Implications of Basel II for emerging markets and China’s approach to Basel II

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2006 KDI Conference on

Adopting the new Basel Accord:
Impact and policy responses of Asian-Pacific Developing Countries

6 July 2006

Let me first thank Korea Development Institute for your kind invitation to this conference. It is my pleasure to share with you our thoughts on Basel II, a subject which is currently engaging the full attention of the international banking and supervisory community and will continue to do so in the years to come. In my remarks today, I will focus primarily on two issues: the implications of adoption of Basel II for emerging markets and China’s approach to Basel II.

Implications of adoption of Basel II for emerging markets

Capital adequacy regulation is the key for prudential regulation of the banking industry. In this context, the Basel Committee should be commended for taking up the challenge in revising the 1988 Basel Accord and developing the new framework, known as Basel II. Over the years, supervisors and banks around the world have increasingly recognized the significance of capital regulation and its impact on banks’ behavior. It is useful to recall that when Basel was first announced it was hardly greeted with universal acclaim (Kapstein, 2005). However, following the release of Basel II in 2004, more than 100 countries worldwide, including the 13 Basel Committee member countries have said they would implement Basel II between 2007 and 2009, according to a BIS survey (BIS 2004), which is being updated at the moment.

I do share the view that the principles and vision of supervision in Basel II are applicable to supervisors and banks in all markets. However, given the nature of Basel II, the intended adoption of Basel II by so many countries seems to be much faster than most people would have expected. Indeed, the Basel Committee openly acknowledges that moving toward Basel II adoption in the near future may not be the first priority for all non-G10 supervisory authorities in terms of what is needed to strengthen their supervision, although Basel II provides a range of options for credit risk and optional risk for banks and supervisors around the world to select. Furthermore, the views of the Executive Board of the International Monetary Fund clearly indicate that premature adoption of Basel II in countries with limited capacity could inappropriately divert resources away from more urgent priorities, ultimately weakening rather than strengthening supervision. Instead, they urge staff to be completely candid when asked to assess countries' readiness to move to Basel II and to indicate clearly the risks of moving too quickly and too ambitiously (IMF 2005).

So far, we have seen universal support for the Basel Committee's objective of developing a new capital framework, namely, to promote safety and soundness of the financial system, maintain at least the current level of capitalization of the system, and enhance competitive equality. However, it is important to note that Basel II is basically for internationally active banks in Basel Committee member countries. The supervisors in the United States are absolutely clear on the nature of Basel II. Senior US supervisors frequently say that despite the relatively crude method of assigning risk weights to assets, the 1988 Accord has served the US well but has become increasingly inadequate for large, internationally active banks that offer a broad range of complex and sophisticated products and services. As a result, the US has limited the requirement of Basel II to only a small number of banking institutions that fit the definition of large, complex and internationally active while the vast majority of US banks will continue operating in Basel I. Further, the US supervisory agencies has also proposed amending Basel I in order to mitigate potential competitive distortions that might be created by introducing Basel II (Bies 2006).

To be sure, the Basel Committee is definitely right in primarily focusing on developing capital standards for global and internationally active banks in Basel Committee member countries that make up the core of the international financial system. But the fact remains that Basel II falls short of a new minimum standard for all banks regardless of their country of origin or the extent of their business activities. Indeed, the Basel Committee has worked hard during the consultation process to seek comment from international organizations, regional groups and national supervisory authorities in order to enhance the global application of Basel II. However, it would be difficult to assert that comments received from non Basel Committee member countries have significantly altered the shape of the standards from their earlier drafts.

We may examine a number of typical changes made by the Basel Committee (Carstens, 2004). The first is the formal recognition of the need for flexibility in scheduling implementation of Basel II in non-Basel member countries. This could be seen as an interpretation of Basel Committee’s mandate that as a G10 group, the Basel Committee naturally has no jurisdiction over non-member countries, at least in light of its representation. The second example is the introduction of the simplified standard approach, which does not require the use of rating agencies or bank internal ratings. To my knowledge, no country has selected this option so far, which results naturally in higher capital charges and therefore offers little incentive for the adoption of a new capital framework at all. A third example is the elimination of the sovereign risk "floor." This change is, relatively speaking, significant for non-G10 countries. However, we know for sure that in emerging market countries, particularly those with sovereign ratings in the range of BBB- to A+ that are neither showing structural weaknesses nor have recently experienced a major crisis, very few corporates have higher ratings than their sovereigns.

Therefore, since Basel II is designed and calibrated accordingly to G10 countries, it should not come as a surprise that adoption of Basel II in many emerging markets will not be able to achieve the same set of objectives for Basel Committee member countries. Specifically, contrary to the case in Basel Committee member countries and other developed markets, adoption of Basel II in emerging markets will most likely raise the overall capital requirements in the banking system. In emerging markets, except those that have large retail portfolios with low default experience, banks adopting the standardized approach for credit risk will be subject to simple add-on of operational risk charges, raising the current 8 percent requirement to around 9 percent. Even if banks are sophisticated enough to adopt the Foundation internal ratings-based approach (IRB), it would be very difficult to expect any capital saving for credit risk as well. At present, among 108 countries rated by Standard and Poor's, three countries are rated BBB+, 6 BBB, four BBB-, and 44 below BBB. According to the IRB risk weights, BBB rated corporates with roughly 1% probability of default will be assigned 100% risk weight. Therefore, corporates in all the above 13 BBB rated countries will be subject to at least 100 risk weight and corporates in all the above 44 BBB below rated countries will be subject to higher than 100 risk weight. This finding has been confirmed by some of these countries in their initial impact studies that the adoption of Basel will inevitably raise the capital requirements for all banks across the board.

China's case is broadly the same, even though China is rated A- by Standard and Poor's. In the design of internal rating systems for local banks in China, international consultancy firms strongly believe that the sovereign risk floor does exist and it is very hard for a corporate borrower in most emerging markets, including China, to get a rating above BBB+. In their view, the lift one can reasonably expect based on the size of a company is rather limited (i.e. a mid-sized company with similar financials relative to a very large company with similar financials) in both developed and emerging markets. In an extreme case, this lift is only a few notches, assuming that financials and other conditions are the same. Their sample data also shows that no matter how good the financials look, there are always cases of default in emerging markets, which is translated into a cap of grades for middle market clients for which the sovereign floor is observed. As a result of considering both the sovereign floor and the lift of ratings attributed to size a cap is thus determined for the grades of the largest companies in China below the country ceiling for China.

At the same time, international consultancy firms also stress the danger of credit officers for inappropriate or less prudent upgrades in the application of an internal rating system. With particular reference to borrowers that may stand a realistic chance to get into the top grades, they design a set of rules, which are mapped to the foreign currency rating grades of external rating agencies. While they accept that this may not be the best approach, they value such a practical approach to containing excessive optimism by the users of rating outcomes, who do not necessarily have a good understanding of all the subtleties that the designers of the rating system would apply when rating top borrowers. Therefore very few Chinese large companies may have higher than BBB ratings. And possible quality borrowers above BBB are collapsed into only 3 grades in a master rating scale. Further, in light of the regulated interest rate floor plus the limited experience by local banks with subtle risk based pricing for top grades, international consultancy firms conclude that the difference in ratings of A or BBB would not have any material impact on a bank's business applications. In so doing, they knowingly accept a potentially inaccurate rating for this handful of relatively high quality borrowers and remain conservative for the rest of firms. As a result, it would be a big surprise if any bank in our market would have any capital savings under the present rules of foundation IRB unless it has a large low risk retail portfolio. Adoption of Basel in emerging markets could hardly achieve the broad objective of maintaining the aggregate level of capital requirements in the banking system and what kind of incentives can be expected from supervisors for banking adopting the more sophisticated approaches remains an open question.

China's intended approach to Basel II

Clearly, Basel II has wide-ranging impacts on banks and supervisors in both Basel Committee members and the rest of the world, including China. We, the banking supervisor, have closely followed Basel II developments and fully endorsed the core objective of Basel II to promote stability in the financial system by way of ensuring the safety and soundness of banks. Indeed, in February 2004 we capitalized on Basel II to fully revise the capital rules before the release of Basel II final documents. Our rules are based on Basel I, covering both credit risk and market risk, and incorporate at the same time elements of Pillar 2 and Pillar 3 of Basel II. For example, we defined the risk weights for claims on sovereigns with the help the assessments by external rating agencies, thus abandoning the most criticized the OECD club approach for assigning risk weights. We are pleased to see that while all banks are taking drastic measures towards full compliance of the current capital rules, some of them are working on the improvement of their IT system and data collection for borrowers and facilities in line with the IRB requirements under Basel II..

As inspired by the new framework, all large banks now have Basel II projects in progress, covering enhancement of a comprehensive risk framework across the institutions, and ongoing improvements in corporate governance. A common theme of these efforts is to build a two-dimensional rating system compatible with the IRB requirements under Basel II, with a special focus on quantitative measurement of risks. It is also encouraging to see that some small and medium-sized banks are also actively incorporating elements of Basel II in strengthening internal governance and risk management.

Nevertheless, Basel II implementation projects imply no less than a culture revolution for all large banks. Even our large banks are still miles away from the various requirements under the new framework. What is more, completeness and reliability of historical data is a big challenge for banks. Also, on the supervisory side, our resources are rather limited and would need to strike an appropriate balance between Basel II work and other supervisory priorities. Clearly, we are better to allocate more resources such issues as enhancing our infrastructure for risk-based supervision than a speedy Basel II implementation.

Overall, we plan to adopt a dual-track or a bifurcated approach to Basel II implementation. On one hand, we will require large banks, all with presence overseas, to adopt Basel II in 2010 or 2012. On the other hand, the rest of the local banks, including foreign banks' subsidiaries, will continue their business as usual under the current capital regulation. Of course, small and medium-sized banks, particularly foreign bank subsidiaries, have a choice to opt in if they choose to do so.

Our strategy for adopting Basel II is driven largely by considerations and developments in the following three areas. First, in the financial restructuring program begun in 1998, the government has spent around $300 billion dollars to re-capitalize state owned banks, which represent approximately 50 percent of market share. The objective of this restructuring program is for banks to adopt better corporate governance practices and to enhance risk management and internal controls. As Basel II has raised both supervisors' and markets' expectation for banks' risk management systems, we can consider their readiness for Basel II as a very practical framework to assess these banks' progress toward building a sound system for effective managing credit risk, market risk and operational risk. Indeed, if these large banks can demonstrate in the near future that their systems can meet Basel II standards, the objective of transforming the state-owned banks into commercial banking institutions with international competitiveness can be considered broadly achieved.

Second, as major financial markets are adopting Basel II, large banks with presence overseas are also under both market and official pressure to move toward Basel II for either compliance and/or competitive purposes. The current Basel Committee chairman once indicated that the pace at which market participants need to comply with international practices may differ - e.g. different requirements may be in place for local banks than for international banks - but large commercial banks will certainly have to adopt international standards. To ensure a level playing field this will also imply that at some point large Chinese financial intuitions will have to follow the same international rules and practices as European institutions,- including Basel II (Wellink 2005).

Third, as the intended adoption of Basel II has already triggered tremendous change in the way that large banks manage their business in our market, we feel assured that bank's progress going forward in adopting Basel II will be significant. However, given our supervisory capacities, we do face a big challenge to implement Basel II in exactly the same way as Basel Committee member countries, particularly with respect to Pillar II. In the final analysis, Basel II is more about improving risk management in banks rather than enhancing official oversight.

At present, we have mobilized a Basel II task force including supervisors and representatives from the industry. Our plan is to have the first draft proposals ready by the end of this year. As far as Pillar 1 is concerned, we intend to mandate the foundation IRB approach for credit risk, internal model approach for market risk and standardized approach for operational risk. We consider that advanced IRB may well be beyond the reach even for large banks in a few years time. Of course, going forward, we will issue further guidance on the requirements for advanced IRB approach, sending out a clear message to banks that the overall direction is to encourage them to become more and more sophisticated in credit risk management.

Operational is material in our market and has caused severe losses to our banks. Indeed, in May in this year, Bank of China disclosed in its prospectus for global offering that similar to other banks, Bank of China has been, from time to time, subject to fraud and misconduct committed by the employees, customers and other third parties. Some incidents have involved even top senior management. However, no matter how real and serious it can be, operational risk is hard to measure, particularly so for emerging markets. Pillar I treatment of operational risk is fully justified as it can help attract more management attention and mobilize more resources to operational risk management. The standardized approach has the potential to provide a well-defined framework to operational risk management while methodologies for quantitative measurement under advanced measurement approach (AMA) are evolving even in developed markets and would not seem to be a practically feasible approach for supervisory purposes in terms of integrity of the underlying methodologies for measuring operational risk, let alone comparability of capital treatment.

Of course, in order to ensure the integrity of internal methods, banks have to comply with a number of qualitative requirements. Correspondingly, supervisors should develop review procedures for ensuring banks' compliance with those qualitative requirements to make sure that banks' systems and controls are adequate. With respect to Pillar II application, we certainly expect all large banks to have an adequate assessment process that includes all the key elements of capital planning and management and generates an adequate amount of capital to provide a cushion to cover various risks. However, we are not in favor of a set of hard and fast rules that would translate the supervisory assessment process into an automatic capital add-on. Instead, we intend to look to other prudential measures that would require banks to improve their systems and controls. Additional capital charges may be considered only in exceptional cases, where all other supervisory measures appear to be insufficient to improve a banks' systems and controls. It is important to note that Basel II banks are already subject to higher capital requirements under Pillar I vis-à-vis non-Basel II banks in the banking system.

With respect to the home and host issue in the implementation of Basel II, we endorse high-level principles issued by the Basel Committee for enhancing home-host cooperation and coordination. Provided that an effective cross-border supervisory arrangement is in place, we would certainly try to allocate our supervisory resources efficiently, reducing the burden of redundant approval for foreign banks and facilitating their efforts to roll out Basel II globally.

Conclusion

Basel II is a comprehensive framework for capital regulation by aligning capital charge more closely to risk and offering banks strong incentives to improve risk measurement and management. As a major milestone for banking supervision, Basel II is the way forward for all supervisors globally going forward. But emerging markets are best advised not to rush for an artificial adoption of Basel II in light of their own market conditions. Emerging markets should capitalize on Basel II in jumping up the learning curve for better risk management. Indeed, in emerging economies including China, Basel II has already served as an important catalyst to accelerate the introduction of best risk management practices. Developing a better understanding of more quantitative analysis of risks for bank’s operation is essential for banks beyond the mere compliance of Basel II or whatever forms of other regulation. During the course of Basel II implementation, we should always keep in mind the final objective of prudential supervision, namely to help strengthen the safety and soundness of the banking sector by putting in place robust risk-based supervision and enhancing banks risk management system. Going forward, better risk management may well be the most essential element of success in banking.

Thank you.