

BASEL II – IMPLEMENTING THE NEW ACCORD & OPTIMIZING SHAREHOLDER VALUE

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Outline

- Implications of Basel II for the region
- SWOT Assessment of Gulf Banks
- Basel II – Value Creation?
- A Road Map for Success for the Region
- Going Beyond Basel II

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

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 regulatory capital allocation process, along with improvements in risk management processes, that are validated by the regulator

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 in general

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 pro-cyclical effects on regional economies of Accord implementation

Capital Charge/Benchmark 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

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 among 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, once full economic capital allocation models are deployed
- Under-leveraged balance sheets broaden options for deployment into synergistic portfolios from a risk management view point

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

Basel II – Value Creation

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

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

$$\text{Required Return} - \text{Growth Rate}$$

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

$$\text{Required Return} = \text{Risk Free Rate} + \text{Beta (Market Premium)}$$

$$\text{Beta} = \text{Function (Volatility of Stock, Volatility of Market)}$$

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

Basel II – Value Creation

- Both the standardized and the Internal Ratings Based (IRB) approaches under Basel II provide relative indicators of risk, associated with the various portfolios, and asset classes, that can be used as proxies for 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 to 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

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

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

A Regional Road Map 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 it, but also by the regional context in terms of availability of default data pools, and other resources (systems and trained HR)

Beyond Basel II
Enterprise Wide Risk Management



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

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 a certain risk of tolerance, 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 merger
 - Expansion into new business lines
 - Or a mix of some or all of the above

Thank you