

Impact of Basel II on the Philippine Banking Sector with Special Focus on Risk Management

*Mr. Nestor A. Espenilla, Jr.
Deputy Governor
Bangko Sentral ng Pilipinas*

*Asian Institute of Management
Quarterly Risk Management Forum
7 September 2005*



Bangko Sentral ng Pilipinas
Supervision and Examination Sector

Impact of Basel II on the Philippine Banking Sector with Special Focus on Risk Management

- A. What is BASEL 2 ?
- B. BSP's Implementation Plans
- C. Impact on Philippine Banking Sector



Bangko Sentral ng Pilipinas

Supervision and Examination Sector

International Convergence of Capital
Measurement and Capital Standards: A
Revised Framework
“Basel 2”



International Convergence of Capital Measurement and Capital Standards: A Revised Framework

“Basel 2”

- Document issued by the Basel Committee on Banking Supervision (BCBS) on 25 June 2004
- Revision of the 1988 Capital Accord and its amendments (“Basel 1”)
 - Minimum capital requirements based on credit risk and market risk
- Promotes adoption of stronger risk management practices by banks
- Framework based on three mutually reinforcing “pillars”

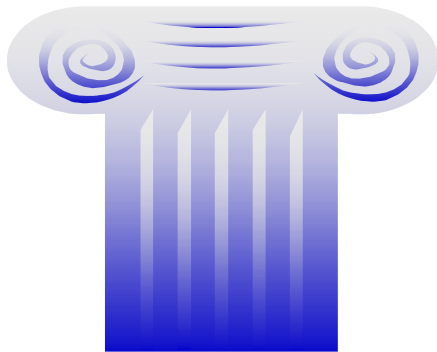


International Convergence of Capital Measurement and Capital Standards: A Revised Framework

“Basel 2”

THE THREE PILLARS

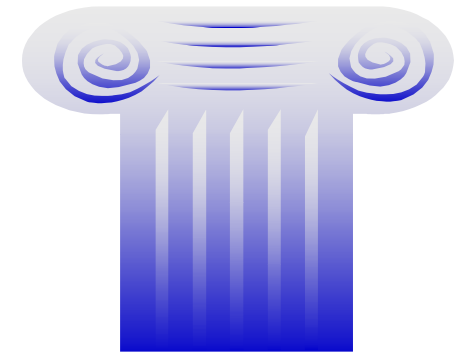
Minimum Capital Requirements (Pillar 1)



Supervisory Review Process (Pillar 2)



Market Discipline (Pillar 3)



International Convergence of Capital Measurement and Capital Standards: A Revised Framework

“Basel 2”

- Pillar 1: Minimum Capital Requirements
“Banks should have capital appropriate for their risk-taking activities.”
- Prescribes requirements for
 - Credit Risk (major change)
 - Market Risk (minor change)
 - Operational Risk (new provision)

that can be computed using different approaches depending on banks’ level of sophistication



International Convergence of Capital Measurement and Capital Standards: A Revised Framework

“Basel 2”

Menu of Approaches to Capital Charge Computation

SIMPLE  **COMPLEX**

Credit Risk	Standardized Approach		Internal Ratings-Based Approaches	
			Foundation IRB	Advanced IRB
Market Risk	Standardized Approach		Internal VaR Models	
Operational Risk	Basic Indicator Approach	Standardized Approach	Advanced Measurement Approaches	



International Convergence of Capital Measurement and Capital Standards: A Revised Framework

“Basel 2”

- Pillar 2: Supervisory Review Process

“Banks should be able to properly assess their capital adequacy in relation to the risk they are taking, and supervisors should be able to evaluate the soundness of these assessments.”

- Pillar 3: Market Discipline

“Banks should be disclosing pertinent information necessary to enable market mechanism to complement the supervisory oversight function.”



Basel 2

BSP's Implementation Plans



BSP's Implementation Plans

A Snapshot

2005	2006	2007	2008	2009	2010
Gradual phasing in of certain Basel 2 provisions (securitization SA, past dues, highest credit quality corporates)		Credit Risk - standardized approach Operational Risk - basic indicator or standardized approach			Credit Risk - FIRB and AIRB allowed Operational Risk - AMA allowed

Pillar 2 (Supervisory Review) - a continuing process

Pillar 3 (Market Discipline) - gradual implementation starting 2007



Basel 2
Impact on
Philippine Banking Sector



Impact on Philippine Banking Sector

- Improvement of Risk Management System
- Better Quantification and Assessment of Risk
- Stronger Corporate Governance
- Increasing Emphasis on Internal Capital Adequacy Assessment Process
- More Investment in IT infrastructure
- More Requirement for Specialized Skills
- A Shift in BSP's Supervisory Review Process
- A Greater Role of Market Discipline



Improvement on Risk Management Systems

- Regulatory capital more aligned with the bank's underlying risks.
- A trend toward convergence of regulatory capital and economic capital, particularly for advanced approaches.
- Closer linkage between capital adequacy and risk management system.



Better Quantification and Assessment of Risks

On Credit Risk

- As an initial step, Circular No. 439 dated 5 July 2004 requires banks to develop and implement an internal credit risk rating system for loan underwriting and ongoing review of credit exposures.

On Market Risk

- Circular No. 360 dated 3 December 2002 allows banks to use their own internal VaR models for calculating capital charge for market risks.



Better Quantification and Assessment of Risks

Operational Risk

- Banks are encouraged to comply with the Basel Committee on Banking Supervision's guidance on *Sound Practices for the Management and Supervision of Operational Risk* (February 2003).



Stronger Corporate Governance

- ✓ Changing Role at the Board Level
 - BSP is expressing its expectations from the board with regard to risk management with increasing clarity
 - Where previously the board might delegate management of the bank, including setting risk tolerances, BSP now calls for specific board accountability on risk policies and risk decisions
 - Regular flow and integrity of information is a must to give directors confidence in setting risk tolerances



Stronger Corporate Governance

- ✓ Mechanisms for control of risk at the board level
 - Policy statements act to give broad authority to management subject to clear boundaries and qualitative restrictions
 - Delegations of authority set up clear authority for decision making and clear accountability
 - Capital management policy sets out numerical limits to the degree of capital leverage
 - Specific limits on risk types set out maximum large exposures or other concentrations of credit risk or maximum levels of other risks
 - To be effective, these tools should be reviewed annually and the board should expect that the policies and delegations are being followed



Stronger Corporate Governance

- ✓ Setting of risk tolerances across all risk classes –
Economic Capital Model
- Need for a mechanism to assess the combined result of risks taken in credit, market, operational, and other risks
- Allows board to identify impact of all risks on earnings and capital under various scenarios



Stronger Corporate Governance

- ✓ Setting of risk tolerances across all risk classes – Capital Management
- Banks should choose to run at a level of capital which:
 - Matches their risk tolerance
 - Meets ratings agency and counterparty expectations
 - Meets regulator expectations
 - They can earn an acceptable return



Increasing Emphasis on Internal Capital Adequacy Assessment Process

- ✓ It is the prime responsibility of banks to ensure that it has adequate capital commensurate with its risk profile and control environment.
- ✓ It is expected that banks should have in place comprehensive capital adequacy assessment process (CAAP) that should identify and measure all material risks and relate capital to the level of risk in conformity with the institutions stated objectives.



More Investment in IT Infrastructure

- ✓ Information is power!
- ✓ Banks should not wait for a regulatory push before putting in place a system to accumulate pertinent portfolio information
- ✓ This should not be a compliance issue but a business decision



More Requirement for Specialized Skills

- ✓ Hiring of personnel with technical background and knows how to use data for risk management.
- ✓ Expanding need for non-Accountants such as Economists, Statisticians, and Finance-oriented personnel, for both the supervisor and the banks, should be foreseen.
- ✓ Training could not be overemphasized in enhancing human resource skill endowment.



A Shift in BSP's Supervisory Review Process

✓ Principles of Supervisory Review

- Supervisors should review and evaluate bank's internal capital adequacy assessments and strategies;
- Supervisors should expect banks to operate above minimum regulatory capital ratios and should have the ability to require banks to hold capital in excess of the minimum;
- Supervisors should seek to intervene at an early stage to prevent capital from falling below minimum levels required to support characteristics of a particular bank and should require rapid remedial action if capital is not maintained or restored.



A Shift in BSP's Supervisory Review Process

- ✓ Some of the groundwork BSP have done or are currently doing in Risk Based Supervision
 - The BSP has an on-going structured training program for bank examiners emphasizing the assessment of bank risks.
 - Charter amendments in order to strengthen its regulatory power is also being pushed through. This includes the authority to impose differentiated capital requirements for banks in the same category.
 - Reorganization of supervision to be able to hone specialists and generalists to cope up with the challenges of Basel 2.



A Greater Role of Market Discipline

- ✓ Market discipline entails the need to disclose specific information on the bank's annual reports

Including but not limited to:

- Capital structure and capital adequacy, **INCLUDING CAPITAL ADEQUACY RATIO**
- Risk exposures and assessments
- Additional disclosures for credit risk, market risk and operational risk, and interest rate risk in the banking book



A Greater Role of Market Discipline

- ✓ Pillar 3 recognizes that markets contain disciplinary mechanisms that can reinforce the efforts of supervisors by rewarding banks that manage risk effectively and penalizing those whose risk management is inept or imprudent.
- ✓ Pillar 3 is envisaged to result in well-founded counter-party risk assessments.
- ✓ It is also seen that Pillar 3 would support efforts to foster strong corporate governance within banks.



BSP Initiatives to Promote Market Discipline

- ✓ The BSP announced the adoption of the International Accounting Standards (IAS) and International Financial reporting Standards (IFRS) effective the annual reporting period beginning 1 January 2005 in its Memorandum to All Banks and Other BSP Supervised Financial Institutions dated 11 January 2005
- ✓ The adoption of the IAS/IFRS aims to promote fairness, accuracy and transparency in financial reporting.



BSP Initiatives to Promote Market Discipline

- ✓ The disclosure requirements under the new standards enhance the financial statement users' understanding of the financial reports. These may include disclosures on the risks and uncertainties affecting the entities, and resources and obligations not recognized on the balance sheet.



Implications of the Adoption of IAS/IFRS

Change in risk management strategies

- Strict hedge accounting requirements.

Fair value measurement

- Problem for instruments with no active market
- Entails a considerable amount of investment to develop own valuation methodology.

Systems change

- Adoption of the Standards necessitates systems change and extensive training of concerned employees.



Impact of Basel II on the Philippine Banking Sector with Special Focus on Risk Management

*Mr. Nestor A. Espenilla, Jr.
Deputy Governor
Bangko Sentral ng Pilipinas*

*Asian Institute of Management
Quarterly Risk Management Forum
7 September 2005*



Bangko Sentral ng Pilipinas
Supervision and Examination Sector