophisticated risk management analysis, deploying

advanced economic capital allocation models and adopting a risk-adjusted performance measurement framework — represents one final implementation challenge. If a bank makes use of all of Basel II's risk analysis tools, it can incorporate risk costs properly, rather than rely exclusively on the more traditional accounting-based profit and loss (P&L) view.

While the US has committed to a limited Basel II implementation — via including only the 20 largest institutions in the country and narrowing capital calculations methods to only the advanced approaches — Europe and Asia will rollout the Basel regulation to all supervised banks and securities firms without limitations of any kind. For most larger financial institutions, this means that they will be asked to comply with Basel's three Pillars by a specific deadline set by their national regulator.

As can be seen in figure 1 (pg. 32), stage one of most Basel II projects is an extensive data management review aimed at developing a clear understanding of what needs to be done in order to compile, verify and validate the complete set of data required, on a recurring basis, for capital calculation and risk measurement purposes.

A complete and comprehensive collection of high-quality data is a pre-condition for what follows in the second stage: the development of the analytics needed to assess and measure risk and to determine capital (be it regulatory capital or, more importantly, economic capital). The analysis tools a bank uses to evaluate operational loss data or key risk indicators in the operational risk management space are an example of the aforementioned analytics, as is the rating system used to estimate PD, EAD and LGD.

The third and final Basel II stage involves integrating these analytics components seamlessly into the bank's enterprisewide risk management framework. This requires

banks to deploy results in a way that adds value to the risk management decision-making process. Ideally, these results will be reflected in a bank's economic capital allocation and risk-adjusted performance measurement reports.

Ultimately, all of the Basel II phases will have an impact on senior management decisions about business activities or risk exposures, as well as on the returns that compensate an institution for bearing the risks inherent in its various business activities.

In the Asia-Pacific region and other parts of the globe, the coming years will be crucial, both in terms of achieving compliance with the Basel II regulation and in making the leap to a more sophisticated risk management environment that allows financial institutions to make consistently better and more informed decisions on risk-return opportunities.


The deadline for Basel II deployment is still a couple of years off, but it is approaching swiftly. The implementation timelines issued by national supervisors are more or less in line with the "official" end of 2006 implementation deadline⁵ issued by the Bank for International Settlements in June 2004.

Given quite diverse levels of Basel II preparedness across Asian countries, the most important goal in our view is not to look for the quickest possible way to reach an internationally comparable Basel II level. Instead, we feel it is crucial that each step ahead towards a more sophisticated risk management framework be made on a sustainable basis.

Every institution that has to comply with the accord must allow enough time and effort for each critical component — people, expertise, processes, organization, methods, IT systems, data — to be soundly built, improved, deployed, validated and supported on a continuing basis. In this sense, it is crucial to remember that Basel II compliance is not just a project but the first step in a continuing process. ■

FOOTNOTES:

1. Basel Committee on Banking Supervision. "International Convergence of Capital Measurement and Capital Standards: A Revised Framework," June 2004 (www.bis.org).
2. Surveys by Standard & Poor's (March 2005); statements from: Fitch Ratings in *Asia Risk* (April 2005) and *The Asian Banker: Annual Regional Risk Management Survey of Financial Institutions in Asia* (November 2004).
3. Australia-New Zealand Bank (ANZ), Commonwealth Bank of Australia (CBA), National Australia Bank (NAB) and Westpac account for approximately 70% of Australia's banking assets.
4. Ernst & Young, Asia-Pacific Basel II Survey, December 2004.
5. The Basel II implementation deadline varies quite significantly and depends on the national jurisdiction: While the US and Australia have committed to end of 2007, other jurisdictions have chosen either a more aggressive time plan (end of 2006) or postponed the implementation to 2008 or 2010 (e.g., some Asian countries like Malaysia).

 **DR. DEAN JOVIC** is SunGard's group managing director of risk management/Basel II, based in Zurich. Dr. Jovic is responsible for developing, implementing and promoting SunGard's strategic plans in the risk management space.