2003 August

ISSUES@

PACIFIC ECONOMIC COOPERATION COUNCIL

PECC INTERNATIONAL SECRETARIAT

4 Nassim Road Singapore 258372
Tel: 65-6737 9823 Fax: 65-6737 9824
Email: peccsec@pacific.net.sg
Home page: http://www.pecc.net

pecc

Risk Management in the Banking Sector of APEC Economies: Current Practices and Capacity-Building Challenges

ISSUES@PECC presents the current work of PECC's three Forums on Trade, Finance and Community Building and collaborative work with other groups. Complimentary copies are available upon request from the PECC International Secretariat. It is also available on line at http://www.pecc.net.

About this Issue

This **ISSUES@PECC** is the summary report of a survey done in 2003 by the PECC Finance Forum, in collaboration with the Asian Bankers' Association, on *the regulatory and business environment for risk management practices in the banking sectors of APEC economies*. The full report was presented and discussed at the 2nd Annual Conference of the PECC Finance Forum held in Hua Hin, Thailand, on July 8-9, 2003.

The PECC Finance Forum serves as an open forum for a tri-partite dialogue among the academia, government, and business sector, on the financial policy issues facing the Asia-Pacific region. The purpose of the dialogue is to assess the international environment for financial stability and development in the region, to assess progress in the promotion of financial reforms, integration and cooperation in the region, and to develop the desired vision of regional financial and monetary cooperation. For the purpose of these assessments, the Finance Forum undertakes survey-based task force studies on specific issues as well as convenes an annual conference of experts drawn from the member economies and the international financial institutions. For more information, visit www.pecc.net/finance.

The author of this report is:
Dr Julius Caesar Parrenas
Senior Advisor, Taiwan Institute of Economic Research and Chinatrust Commercial Bank, Chinese Taipei.

Editorial Committee:

Dr. Soogil Young
Coordinator, Finance Forum
Ms. Eunsuk Lee
Assistant Coordinator, Finance Forum

The Pacific Economic Cooperation Council (PECC) is a unique partnership of senior representatives of business, government and research from 25 Asia Pacific economies, who work on practical policy issues to enhance trade, investment and economic development in the region. It is the only non-government, independent Official Observer organization of APEC.
See:http://www.pecc.net

ISBN: 981-04-9516-1
Published by the PECC International Secretariat
Printed in Singapore by Printing Farm Pte Ltd

Report of a PECC Survey on Preparedness for Basel II

Introduction

Risk management in the banking sector is a key issue linked to financial system stability. Unsound risk management practices governing bank lending played a central role in recent episodes of financial turmoil, most notably during the Asian financial crisis of 1997-98. The current regulatory framework governing the standards of bank capital, the 1988 Basel Capital Accord, played a part in this crisis. Major flaws made it ineffective in promoting sound risk management practices, as it did not sufficiently discriminate between different levels of risk, and in certain areas encouraged excessive risky lending and investing.

Consequently, the Basel Committee on Banking Supervision has moved to revise the framework. A new capital accord (Basel II) is now being finalized to replace the current one. The introduction of Basel II is a significant measure that promises to promote sound risk management practices. It seeks to enhance the risk sensitivity of capital requirements, promote a comprehensive coverage of risks, offer a more flexible approach through a menu of options, and is intended to be applied to banks worldwide. It incorporates minimum capital requirements into a three-pillar structure that includes robust supervisory review and a greater role for market discipline through more meaningful disclosure.

Preparing for the scheduled implementation of Basel II at the end of 2006 is a challenge for banks and bank supervisors alike. Its adoption is seen to involve significant costs for many banks as well as major improvements in practices and operations. It is also expected to entail extensive preparation on the part of financial regulatory and supervisory authorities, significant legal and regulatory changes, and intensified international cooperation among relevant authorities.

Implementing Basel II

To meet this challenge, the following needs to be done:

- Each jurisdiction has to look into ***overarching policy considerations*** with respect to the implementation of Basel II. This requires an assessment of domestic priorities vis-à-vis the benefits of early implementation of the accord, focusing on the implementation of core principles, the legal and regulatory infrastructure, the role of market discipline, accounting standards, human resources and the soundness of corporate governance structures.
- Each jurisdiction should determine the ***scope of application*** of Basel II within its area. This involves an assessment of the current status and needs of the banking system, the identification of the range of approaches that banks could reasonably be expected to implement

(including the identification of significant banks taking into consideration size, complexity, international presence and systemic importance), and the determination of timing and way of implementation.

- Each jurisdiction should make an ***assessment of banks' capabilities*** (especially risk management capabilities of significant banks), ensure that the supervisors assist banks in this process, provide guidance on which models will be acceptable and on data collection specifications, and discuss validation of internal assessments with banks.
- Each jurisdiction should make an ***assessment of supervisory preparedness.*** Efforts should focus on how to translate the findings of the assessment of banks' capabilities into legislation and a new supervisory framework, how to develop national guidance and the timeframe involved, supervisory resource and training requirements with regard to internal resources and staffing, and infrastructure requirements (such as information technology and reporting).
- Finally, each jurisdiction should work on implementation, finalizing legislative action, make adjustments to domestic conditions if necessary, manage the parallel running of the old and new systems and ensure the continuation of international dialogue among supervisors.

Bank supervisors must implement the framework in a way that suits national circumstances while ensuring safety and soundness of the banking system and encouraging sound risk management. They should ensure that they are eventually in a position to offer their significant banks the possibility to move to more advanced methodologies, inasmuch as the vision behind Basel II is the continued improvement of banks' risk measurement and management over time.

Are the banks ready for Basel II?

To assist in the preparations on the part of banks and supervisory authorities, the PECC Finance Forum, in collaboration with the Asian Bankers' Association, has undertaken a survey of the regulatory and business environment for risk management practices in the banking sectors of APEC economies. The key results of the survey are as follows:

- The survey highlighted the broader array of credit and operational risks facing banks in emerging markets, especially in the less developed ones, compared to their counterparts in mature markets.
- Emerging market bank supervisors, and banks themselves, are aware of these risks, and this awareness is reflected in efforts toward sound practices on the part of bank supervisors and banks alike.
- All in all, however, emerging market banks still lag far behind mature market banks in maintaining robust risk management practices in most

areas, as well as in the use of sophisticated risk management systems.

- Basel II is seen by most banks in emerging markets as an opportunity to improve their risk management practices. More emerging market banks plan to adopt the more sophisticated approaches to measuring credit, market and operational risks than their respective supervisory authorities expect.
- Many of these banks, however, face serious resource constraints, most especially with respect to technology, data availability, and to a limited extent in the case of less developed emerging markets, staffing. There is also a need for improved cooperation between banks and regulators, as well as for addressing shortcomings in the policy and business environments that affect risk management practices.
- The survey report concludes with recommendations to focus capacity-building on technology, training, and data collection infrastructure, as well as on improving corporate governance, systems for resolving banking sector problems, accounting principles and rules, auditing practices and payment and clearing systems. It asks APEC to work toward strengthening capacity-building efforts for bank supervisors and banks in the region.
- Lastly, the report highlights the importance of the initiative being undertaken by PECC and ABAC to establish a *Public-Private Sector Advisory Group on Financial Sector Capacity-Building* to promote enhanced coordination and complementation of programs and promote greater private sector contribution to capacity-building within APEC.

In addition, the discussions of the Finance Forum on the results of the survey highlighted the following issues:

- Much remains to be done to improve the policy environment affecting risk management. Banks nevertheless acknowledge the significant reforms that have been undertaken in the region's emerging markets in recent years, especially in banking and capital market laws, as well as efforts by supervisors and private groups to improve corporate governance in banks.
- There remains a great deal of concern in emerging markets about the impact of Basel II on lending to SMEs, as well as the impact of the introduction of operational risk in the framework for calculating minimum capital requirements.
- There is a need to harness to a greater extent for capacity-building efforts the expertise available in the private sector, especially in the area of risk management.

Policy Recommendations

The presentations and discussions during this session give rise to the following policy recommendations for APEC:

1. To promote sound risk management practices as a solid foundation for financial stability in the region, APEC should take advantage of the introduction of Basel II by encouraging banks to move on to more advanced approaches to risk measurement and management, while developing bank supervisors' capabilities to effectively supervise banks using such advanced approaches.
2. APEC should ensure, and where necessary undertake, the delivery of capacity-building for bank supervisory authorities, focusing on technology, training and data collection infrastructure, while promoting access of banks in the region to high-quality training in risk management and encouraging enhanced cooperation between banks and bank supervisory authorities. APEC should also look at ways to build capacity in key areas of the policy and business environment affecting risk management practices in member economies, including corporate governance, systems for resolving problems in the banking sector, accounting principles and rules, auditing practices and payment and clearing systems.
3. To improve coordination and complementation among existing capacity-building programs in the areas outlined above, to effectively facilitate the introduction of new programs, especially in the area of risk management, and to strengthen public-private sector cooperation in these efforts, the APEC Finance Ministers should support and actively participate in the *Public-Private Sector Advisory Group on Financial Sector Capacity-Building*, an initiative jointly being promoted by ABAC and PECC, which will hold its inaugural meeting on September 5, 2003 in Phuket.

This report stems from the discussion at the 2nd Annual Conference of the PECC Finance Forum held in Hua Hin, Thailand, on July 8-9, 2003, of the following full report on the subject matter:

Parrenas, Julius Caesar, "The Regulatory and Business Environment for Risk Management Practices in the Banking Sectors of APEC Economies: Report of a Collaborative Survey Undertaken by the Pacific Economic Cooperation Council Finance Forum and the Asian Bankers' Association".

The full report is available on line at http://www.pecc.net/finance/forum2003.