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BASEL II - THE NEW ACCORD IN LIGHT OF REGIONAL OPPORTUNITIES POLITICS, AND CHALLENGES

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Outline

- Basel II Goals and Concepts
- Implications of Basel II for the Region
- SWOT Assessment for Gulf banks
- A Road Map for Success for the Region
- Basel II - Value Creation?
- Going beyond Basel II

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Basel II Goals and Focus

- Increase risk sensitivity of regulatory capital requirements
- Align regulatory requirements with management practice
- Maintain financial system safety and soundness
- Help create level playing fields across banks and jurisdictions

Focus – Internationally Active Banks

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Basic Concept

- Spectrum approach to Risk Management beginning from the Standardized Approach to Foundation IRB to Advanced IRB
- Banks are incentivized to invest, and upgrade, to more elaborate approaches to risk management through the potential reduction of regulatory capital requirement, and the resulting improvement in yield to shareholders
- The other major incentive is the ability to incrementally influence the capital allocation process, along with improvements in risk management processes, that are validated by the regulator

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Regional Implications and Challenges

- Some regulators in the region are in the process of deciding on the degree of implementation in their respective markets, given Accord objectives/focus, international developments, and national interests
- Some may opt for partial or phased implementation
- Vital requirement for regulators and banks to coordinate implementation strategies in the above context
- Some research on Basel II impact on emerging markets concludes that the cost of lending into these markets is likely to go up
- This is a possible outcome in our region unless significant ratings upgrades take place over a 3 years horizon
- This is likely to affect the cost of hard currency funding generally

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Regional Implications and Challenges

- Default and Loss data paucity in qualitative and quantitative terms is a competitive disadvantage
- Lack of regional ratings agencies
- Embryonic internal ratings systems
- Non-standardized Default and Loss definitions
- Short migration and default track records
- Lack of resources at some regulators and banks to prepare for implementation of Internal Ratings Based (IRB) Approach
- Lack of clarity on implementation of National Discretion Parameters
- No assessment mechanism for potential degree of procyclical effects on regional economies of Accord implementation

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Capital Charge/Risk Weight Curve-CP3 Corp

Rating	RW- Std.	Capital- Std.	RW- IRB(F)	Capital-IRB(F)
AAA	20%	1.6%	15%	1.2%
AA	20%	1.6%	20%	1.6%
A	50%	4%	30%	2.4%
BBB	100%	8%	40%	3.2%
BB	100%	8%	86%	6.8%
B	150%	12%	154%	12%
CCC	150%	12%	303%	24%

Source : www.bis.org

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Quantitative Impact Study-3-Post CP3-Group 1 Banks

Portfolio/Risk	Standardized	IRB-Foundation	IRB-Advanced
Corporate	1%	(9)%	(14)%
Sovereign	19%	47%	28%
Bank	43%	45%	16%
Retail	(25)%	(45)%	(49)%
SME	(4)%	(15)%	(13)%
Overall Credit	0%	(7)%	(13)%
Overall Ops	10%	10%	11%

Source : www.bis.org

SWOT Assessment for Gulf Banks

Strengths

- High equity bases , in general
- Low average funding costs due to high proportion of low cost customer deposits, relative to other deposits and liabilities
- Low tax environments
- Strong margins and profitability
- High liquidity
- Good asset quality profiles
- Strong regulatory risk asset ratios, under the current Accord
- Regulatory Risk Asset Ratios only marginally impacted under the Standardized Approach of the New Accord

SWOT Assessment for Gulf Banks
Weaknesses

- Economic capital allocation models are still at an embryonic level at most Gulf banks
- Risk Adjusted Return on Capital (RAROC) for business lines is only just beginning
- MIS for product profitability, and business line profitability, has advanced but requires further refinement at many banks
- Default data, and Loss Given Default data are not yet at a statistically significant level in each rating grade (of an 8+ rating system) at most, if not all, Gulf banks
- Determination and apportionment of Credit Risk, Market Risk, and Operational Risk to products, processes, and business lines

SWOT Assessment for Gulf Banks
Opportunities

- The Internal Ratings Based (IRB) approach under Basel II creates the impetus to develop regional default and loss data bases that are statistically significant
- Coordination mechanisms already exist amongst GCC central banks to facilitate harmonized regulation
- Enhancement of the quality of income streams, and risk adjusted returns, to reduce risk premia in valuing share price, through reduced Betas, and/or reduced earnings volatility
- The opportunity to develop high granularity low Unexpected Loss (UL) portfolios in the GCC
- Demographics and the anticipated development of the private sector allow for growth in consumer finance and SME lending

SWOT Assessment for Gulf Banks
Opportunities

- High profitability levels allow for investment in advanced risk management infrastructures
- Lack of elaborate regulatory codes allow for development of Basel II compliant frameworks
- Diversified bank business models allow for correlation benefits to reduce capital charge
- Under–leveraged balance sheets broaden options for deployment into synergistic portfolios from a risk management view point

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SWOT Assessment for Gulf Banks
Threats

- Strong but relatively volatile economies, subject to oil cycles
- Population growth demographics, unemployment, and infrastructure requirements raise the likelihood of taxation
- High capital cushions and profitability can create a climate of complacency with respect to risk management
- Lack of categorized regional operational loss databases
- Media magnifying perceptions of regional tensions
- More sophisticated clientele, and Islamic banking, mean higher average funding costs, in future

A Regional Road Map for Success

- Banks and Regulators in the region must assess and coordinate implementation strategies given Basel II developments on the international scene, and within the regional context
- This should include degree of Accord implementation within the interests of the region, and Accord objectives/focus
- The IIF (Institute of International Finance) has helped instigate dialogue amongst regional regulators and banks on the recommendations of the IIF MENA CRO Forum
- Standardization of definition of default has been placed on the agenda of such dialogue
- Establishing a minimum degree of compatibility of internal ratings systems and mapping mechanisms to facilitate data pooling

A Regional Road Map for Success

- Establishment of regional rating agencies and ECA's that meet Basel standards
- Establishment of regional risk management research facilities and data repositories to share investment required, and critical mass of data
- Coordination amongst regional regulators and major banks to mobilize, organize, and potentiate regional Basel advocacy efforts
- Pool QIS-3 data and share regionally
- Conduct and pool QIS-4 data, if it takes place
- Establish regional operational loss databases to categorize and determine loss distributions per Basel business lines
- This will require MIS development at the bank level, standardization of business line definitions amongst regulators and banks regionally

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A Regional Roadmap for Success

- Establish regional Risk Management Association, and pooled research Facility
- Appropriate implementation of the IRB approach under Basel II can create value for shareholders, at some banks, through lowering risk premia on discount rates for shares/stock valuation
- Basel II provides the impetus, in our region, to define conscious and proactive capital management strategies based upon shareholder risk tolerance, and return objectives, that are explicitly enunciated
- It also catalyzes linking business strategy, as manifested in balance sheet positioning and business line management.
- The feasibility of implementing this approach is influenced not only by regulatory capital savings of implementing this approach, but also by the regional context in terms of availability of default data pools, and other resources (systems and trained HR)

Basel II – Value Creation

- The lower the required return , the higher the stock price

$$\text{Price of Stock} = \frac{\text{Dividend (1+ Growth Rate)}}{\text{Required Return – Growth Rate}}$$

- The lower the Beta, the lower the required return

Required Return = Risk Free Rate + Beta (Market Risk Premium)

- The lower the volatility relative to the market volatility, the lower the Beta

Beta = Function (Volatility of Stock, Volatility of Market)

$$= \frac{\text{Standard Deviation (Stock) x Standard Deviation (Market) x Correlation (Stock, market)}}{\text{[Standard Deviation (Market)]\^{}2}}$$

Basel II – Value Creation

- Both the Standardized and the Internal Ratings Based (IRB) approaches under Basel II provide relative indicators of risk, associated with various portfolios, and asset classes, that can be used as proxies for economic capital in the absence of, or lack of, data, to fully implement economic capital allocation models to estimate risk adjusted return on capital
- Business decisions based upon (RAROC) can be tactical and/or strategic
- In other words they can be associated with decisions relating to asset acquisition, such as lending decisions, or business line / strategic decisions, or with growing and/or consolidating asset portfolios or sub-portfolios.
- The single most significant missing link between using Basel II, as a proxy, and full economic capital modeling processes to determine required return, is the incorporation of diversification effects and correlation factors

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Basel II - Value Creation

- Utilizing relative Basel II risk weight ratios , a bank can arrive at a proxy for required returns for various portfolios, and its business as a whole , in the absence of robust inputs into an economic capital model
- By arriving at current, and projected required returns, one may estimate the value potentially created by implementing Basel II IRB in place of the Standardized Approach, or indeed the current Accord, at a high level
- Of course, a major qualification is that these risk weights are built on estimations of default, and loss experience, in G-10 markets, and hence they should primarily be used as relative measures as opposed to absolute measures

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Enterprise Wide Risk Management

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Beyond Basel II
Risk Adjusted Return on Capital (RAROC)

- Risk Adjusted Return on Capital (RAROC) or Economic Value Added (EVA) measures the effective (or ineffective) utilisation of shareholders' capital
- Provides strategic decision-making such as growing or divesting from certain business activities
- Gives the ability to compare the relative (risk adjusted) profitability of activities with different risk profiles
- Enables an estimate to be made of the impact of business decisions on the value of the Bank; and
- Provides the basis for determining incentives that are aligned to the interests of shareholders

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Gross Income

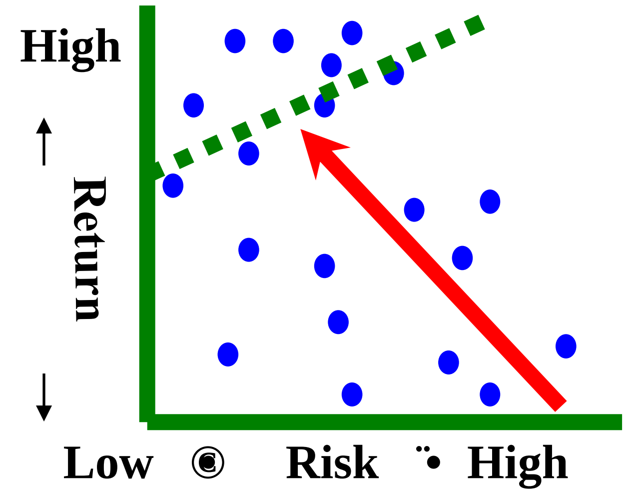
(Expected Loss)

Net Income

Capital At Risk (Unexpected Loss)

Risk / Reward Ratio

Target Yields



Risk Adjusted Return On Capital “RAROC”

Performance Measurement / Economic Value Added

Beyond Basel II
Effective Utilisation of Shareholders' Capital

- Pricing the profit on a deal includes the amount of capital needed. The excess return over the cost of capital required generates excess shareholder returns
- The total portfolio of transactions shows the total capital required by the bank to sustain the business given certain risk tolerance, and targeted return and/or credit rating (A, AA, AAA)
- If the balance sheet has excess capital over regulatory and/or economic capital requirements the Bank should consider:
  - Reducing capital via a return to shareholders
  - Increasing the asset portfolio through rapid organic growth
  - A takeover or expansion into new business areas
  - Take more risk and earn a higher return (higher volatility)
  - Or a mix of some or all of the above.

Beyond Basel II
Superior Shareholder Value

- Superior banking is superior risk management
- Robust Risk Management means a low risk premium on the share price due to stable and predictable expectations of future earnings flows, and therefore a higher share price/rating
- Return/Yield Management
- Loss Management /Recovery processes
- Net Returns/Yields
- Diversification/Correlation/Concentration
- High granularity low Unexpected Loss portfolios
- Limit Volatility of Returns
- Optimal Shareholder Value =

  Superior Net Returns/Limited Volatility

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Thank you

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