Basel II Implementation in Malaysia

26 May 2015
Outline

• Overview of BNM’s Approach towards Basel II Implementation
  – Relevance to overall Malaysian regulatory environment & future landscape
  – Understanding the implementation challenges in Malaysian context

• Preparing for Implementation in Malaysia

• Other Implementation Issues
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Current state of Basel II implementation

Credit Risk

• 45 banking institutions adopt Basel II Standardised Approach
• 10 banking institutions from six banking groups have been allowed to adopt the IRB approach for under Basel II capital regime
  – accounts for approximately 51% (RM1.18 trillion) of total assets in the banking system (RM2.33 trillion)

Operational Risk

• 51 banking institutions report operational risk using Basic Indicator Approach (BIA)
• “The Standardised Approach” (TSA) adoption
  – 3 commercial banks and 1 Islamic bank have been allowed
The need for Basel II

• Limitation of Basel I:
  – Lacking in risk sensitivity – one size fits all institutional approach (e.g) classification, 100% risk weight for all corporate
  – Broad-brush risk weighting structure (e.g sovereigns based on OECD and Non-OECD)
  – Overly simplified which enable banks to structure transactions to minimise regulatory capital

• Banks have become more complex and innovative
  – Change in risk appetite and risk profiles
  – A need for better risk management of such complex risks

• Enhance banking institutions (in our case, Malaysian banks) competitiveness in the global capital market
  – Effects on credit rating which influence cost of borrowing and cost of capital
Basel Committee
on Banking Supervision

International Convergence
of Capital Measurement
and Capital Standards
A Revised Framework
Comprehensive Version

This document is a compilation of the June 2004 Basel II Framework, the November 2004 Consultative Document to the June 2004 Framework, the April 2005 Consultative Document on Basel II: Amendment to the Framework, and the 2005 paper on the Application of Basel II to Trading Activities and the Treatment of Doubtful Debt Exposures. No new risk-measurement models have been introduced in this booklet.

June 2005

ISLAMIC FINANCIAL SERVICES BOARD

CAPITAL ADEQUACY STANDARD FOR INSTITUTIONS
(OTHER THAN INSURANCE INSTITUTIONS) OFFERING
ONLY ISLAMIC FINANCIAL SERVICES

December 2005

BANK FOR INTERNATIONAL SETTLEMENTS

BANK NEGARA MALAYSIA
CENTRAL BANK OF MALAYSIA
Malaysia’s parallel dual banking system creates additional complexity to implementation of new capital framework.

- Conventional banks
- Islamic banks
  - Conventional banks
  - Islamic subsidiaries
    - Leveraging on operating infrastructure of conventional banks

- Conventional banking system
- Islamic banking system

- Need to minimize any potential regulatory arbitrage
Adoption of Basel II is aligned with regulatory environment envisaged under Malaysia’s Financial Sector Master Plan (FSMP)

- Basel II advocates enhanced risk management practices across industry
  - Better identification & measurement of credit & operational risk
  - Leads to better pricing for risk undertaken & more efficient use of capital resources

- Aligned with objectives of FSMP, a 10-year plan introduced in 2001, which aims to develop a strong, resilient & dynamic banking system able to compete regionally

- Facilitates preparation of domestic players towards Phase 3 of FSMP (2008 – 2010) which aims to:
  - Assimilate local banks into global arena
  - Introduce greater foreign competition

- Improved transparency standards under Basel II instills market confidence
Basel II Implementation approach in Malaysia based on 4 high level principles

Accommodate capacity building efforts as per FSMP, while gradually enhancing risk management framework for banking institutions

Flexible timeframe that allows capacity building measures to be implemented

Emphasis on strong business justification instead of regulatory mandate for the adoption of IRB approach

Enhanced supervisory methodology to assess advanced internal risk management systems

Principles translated into a two-phased implementation approach

Banks to implement Standardised Approach for Credit Risk (SA) as well as Basic Indicator Approach (BIA), Standardised Approach (TSA) and Alternative Standardised Approach (ASA) for Operational Risk

Earliest date for banks to implement IRB approach for Credit Risk

2008

2010
Dual banking system:
Malaysia’s parallel dual banking system creates additional complexity to implementation of new capital framework

- Need to minimize any potential regulatory arbitrage
Dual Banking System:
Capital adequacy framework for full-fledged Islamic banks has been established consistent with IFSB CAS

- Subjected to BNM CAS, which has been developed based on IFSB CAS with enhancement mainly on application of Islamic contracts.
- Enhancement clarifies the credit risk capital charges at various stages for different types of Islamic contract.
- Enhancement also clarifies the treatment for Mudharabah funding that has risk absorbent element.
Dual Banking System:
Islamic banking window to adopt ‘enhanced Basel II’ approach

Basel II (SA/IRB Approach)

- Implementation in Islamic window would be practically challenging to BNM and the banks due to the need to comply with requirements under two standards in one bank
- Inappropriate without adjustments
  - Possibility of under-statement of capital requirement, as certain risks are not addressed in Basel II Pillar 1

Enhanced Basel II (Consistent with CAS)

- Basel II Pillar 1 enhanced by taking into account additional features of CAS specific to Islamic banking
- Implementation would be less complicated given similar foundation
- Less confusion & more consistency in implementation and compliance with one standard
Operational risk:
Advanced Measurement Approaches (AMA) would be made available at a later stage

The considerations ...

Methodology & approach
• AMA approach was unstable as there were still unresolved issues even at international level e.g. UL & EL calculation, Insurance as risk mitigation, data scarcity, statistical challenges etc

Industry readiness
• Malaysia banking industry lacked internal loss data
  – Data collection was at infancy stage and some data not collected in accordance to Basel requirement,
• Concerns that the industry may adopt AMA by buying off the shelf solution without really understanding the nature of operational risk

Internal considerations
• BNM has yet to develop the right competencies and capabilities to validate and understand the specificity and intricacy of AMA, given the still evolving nature of AMA
• Credit risk should remain the priority for banks thus focus should be on building up their capabilities for the IRB approach before moving towards AMA
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Crafting the Policy Governance Structure of Basel II Project in BNM

Approving authority for policy design and issuance

Management Committee

Basel II Steering Committee

Prudential Financial Policy Department

Credit Risk (9)  Market Risk (9)  Operational Risk (4)

Reviews of technical features and potential impact
- Consistency of parameters and approach
- Implementation challenges

Develop and review policy recommendations to be submitted for management approval

Projects subgroup with participation from the Supervision Departments staff on full time basis.
- Undertake research, develop technical proposals and strategy options for consideration of Department
Early efforts established foundation for implementation

Deliberation on critical issues which will have implications on implementation plan of Basel II in Malaysia

Undertaking detailed analysis on capability gap of banks & potential impact of Basel II on relevant stakeholders

Assessing the appropriateness of Basel II parameters in local environment (How should Islamic banking be aligned with Basel II)

Bilateral dialogue with individual banks on implementation plans

Crafting of strategies/guidance based on deliberation of issues
Conditional approval granted for banks intending to migrate directly to IRB approach
  - Allows institutions to remain on current framework until IRB implementation
  - Avoid additional costs attached to adopting Standardised approach as interim measure
  - More lenient timeline for implementation of Pillar 2 & Pillar 3
    - Allows institutions to focus on Pillar 1 issues

Identification of areas in framework which:
  - Will have significant impact on banks' capital levels
  - Banks may encounter difficulties in meeting operational requirements for purposes of capital relief

How can Basel II be used to incentivise banks to enhance risk management practices and move towards adopting the more sophisticated approaches in Basel II?
Beyond compliance

- BNM needs to ensure that Basel II is a means to improving risk management and not just for banks to enjoy capital savings

BNM capabilities

- To support industry implementation, BNM’s internal capabilities also need to be enhanced
  - Developing new capabilities in manpower & skills
  - Risk-based supervisory processes and systems

Industry readiness

- Most banks are starting from a relatively low level of preparation
- Full IRB/AMA programs take at least 3 years for development and longer for the bank to fully embed them (ie to fulfill the ‘use test’ requirement
Regulators need to analyse potential effect on these stakeholders & deliberate on possible measures to mitigate any adverse implications, where necessary.

Development of Rating Industry
Penetration of domestic ratings currently low
Stringent ECAI recognition criteria could hinder industry development

SMEs
Would Basel II have an adverse impact on SME lending?
Assessment has to be conducted as SMEs critical component of economy

Other Regulators and Standard Setters
Ie Securities Commission, Deposit Insurance Corporation and Accounting Standards Board

To minimise opportunities for regulatory arbitrage and align expectations to ensure consistency and minimise regulatory burden
Several Basel II parameters have been validated to avoid significant misalignment for local implementation.

- Haircuts provided in Basel II document based on historical analysis of data from G-10 countries.
- Replication of analysis conducted on local data using similar approach / assumptions.
- Mapping conducted on external ratings of corporates in Malaysia based on ratings extended by RAM & MARC.
- Comparison made to cumulative default rates specified under Basel II which were based on S&P & Moody’s experience.
Impact of customising Basel II has to be equally understood

• Feedback was sought both internally and externally
  – Concept Papers, impact studies, focus groups and bilateral meetings

• Greater interaction between policy developers and supervisors
  – Understand implementation challenges facing banking institutions
  – Understand practices of banking institution
  – Minimises the need to make further changes following implementation
  – Gauge ability of banking institutions to meet requirements

• Active engagement with banking institutions
  – Ensures understanding of Basel II in Malaysian context vs. BCBS
  – Gauge ability of banking institutions to meet requirements
  – Allows the Bank to explain issues and expectations
Adoption of the IRB approach

• Indication by banks to adopt IRB has already been communicated to BNM since 2004
  – Periodic discussions (minimum 6 months basis) have been on-going to update BNM on plans and related implementation efforts
  – This facilitated formal application which was only done in 1st half of 2007 and subsequent assessment

• BNM has effectively approved 9 institutions (inclusive of 4 locally incorporated foreign banks (LIFBs)) to directly migrate to IRB in 2010

• Continuous monitoring the progress of these institutions
  – Periodic update required on a quarterly basis

• For LIFBs, actively engaging with home supervisors
  – Have already been involved in joint validation exercises with the MAS and the FSA
  – Seek to achieve common understanding on supervisory expectations and information requirements
Adoption of IRB Approaches:
Two phased approach implementation approach adopted

2008
Banks to implement Standardized Approach for Credit Risk (SA) as well as BIA, TSA or ASA for Operational Risk

2010
Earliest date for banks to implement IRB approach for Credit Risk

Direct migration to IRB allowed

- For banks which aspire to expand regionally/internationally, more sophisticated approach would be desired
- Allowed because
  - Implementation requires significant investments
  - IRB implementation is a lengthy process
    - 12 months for data collection and model building, followed by another 12 months to test and another 12 months to develop Basel II compliant credit rating models
    - Ensure banks do not have to undertake unnecessary investments for SA
- Subject to:
  - Comprehensive plans which are achievable
  - Capabilities are already up to certain sophistication
  - Disciplined implementation and follow-through
Adoption of IRB Approaches:
Realistic implementation plan the core criterion for approval for direct migration to IRB

Implementation Plan Review

Assessment Criteria

1. Support & Sustainability of Implementation/Governance
   - BOD support
   - PMO structure
   - Resources
   - Completeness
   - Credibility
   - Track record

2. Substantive Milestone Achievement and Discipline in Implementation
   - People
   - CRM processes
   - Systems

3. Risk Management Capabilities to Support IRB Approach

(± 3 years to build new system)

By 31 March 2007
Substantial % of RWA should be covered by IRB systems

By 1 January 2010
Material coverage of total RWA
Adoption of IRB Approaches:
Approval Process for Direct Migration – BNM internal resource arrangements

- Information Submitted
- Implementation Plan
- Gap analysis/Self assessment
- Specific info on IRB systems

Assessment Criteria

Pros: Input from RM sought at 1st level assessment. Overall Assessment becomes notional sum.

1. Governance
   - Implementation Plan

2. Discipline
   - Min. Coverage

3. Risk mgmt Capabilities
   - Qualitative
   - Quantitative

Assessment by line supervisors

Overall Assessment by line supervisor
Consultation with CRSU & PFP

Assessment by specialists

Approval by Senior Management

Letter to BI from respective Sup Depts

Mirrors future process for full approval, which focuses on (3)
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• Enhancing the existing supervisory framework
  • Implementation of Supervisory Risk Based Framework (SuRF)
  • Establishment of ‘Relationship Manager’ concept
  • Aligned to enable Pillar 2 review which provides flexibility to supervisors to impose capital add-ons or differentiated capital requirements
  • Entails development of a more comprehensive off-site surveillance mechanism
  • Greater enforcement responsibilities via prompt corrective action framework

Proper framework & infrastructure must be installed

• Inadequacies in current reporting framework & internal IT system
  • Surveillance mechanism need to cater for expanded scope/greater amount of data
  • Need support system for enhanced off-site analysis
  • Need enhanced knowledge management infrastructure to facilitate sharing of information
Pillar 2 and SuRF – Important to be clear on the interlinkages

**Internal Capital Adequacy Assessment Process (ICAAP)**

- Assess all risks; identify material ones; identify controls to mitigate the risks
- Identify amount and quality of internal capital in relation to risk profile, strategies and business plan
- Produce ICAAP number and assessment

**Supervisory Review Process (Process)**

- Supervisory risk assessment: Identify, review and evaluate all risk factors and control factors
- ICAAP review: Assess, review and evaluate the ICAAP
- Overall assessment and conclusions

**Capital requirements**

- Pillar 1 minimum regulatory capital
- Capital allocated for Pillar 2
- Punitive capital requirement

**SuRF**

- Supervisory evaluation of ongoing compliance with minimum standards and requirements

- ICAAP process/results fully satisfactory
- ICAAP process/results not fully satisfactory

- Whole range of available prudential measures including punitive capital requirements
• Greater reliance placed on institution’s internal oversight functions to identify emerging risks and safeguard an institution’s financial conditions

• To support such reliance, BNM regularly engages the Board and senior management and key staff on issues surrounding the bank

• Greater reliance is placed on the work of external auditors appointed by the banks

• BNM also have regular engagements with these external auditors to enhance awareness and clarity of BNM’s expectations of their roles and the degree of reliance placed on them
Basel II requires continuous development of supervisory skills

- Currently, supervisors in emerging markets have relatively limited skills in model reviews (in particular for credit & operational risk modelling)
- Relationship examiners must fully understand Pillar 1 risks & be trained in assessing other risks under Pillar 2
- More in-depth analysis required given greater access to information under Basel II

- Need for on-going re-skilling exercise as well as targeted recruitment exercise
- Creation of specialised unit to facilitate model review for approval & for subsequent validation
Need for greater coordination of home-host efforts

• Leveraging on participation in regional forum & home-host relationships
  – EMEAP Interest Group on ECAI recognition
  – College of supervisors

• Deliberation and to seek agreement on key issues such as:
  – Operations deemed material/ significant
  – Mutual recognition of authorised ECAI
  – Mutual recognition of approved models/ approaches
  – Conduct of joint validation & approval exercise
  – Mechanism for information sharing & maintaining confidentiality
Further development of internal infrastructure

• Leveraging on the credit bureau infrastructure to facilitate Basel II-related developmental initiatives
  – Exploring possibility of industry-wide data pooling initiative on LGD, benchmark PDs, operational risk loss data

• Reporting infrastructure has to support greater amount of information available from banks under Basel II
  – Structure for reporting has to accommodate needs under revised supervisory framework
  – Periodic submissions to be supplemented by internal management reports for continuous off-site risk assessment
  – Thick documentation on model development
- end of presentation -