Asian Shadow Financial Regulatory Committee Addresses Implementation Issues of Revised Capital Standards for Banks in Asia (Basel II)

January 17, 2005…The Asian Shadow Financial Regulatory Committee (ASFRC), releases a statement today which analyzes the implementation issues of the Basel II framework. The Committee also addresses supervisory discretion, institutional matters and makes policy recommendations.

ASIAN SHADOW FINANCIAL REGULATORY COMMITTEE

Statement No. 2

Hong Kong, January 17, 2005

IMPLEMENTING BASEL II IN ASIA

On June 26, 2004 the Basel Committee on Banking Supervision achieved consensus on the proposals for a new capital adequacy framework for banks to respond to deficiencies in the 1988 Capital Accord on credit risk. The proposed framework, commonly referred to as "The New Basel Capital Accord" or "Basel II", addresses new aspects of regulation and supervision of banks, structured around three "pillars". The first pillar deals with the minimum regulatory capital requirement and contains new rules for calculating more refined risk weights for different kinds of loans. Moreover, it suggests that capital should be held against so-called operational risk. The second pillar is the supervisory review process, which requires supervisors to ensure that each bank has sound internal processes in place to assess the adequacy of its capital based on a thorough evaluation of its risks. The third pillar aims to bolster market discipline through enhanced disclosure by banks. Although the new framework's focus is on internationally active banks, its underlying principles are intended to be suitable for application to banks of varying levels of complexity and sophistication, including banks in Asia.

Under the 2004 Basel II Accord, the Basel Committee tries to refine the risk weighting process, in particular with respect to loans to the private sector. The risk weights are to be refined by reference to a rating either provided by an external credit assessment institution ("standardized approach") or produced by a bank's internal ratings based (IRB) system. The IRB approach will only be allowed for banks having "sophisticated" risk management systems. It has two options, namely the "foundation approach" and the "advanced approach". In the foundation approach, banks estimate the probability of default (PD) associated with each borrower, and the supervisor will supply the other inputs, notably the loss-given-default (LGD) estimates. In the advanced approach, a bank with a sufficiently developed internal capital allocation process will be permitted to supply other inputs as well. Under both IRB approaches, the range of risk weights will be far more diverse than those in the standardized approach, resulting in greater risk sensitivity.

Basel II creates powerful incentives for banks to invest in an upgrading of their risk management since banks using the IRB approach are likely to have a lower regulatory capital requirement. This is viewed by the Asian Shadow Financial Regulatory Committee (ASFRC) as a very positive development. However, the ASFRC has serious concerns whether the institutional, regulatory and political structure in Asia is ready for effective implementation of Basel II. Our concerns are as follows:

1. Asian banking systems can be captured by political and business elites and can be severely compromised by related party transactions.
2. Regulators often lack the technical capability and/or institutional independence to regulate in a professional and objective manner.
3. Market discipline cannot be presumed to be effective for several reasons. Accounting information is often unreliable; banks are dominated by family groups or the state; there is a presumption of government-sponsored safety nets against bank failure; capital markets tend to be underdeveloped; shareholders tend to focus on short-term gains; and market analysts' assessments can be manipulated.
4. The current level of human resources and institutional infrastructure in many Asian countries may be inadequate to implement the Basel II targets or may render them meaningless or even counterproductive.

Based on the preceding analysis the ASFRC would like to make the following recommendations on the implementation of Basel II in Asia:

1. The fact that other regions in the world are moving forward in a determined manner to implement Basel II is a wake-up call for Asian countries to act rapidly to address the problems listed above. Otherwise, the forced march towards Basel II could have negative impact on economic growth in Asia for several important reasons.

   First, many Asian banks will not be ready, even with best efforts, to implement effectively any IRB approach in the medium term. Therefore, they will have to implement the standardized approach of Basel II. This may exacerbate the discrimination against small- and medium-sized enterprises (SMEs). The reason for this is that under the standardized approach the risk weights on SME lending tend to be higher, thereby increasing the cost of capital to banks and cost of borrowing by SMEs.

Second, regulators may act more conservatively and impose higher capital requirements to protect their reputation, and pillar 2 gives regulators heightened regulatory discretion that they may not exercise objectively.

Third, compliance with Basel II may divert the attention of supervisors away from more fundamental issues such as building a strong system of independent supervision and credible enforcement.

Fourth, the use of a risk-sensitive measure of capital adequacy under Basel II gives rise to pro-cyclicality. In good times, the perception of reduced risks will tend to lower regulatory capital requirements and feed the boom by allowing more loans. The opposite occurs in bad times. The difficulty of raising capital in a downturn plus the higher capital requirements due to perceived higher risks may lead to a "credit crunch" even for basically sound companies, thereby lengthening and deepening the downturn. Given the importance of bank lending in Asia, this pro-cyclicality problem is salient.

2. There should be greater transparency on the part of banks, particularly as regards related party transactions or lending concentration. Regulators also need to disclose validation standards and their personal interests. Asian economies should welcome international scrutiny and promote comparative studies of banking regulation.
3. Capacity building in risk management, particularly in emerging markets, is urgently needed and international institutions such as ADB, BIS, IMF, OECD and World Bank could contribute more to this effort.

Notwithstanding the concerns expressed in this statement, the ASFRC thinks that effective implementation of Basel II in Asia is feasible. However, this first requires a strengthening of the institutional and regulatory structure. Otherwise, immediate implementation of Basel II could generate unintended and undesirable consequences, possibly leading to a negative impact on economic growth in Asian economies. Naturally, the extent of needed changes will differ across economies.

ASFRC Website: http://www2.hawaii.edu/~fima
http://www.aei.org/research/shadow/about/projectID.15/default.asp