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BASEL II: THE PATH TO PROMOTING FINANCIAL STABILITY IN THE ASIAN AND PACIFIC REGION?[1]

A third consultative paper was issued by the Basel Committee in April 2003

Although the Basel Capital Accord of 1988 (the existing Accord, or Basel I) was a milestone in ensuring effective banking supervision, subsequent changes in the banking industry, financial markets, risk management and bank supervision, as well as financial crises such as that in South-East Asia and East Asia in 1997-1998, led the Basel Committee on Banking Supervision to issue a revised consultative paper (CP2) in January 2001 containing a set of proposals for replacing the existing Accord. Work on a new set of international standards for capital adequacy (the new Accord, or Basel II) has been continuing since then to consider the numerous comments received. On 29 April 2003, the third consultative paper (CP3) was released, on which comments were due by 31 July 2003.

Several countries from Asia and the Pacific participated in the quantitative impact study

The Committee also initiated a series of quantitative impact studies in April 2001 to gather the data necessary to gauge the impact of the proposals on capital requirements across a wide range of banks in a number of countries. The third such study (QIS3), focusing on the proposed minimum capital requirements under pillar I of Basel II, was launched in October 2002. The results of the study, in which over 350 banks from 43 countries participated, were released on 5 May 2003, and further supplementary information was made available later in the same month. In the Asian and Pacific region, the following countries participated in QIS3, which may give some indication of the countries that might implement the new Accord:

Subregion	***Country***
South-East Asia:	Indonesia Malaysia Philippines Singapore Thailand
East Asia:	China (including Hong Kong) Republic of Korea
South Asia:	India
Developed countries:	Australia Japan

[1] Prepared by Lene Andersen, former staff member of the Development Research and Policy Analysis Division, ESCAP.

However, in the aftermath of QIS3, China and India have formally rejected Basel II, stating that it does not take adequate account of the particular circumstances of banks in developing countries. Accordingly, China will exclusively implement the new rules regarding supervision and disclosure and India will exclusively implement the new Accord for major international banks, at least initially. In fact, during the latest hearing process, India urged the Basel Committee to define "internationally active banks".

The European Union sees the new Accord as a global standard

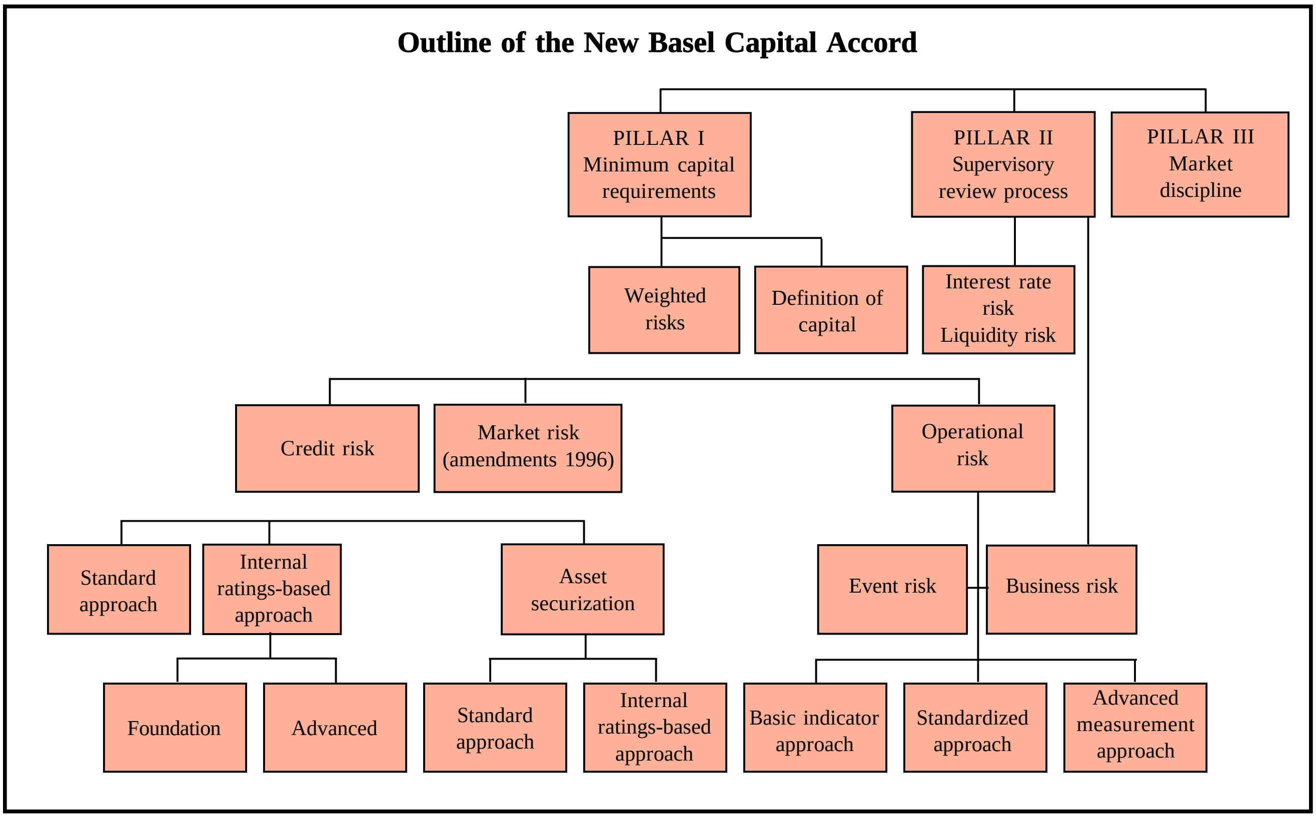
Reactions from the EU and the United States have been mixed. The European Commission has drafted a new Capital Adequacy Directive (CAD3), which is quite similar to the proposed new Accord, which European regulators perceive as the new global standard. However, American regulators made it clear at a congressional hearing in May 2003 that they only intended to apply the new rules to fewer than a dozen banks. However, together with the 10 banks that are expected to implement the new Accord voluntarily, the market share of implementing banks will be considerable. The thousands of other American banks would continue to use the existing Accord and not even the standardized method under Basel II, which is only slightly different.

The new Accord is to be implemented by 2006. The Basel Committee has realized that although regulators may wish to introduce the new Accord, some of the countries that have implemented Basel I have done so fairly recently and may need more time to implement the new framework. This is underscored by the fact that banks in the Asian and Pacific region have not yet entirely overcome the problem of non-performing loans or completed the restructuring needed in the aftermath of the financial crisis.

Background

The primary objective of the new Accord is to make it more risk-sensitive and thus strengthen banking systems even in periods of financial crisis. Consequently, the new proposal moves ahead of the "one-size-fits-all" approach and adopts a methodology for gauging capital adequacy ratios based on credit risk, while also incorporating charges for operational risk.[2] Proposals for a stringent supervisory review process and recommendations for increased levels of market discipline are also included. The three pillars of the new Accord are illustrated in the figure below:

[2] See, for example, Vimala Aldis and Fareeda Maroof Hla, "Implementation of the New Basel Capital Accord in the Asia-Pacific region: potential challenges and rewards", *Bulletin on Asia-Pacific Perspectives 2001/02* (United Nations publication, Sales No. E.02.II.F.2).



Concerns raised by CP2 have not been fully addressed in CP3

Whereas it is generally sound to link capital requirements to actual risks, two concerns have been raised in respect to the implementation of the new Accord. First, more cyclical lending could be a direct consequence of a more precise risk assessment and second, capital flows and international bank lending to developing countries might be constrained by the new Accord, particularly as project finance, which is often the type of lending used to finance development projects, will be subject to high capital requirements in the new Accord. However, as the distinction between borrowers that are members of OECD and other countries has been eliminated in the new Accord and credit risk is to be evaluated directly, this may lead to increased lending at lower cost to higher-rated sovereigns. Lending costs to developing and emerging market countries are nevertheless expected to rise under Basel II as regulatory capital for borrowers rated below B- will increase significantly. It is worth noting, however, that new techniques such as credit derivatives might be more widespread in the future, thus allowing banks to go into risky loans and sell off part of the risk.

Counteracting a new financial crisis …

One of the major credit risks for banks is concentration of exposures and the new Accord emphasizes portfolio diversification. Further, more attention is paid to maturity and fluctuations in real estate prices, mainly in response to the 1997-1998 financial crisis. As mentioned in the *Bulletin on Asia-Pacific Perspectives 2001/02*, a bias in favour of short-term loans is part of the existing Accord[3] and the consequences of this were illustrated

[3] Ibid., pp. 78-79.

during the financial crisis. In the new Accord, rules are added in an effort to counteract these risks. For example, under the standardized approach to measuring credit risk, supervisors are responsible for assigning credit assessments by eligible external credit assessment institutions to the risk weights available under this approach, and credit risk mitigation (collateral, guarantees and credit derivatives) is only fully recognized for capital purposes in cases where there is no maturity mismatch. Maturity is one of the characteristics that banks have to monitor in order to avoid excessive risk concentration. Under pillar II of the new Accord, it is explicitly mentioned that risk concentration is arguably the single most important cause of major problems in banks and it is thus a requirement that banks should have in place effective internal policies, systems and controls to identify, monitor and control it.[4]

The use of commercial property as collateral for risk mitigation is strictly regulated

In East and South-East Asia, the demand for commercial and residential space made real estate a robust growth sector in the boom years of the early to mid-1990s. However, the highly leveraged lending connected to that rapid growth led to a property price bust that contributed to the collapse of Thailand's economy in 1997, setting off the financial crisis in the region. The sharp decline in the value of real estate given as collateral against loans played a significant role in the subsequent weakening of banking systems. In the new Accord, it is proposed to counteract these risks in the following ways. First, although the Basel Committee holds the view that commercial property lending has been a recurring cause of troubled assets in the banking industry over the past few decades and that mortgages on commercial real estate justify a 100 per cent weighting of the loans secured, in the light of comments received on CP2 this rule may be relaxed under strictly defined conditions.[5] Supervision of credit risk concentrations under pillar II of the new Accord and of correlations between the credit quality of the counterparty and the value of the collateral is also to be enhanced.

The Basel Committee has chosen to provide incentives for lending to SMEs rather than relax risk management

A number of countries in Asia and the Pacific, including India, Malaysia, Thailand and the Republic of Korea, have reacted to CP2 and CP3: extracts from their comments are given in table 1. Real estate lending still constitutes a substantial portion of bank lending portfolios in the region and, further, many SMEs are dependent on using real estate as collateral to obtain funding. The Basel Committee has chosen to give incentives to lend to the retail

[4] In the view of some commentators, this issue should also be dealt with in pillar I. See, for example, IMF, "IMF staff comments on the April 2003 Consultative Paper (CP3) on the New Basel Capital Accord (Basel II)", available at <www.bis.org/bcbs/cp3comments.htm>. Furthermore, in the view of IMF, concentration of foreign currency exposures, especially in dollarized countries, has not been addressed in CP3.

[5] For well-developed and long-established markets, mortgages on commercial property can receive a 50 per cent risk weight for the tranche of the loan not exceeding the lower of 50 per cent of market value or 60 per cent of the mortgage lending value. See Basel Committee on Banking Supervision, Bank for International Settlements, *The New Basel Capital Accord*, "Part 2, The First Pillar – Minimum Capital Requirements", p. 12, available at <www.bis.org/bcbs/cp3part2.pdf>.

and SME segment rather than loosen up on portfolio risk management, which is perceived as a necessary precondition for the stability of the banking sector. In the new Accord, SMEs are to be treated as either retail or minor corporates. That means lower capital requirements under the internal ratings-based (IRB) approaches as well as under the standardized approach, where they attract a risk weighting of only 75 per cent. From a development perspective, this incentive for banks to lend to SMEs is commendable but the definition of SMEs as firms with annual sales below 50 million euros is more suited to developed economies and may work to reduce the risk sensitivity of Basel II.[6]

The improvements achieved as regards SME financing are, however, imperilled by the introduction of the so-called "granularity criterion". This criterion relates the exposure to each individual SME to the total size of the retail portfolio, setting a maximum of 0.2 per cent, thereby limiting the ability of smaller banks to obtain preferential treatment in respect of their SME lending, as their retail portfolios are simply not large enough. In the latest CAD3 from the European Commission in July 2003, the granularity criterion is omitted and Asian supervisors could choose the same approach.

Table 1. Extracts from comments made by countries in Asia and the Pacific on the second and third consultative papers on the New Basel Capital Accord

Comments on CP2		*CP3*	*Comments on CP3*	
A. Implementation date				
India Indonesia	Time constraint with respect to readiness of the FSAs[a]	Implementation by 2006	China India	Formally rejecting the new Accord. China will remain on Basel I for "at least a few years" after 2006
Republic of Korea	Implementation should be postponed from 2005 to 2006			
B. Pillar I: minimum capital requirements ***(a) Credit risk***				
China India	A simplified standardized approach, based on internal rating systems, for domestically oriented, relatively smaller banks should be included	Annex 9 to CP3: The simplified standardized approach. The approach should not be seen as another approach for determining regulatory capital; rather it collects in one place the simplest options for calculating risk-weighted assets (i.e. based on external risk assessments)	India	Restating the need for a simplified approach based on internal rating systems which might serve as an initial step towards complying with the IRB[b] approaches

[6] See, for example, Asian Bankers' Association, "Comments on the third consultative paper on the New Basel Capital Accord", p. 4; and China Banking Regulatory Commission, "Comments on the third consultative paper on the New Basel Capital Accord", p. 3, available at < www.bis.org/bcbs/cp3comments.htm > .

Table 1 *(continued)*

Comments on CP2		*CP3*	*Comments on CP3*	
India Japan Thailand	The 150 per cent risk weight for past-due loans (net of specific provisions and any eligible collateral or guarantees) leads to a pre-emption of scarce capital not reflected in the historical loan loss experience	The treatment of past-due loans under the standardized approach is amended; for example, a risk weight of 100 per cent applies when specific provisions are not less than 20 per cent of the outstanding amount of the loan	Malaysia	The preferential risk weight should be based on the size of provisions against the unsecured loan amount instead of against the entire outstanding amount of the loan
Indonesia Republic of Korea	Standardized approach biases incentive for borrowers to remain unrated Unrated claims carry a risk weight (100 per cent) lower than claims with a B- rating (150 per cent)	No change from CP2 to CP3; however, the “mapping process” will be at the discretion of the national supervisors	Malaysia	Biases incentive for institutions to encourage clients (borrowers) to remain unrated
India Malaysia	Higher funding costs for Governments due to risk weights based on sovereign ratings Today, foreign currency funds from locally incorporated foreign banks offer better rates than in the global market	As above	China India	More flexibility at national discretion to reflect conditions in non-G10 markets better
India Malaysia Republic of Korea Singapore Thailand	A lower than 40 per cent LGD[c] floor on real estate collateral under the IRB approach should be applied Non-financial collateral under the standardized approach should be recognized	35 per cent LGD floor on real estate collateral under the IRB approach in CP3; however, CP3 introduces an LGD floor of 10 per cent on retail mortgages. Under the standardized approach, no change in the rules on real estate collateral, except under strict conditions, but the risk weight on residential mortgages is reduced from 40 per cent in CP2 to 35 per cent in CP3	Thailand	50 per cent risk weight applied to claims secured by commercial real estate under the standardized approach to be reduced (to match the 35 per cent LGD under the IRB approach)
Singapore	Riskier assets might gravitate to institutions using the standardized approach (higher risk weights under IRB)	Portfolio diversification might counteract this problem		

Table 1 *(continued)*

	Comments on CP2	*CP3*		*Comments on CP3*
B. Pillar I: minimum capital requirements				
(b) Operational risk				
Indonesia	Various regulations with respect to operational, legal and reputational risks should be taken into account	Under pillar II, the supervisor should consider whether the capital requirement generated by the pillar I calculation gives a consistent picture of the individual bank's operational risk exposure		
Malaysia	Financial indicators, business line weights and structure should be calibrated against regional norms			
India Republic of Korea	New capital charge on operational risk is a burden	Changes with respect to the advanced measurement approaches: • Partial adoption • 20 per cent ceiling on insurance mitigation	Malaysia Thailand	Insurance mitigation should be allowed under the standardized approach as well
			India Malaysia Thailand	The alternative standardized approach is welcomed but adds to the capital charge and should be applied with more flexibility
C. Pillar II: supervisory review process				
China as for CP2 Thailand less		More guidance needed with respect to pillar II		Japan Comments Recommends
				conservative approach (for both pillars I and pillar II)
			Thailand	Comments as for CP2 Recommends further emphasis on supervisory transparency and accountability
D. Pillar III: market discipline				
Indonesia Japan Thailand	Too much information Full disclosure in imperfect markets may create market distortions		Japan Thailand	Comments as for CP2 Recommends that disclosure requirements be set at national discretion

Sources: <http://www.bis.org/bcbs/cacomments.htm> and <http://www.bis.org/bcbs/cp3comments.htm>.

[a] Financial supervisory authority.
[b] Internal ratings-based.
[c] Loss given default.

Quantitative impact study

In QIS3, the options for estimating credit risks were as set out in table 2. The parameters in the capital formula, which could either be estimated internally or given by the financial supervisory authority (FSA), are the probability of default (PD); loss given default (LGD); exposure at default (EAD); and maturity (M).

Table 2. Parameters for estimating credit risk under alternative approaches

Approach	*PD*	*LGD*	*EAD*	*M*	*Capital*
Standardized	FSA	FSA	FSA	FSA	FSA
IRB foundation	internal	FSA	FSA	FSA	FSA
IRB advanced	internal	internal	internal	internal	FSA

Source: Basel Committee on Banking Supervision, Bank for International Settlements, *The New Basel Capital Accord*, “Part 2, The First Pillar – Minimum Capital Requirements”, p. 12, available at <www.bis.org/bcbs/cp3part2.pdf>.

The number of banks that participated in QIS3 by region and approach used is given in table 3. Except for Japan, which is a member of the Basel Committee, all participating Asian and Pacific countries are included in the “others” category.

Table 3. Number of banks participating in QIS3 completing each approach, by region

Approach	*Basel Committee members*[a]	*EU*	*Others*	*Total*
Standardized	185	166	140	365
IRB foundation	109	89	28	159
IRB advanced	57	32	11	74

Source: Basel Committee on Banking Supervision, Bank for International Settlements, *Supplementary information on QIS3*, 27 May 2003, p. 2, available at <www.bis.org/bcbs/qis/qis3sup.pdf>.

[a] Nine EU members are also members of the Basel Committee.

Results from QIS3 suggest an increase in capital requirements primarily due to operational risk

Results for individual countries were not published owing to the confidentiality of the data. However, at the portfolio level, some conclusions on the impact of CP3 on capital requirements can be drawn. Each portfolio's contribution to the overall change in capital requirements is calculated as the percentage change in the capital required for that portfolio, comparing Basel II with Basel I, weighted by its significance as measured by the proportion of capital under the existing Accord accounted for by that portfolio. This gives a measure of the impact of the change in the capital requirements for any area of activity on the overall change in the capital requirements for the bank. The results for the average change in capital requirements for all banks are set out in table 4. It should be noted that there was considerable variation in individual bank results. For example, in the "others" group, which includes countries from Asia and the Pacific, the maximum increase in required capital for an individual bank was 103 per cent and the minimum change –17 per cent.[7]

Table 4. Contributions to the change in average capital requirements, standardized approach core portfolios

(Percentage)

Portfolio	*Basel Committee members*		*Others*
	Group 1	*Group 2*	*Groups 1 and 2*
Corporate	1	–1	0
Sovereign	0	0	1
Bank	2	0	2
Retail	–5	–10	–4
SMEs	–1	–2	–1
Securitized assets	1	0	0
Other portfolios	2	1	3
Overall credit risk	0	–11	2
Overall operational risk	10	15	11
Overall change	11	3	12

Source: Basel Committee on Banking Supervision, Bank for International Settlements, *Quantitative Impact Study 3 – Overview of Global Results*, 5 May 2003, p. 5, available at <www.bis.org/bcbs/qis/qis3results.pdf>.

Note: Group 1 banks are large, diversified and internationally active, with Tier 1 capital in excess of 3 billion euros. Group 2 banks are smaller and more specialized.

[7] Basel Committee on Banking Supervision, Bank for International Settlements, *Quantitative Impact Study 3 – Overview of Global Results*, 5 May 2003, p. 3, available at <www.bis.org/bcbs/qis/qis3results.pdf>.

The results indicate that, in general, the new Accord will increase the level of capital that is required for the banking institutions in the region, mainly owing to the new operational risk charge. The operational risk requirement has a proportionately higher effect on specialized institutions, including, for example, a few banks with large amounts of securitization or activities such as fund management, which are not covered in the existing Accord. The new operational risk charge adds a challenge to banks in estimating unexpected losses. However, on the positive side, it adds more transparency and hence, risk control, which is highly commendable. Further, more capital might increase the banks' external ratings, owing to the increased buffer against risks that are not new but have simply not been explicitly taken into account under the existing Accord.

Under credit risk, the figures are consistent with the intent of the new Accord to provide incentives to lend to SMEs. In general, the risk weights for the retail portfolio have been lowered significantly for all sub-portfolios (excluding past-due assets) relative to the existing Accord.

Major challenges ahead

Measuring risks will become more explicit in the new Accord

As discussed in the *Bulletin on Asia-Pacific Perspectives 2001/02*,[8] measuring credit, market, operational, interest rate, liquidity and other risks in compliance with the new Accord will not be an easy task for either bank managers or supervisory authorities, particularly in the Asian and Pacific region, where there is a lack of ratings agencies and the majority of individual claims remain unrated. Further, banks and supervisors will be required to invest considerable resources in upgrading technology, including adequate data access, technical capacity and human resources to meet the minimum standards in the new Accord.[9] In particular, data requirements under the IRB approaches are extensive; for example, three years' usage of classification models and five to seven years of default data are required. Among others, the China Banking Regulatory Commission has urged the Basel Committee, or other relevant international groupings, to take the lead in disseminating the technical know-how for designing a well-developed internal ratings system for banks in emerging markets and less developed economies.[10]

The greater flexibility of CP3 may lead to competitive distortions between jurisdictions

Whereas the current Accord focuses narrowly on setting minimum capital requirements, the new Accord includes a pillar II on the supervisory review process, which adds further room for manoeuvre at the discretion of the national supervisor. For Asia and elsewhere, this provides an option to develop supervisory institutions further. Whereas the greater flexibility introduced in CP3 has been welcomed by some commentators, others feel that

[8] Op. cit., pp. 79 and 83.

[9] See, for example, Reserve Bank of India, "Comments on the third consultative document of the New Basel Capital Accord", p. 1, and IMF, op. cit., p. 5.

[10] China Banking Regulatory Commission, op. cit., p. 2.

it has not gone far enough in permitting national discretion[11] and yet others hold the view that it will introduce competitive distortions among jurisdictions and should be subject to agreed criteria.[12] In this regard, regional cooperation would be an advantage, in order to ensure a level playing field and minimize distortions for banks operating in several markets. In Asia, most internationally oriented banks are located in Japan, Singapore and Hong Kong, China, whereas the banking systems in South Asia, for example, are more domestically oriented.

The new role of national supervisory authorities under pillar II will require considerable capacity-building

Pillar II leaves a considerable amount of room for manoeuvre at the discretion of national supervisors. Supervisors are entitled to increase required capital, in cases where it is found to be inadequate to cover the risks of the bank. Such an increase would have to be documented by the supervisors. The intention is to increase the authority of the supervisors as compared with Basel I and supervisors will be expected to evaluate the board and management of banks, to look into strategic decisions and to evaluate portfolio diversification as well as the ability to react to future risks and a rapidly changing environment, among other things. Further, default, stress tests and so on are not defined in a clear-cut manner in the new Accord, allowing for interpretation by supervisors. In particular, issues of transparency, corporate governance and efficient markets might pose additional challenges in pillar II enforcement in the region, as also reflected in the comments on the new Accord. The supervision of banks is not an exact science and therefore discretionary elements within the supervisory review process are inevitable. Supervisors must make sure to carry out their obligations in a highly transparent and accountable manner, which is part of the pillar II requirements.

In the aftermath of 11 September 2001, attention to money laundering and terrorist financing has increased. This poses an additional challenge to supervisors of banks. According to pillar II requirements, national supervisors have to monitor banks' management of the reputational, operational, legal and concentration risks, including the risks that can arise from a failure to conduct adequate due diligence. These challenges further underline the need for regional supervisory mechanisms.

Avoiding adverse incentives following the implementation of pillar III requirements

As pointed out by Indonesia during the hearing process, the pillar III disclosure requirements might create market distortions as a result of lack of public confidence in the financial system in markets that are imperfect, as is often the case in developing countries. Likewise, there might be an effect on private capital flows to developing countries owing to the transparency implied in the extensive use of ratings. It is hoped that the improved risk assessment, strengthened supervision and greater disclosure will improve confidence and stabilize capital flows to developing countries over time.

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[11] See, for example, Bank of Thailand, "Comments on the New Basel Capital Accord consultative document issued in April 2003 for comment by 31 July 2003", available at <www.bis.org/bcbs/cp3comments.htm>.

[12] Asian Bankers' Association, op. cit., p. 5; IMF, op. cit., p. 1; and World Bank, "World Bank staff comments on the Basel Committee's Consultative Paper 3 (CP3)", available at <www.bis.org/bcbs/cp3comments.htm>.

Conclusion

Regional cooperation among supervisory authorities is called for

Implementing the new Accord is not an easy task for either supervisory authorities or bank managers. The requirements of pillars II and III call for regional cooperation among supervisory authorities, in order to ensure a level playing field and minimize distortions for banks operating in several markets. For international banks, a "lead regulator" approach has been suggested, that is the "home regulator" coordinates and leads the supervisory process based on inputs from other supervisors. Harmonizing the capital adequacy legislative framework within, for example, ASEAN might also facilitate and strengthen the supervisory process.

In general, banks' required capital will decrease with respect to credit risks and increase with respect to operational risks. However, in Asia, several factors may raise the required capital even for credit risks, as real estate continues to be widely used as collateral for business loans, and the standardized approach, which is the most likely approach for many banks, places a 150 per cent risk weight on non-performing loans. By contrast, the 75 per cent risk weight on retail lending and lending to SMEs, as well as the 35 per cent risk weight on home mortgage loans, might lead to some reduction in capital requirements. However, it is important to stress that higher capital requirements might be desirable, to promote the safety and soundness of individual banks and the overall financial system. The increased capital requirements will safeguard the interests of depositors and reduce the probability of calling on public resources in the event of a crisis. Further, higher capital requirements can improve the external ratings of individual banks if the additional capital buffer is perceived as strengthening a bank's ability to manage risks.

The applicability of CP3 to developing countries and emerging markets has been questioned

China and India have formally rejected the implementation of the new Accord in 2006, but may implement the new rules at a later stage. China fully supports pillars II and III and stresses that banks should improve their risk management beyond the narrow compliance with a minimum capital requirement. However, the China Banking Regulatory Commission believes that Basel II would be only marginally more risk-sensitive than Basel I but would increase overall capital requirements for the entire banking system, while adversely affecting capital flows to less developed economies and disadvantaging banks in emerging markets.[13] India is also concerned about the complexity of Basel II and the difficulties and costs of implementation that would be faced by banks and supervisors in emerging markets.[14] The new Accord is intended to provide a global standard, and hence, criticism is bound to arise, not least owing to the differences in national banking traditions. In the Asian and Pacific region, a regional interpretation of the new Accord would be an advantage, to make proper use of the room for manoeuvre left within the new capital adequacy framework.

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[13] China Banking Regulatory Commission, op. cit., covering letter dated 31 July 2003.

[14] Reserve Bank of India, op. cit., pp. 13-14.