Corporate Trends

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Basel Capital Accord II - Its Developments and Implications for Malaysian Banks

In the five years since the Basel Committee introduced the Basel Capital Accord II ("Basel II"), Basel II has evolved as a complex set of recommendations that will likely create a variety of regulatory compliance challenges for banks in Malaysia and around the globe. The key objective of the Basel Committee for Basel II is to encourage banks to better align their risk taking activities and the management of these risks with the banks' capital requirement. By having a more risk sensitive regulatory capital, Basel II will improve safety and soundness of the financial system.

However, the complex requirements of Basel II make its implementation a highly complicated project. Nonetheless, for those banks that are able to successfully implement its requirements, they could benefit from its implementation through better risk management of their business and more efficient use of their capital, to ultimately enhance their shareholders' value.

With this in mind, KPMG has been conducting a global Basel II readiness survey every year in last few years to determine banks' preparation for Basel II compliance. Malaysia participated in this survey for the first time in 2003. Hence, the purpose of this paper is to provide a summary of the results of KPMG 2003 Basel II readiness survey, and specifically, to consider Malaysian banks' preparation and challenges with Basel II compliance, especially in view of Bank Negara Malaysia ("BNM") recent announcement that Malaysian banks intending to adopt the Foundation Internal Rating Based ("FIRB") Approach must submit a comprehensive implementation plan by January 2008 and for full implementation by January 2010. The paper will also consider the issues surrounding Malaysian banks' compliance with Pillar 2 of Basel II.

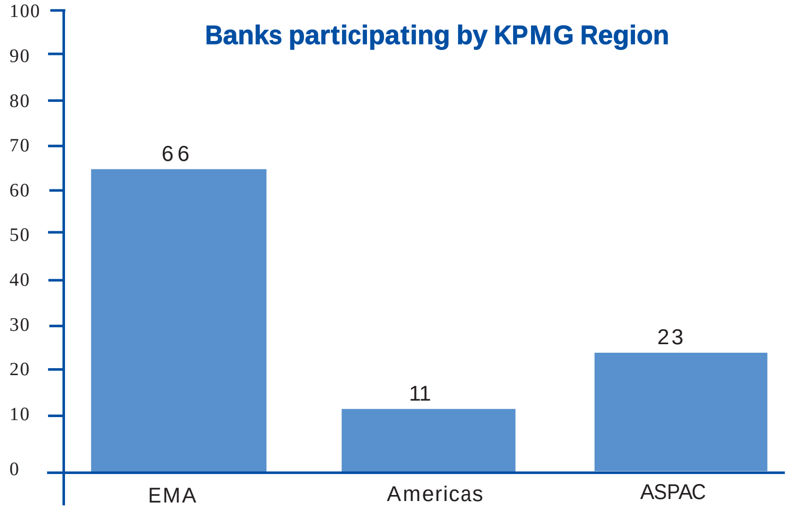
KPMG 2003 Basel II Survey Results

Global Results

The 2003 survey saw 303 financial institutions from 39 countries participating in the survey. The percentage of banks participating from KPMG regions, namely, Europe, Middle East and Africa ("EMA") region, North and South America ("Americas") region, and Asia Pacific ("ASPAC") region, is summarised in Figure 1.

IN THIS ISSUE

Figure 1



Source: KPMG International, 2004

Base: All respondents (303)

A summary of the survey results is as follows:

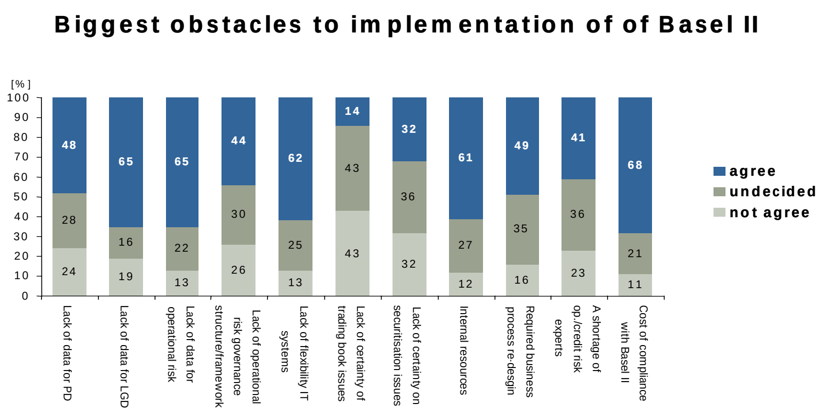
- More than 90 percent of respondents have started a Basel II project;
- Approximately 50 percent of participants are still in the pre-study/assessment phase;
- 70 percent of participants are not further than the phase of systems modelling;
- Less than 20 percent have started with the implementation for credit risk, and less than 10 percent for operational risk;
- Less than 10 percent have started the testing and validation phase, which is one of the key phases of the overall project and one that often proves difficult to complete; and
- 60 percent of the participants see the timing of the implementation as main cause for concern.

Considering the implementation time frame and the project complexity, banks seem to be behind schedule to meet the compliance dateline of January 2007. The biggest obstacles for implementation found in the survey seem to be:

- Cost constraints;
- Lack of data to calculate the necessary parameters;
- Lack of flexibility in the banks existing IT; and
- Lack of internal resources.

Other obstacles indicated by the participants of the survey are provided in Figure 2.

Figure 2



Source: KPMG International, 2004

Regional deviations found in the survey are as follows:

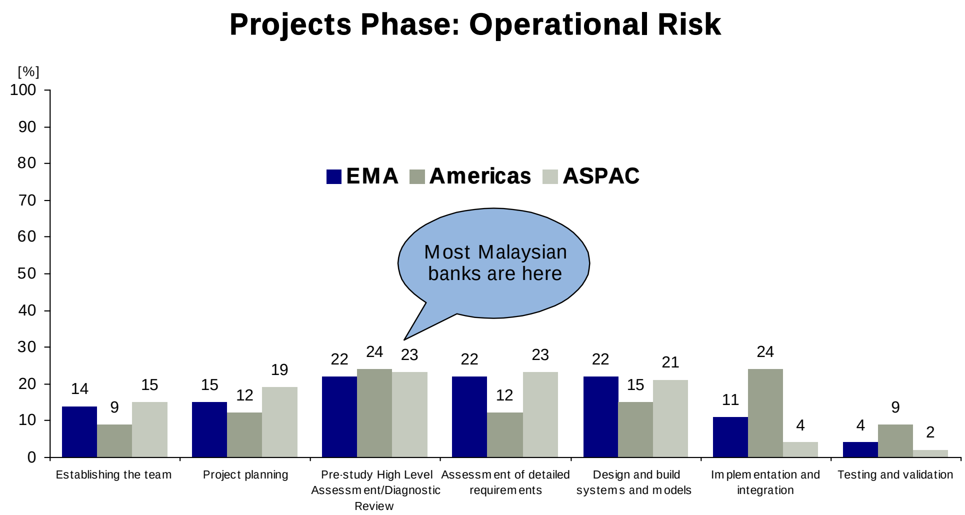
- In the ASPAC region, 16 percent of respondents have not started a Basel II project of any kind, compared to 15 percent in Americas and 4 percent in EMA;
- In ASPAC, 8 percent of respondents are undecided about which approach to adopt for credit risk, for operational risk this number was even higher, 12 percent;
- 89 percent of respondents from the Americas region stated that they expect improved operational risk management post Basel II, compared to 63 percent in EMA and 60 percent in ASPAC; and
- 78 percent of respondents in EMA expect an improved credit rating system as a result of the adoption of their preferred approach, compared to 66 percent in Americas and 60 percent in ASPAC.

It appears from the survey that banks in the ASPAC region are generally behind their counterparts in the EMA and Americas region.

Malaysian Results

Malaysia participated for the first time in this global survey. Like its counterparts in the ASPAC region, it appears that banks in Malaysia are generally behind the implementation timeline, especially in the area of operational risk. Most Malaysian banks are only starting to assess the requirements for operational risk and planning for its implementation, as shown in Figure 3.

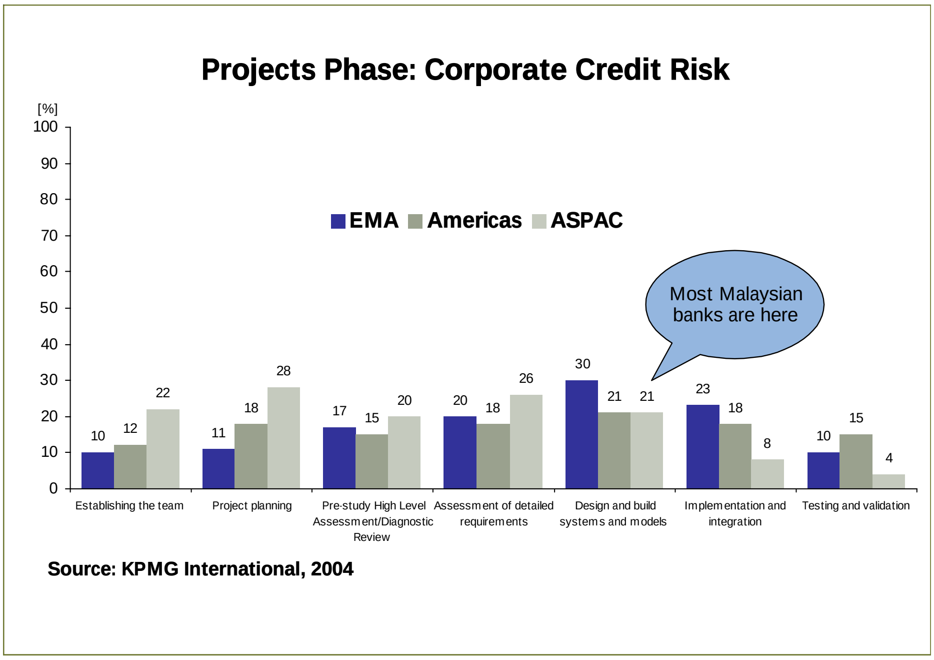
Figure 3



Source: KPMG International, 2004

Nonetheless, in the area of credit risk, Malaysia banks are relatively more advanced in corporate credit risk, whereby most Malaysian banks have build a credit risk grading/ rating model, and are now calibrating the model for probability of default ("PD"), loss given default ("LGD") and exposure at default ("EAD") calculation, as shown in Figure 4.

Figure 4



In retail credit risk however, Malaysia banks are not as advanced. Most banks are only starting the build their credit risk scoring model for their retail loans. This model needs to be in operation for a number of years before the model could be calibrated for PD, LGD and EAD calculation.

Hence, for Malaysian banks intending to adopt the FIRB Approach, it appears that for corporate loans at least, Malaysian banks are well on their way towards planning and implementing the FIRB Approach. Meeting the January 2008 for a comprehensive implementation plan and the subsequent implementation by January 2010 should not be a problem. On the other hand, the same could be said for retail loans. Many Malaysian banks will find it challenging to meet the January 2008 dateline for adopting the FIRB Approach for retail credit unless they start their planning now, as data collection and model calibration would require a number of years of data.

As for operational risk, most Malaysian banks would only be able to comply with the Basic Indicator Approach, unless again they start planning now for implementing a more sophisticated approach.

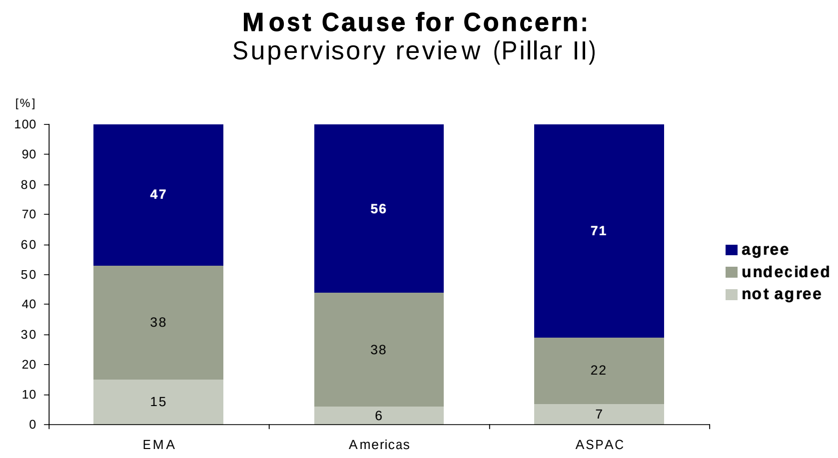
Basel II Pillar 2

Since Basel II's introduction, a lot of attention has been given to Basel II Pillar 1, i.e., minimum capital requirements or regulatory capital requirements. Basel II Pillar 2 has not received as much attention as it should. Basel II Pillar 2, while not as explicit, forces banks to consider more actively the capital implications of their activities, i.e., economic capital management.

In particular, Pillar 2 requires banks to constantly assess their capital adequacy given their risk taking activities. Regulatory authorities will then assess this internal capital adequacy assessment process, and in the event that the regulatory authorities are not satisfied with the internal assessment capabilities, they may impose or require the banks to hold a higher capital requirement than that defined under Pillar 1. In view of this, it is imperative for banks to manage their economic capital more effectively.

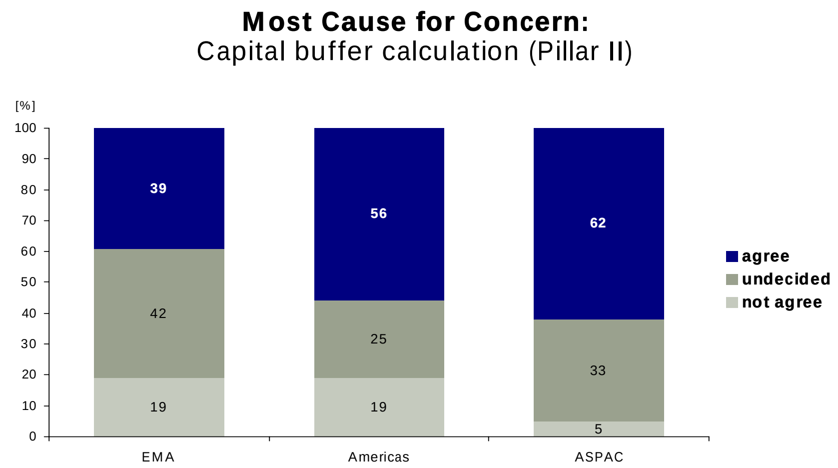
Interestingly, the concerns of Pillar 2 requirements are most prevalent in the ASPAC region, as found in the survey shown in Figures 5 and 6.

Figure 5



Source: KPMG International, 2004

Figure 6



Source: KPMG International, 2004

The Commercial Imperatives for Economic Capital Management

Introduction

Beside Basel II, there are a number of other external and internal factors driving the importance of economic capital management in banks. The most important of these factors are set out below:

External drivers

- The combination of high volatility, unpredictable liquidity and operational instability has generated additional risks for banks; and
- The increasing demand from shareholders that banks are more competitive has led to a recognition that businesses must generate a return that compensates adequately for the capital utilised. The concept of capital as a free resource is evaporating fast with business units within banks are accepting the fact that capital is expensive and there is a cost associated with utilising capital. Strategic decisions are therefore being based not just on the earnings contribution made by business units but also their consumption of capital.

Internal drivers

- Banks are typically comprised of a number of different business units ranging from corporate banking and asset management through to retail banking and capital markets. Since these businesses generate different risks and have varying propensities to absorb capital, organisation-wide portfolio management is particularly complex; and
- To remain competitive, banks need to continually evaluate the development of new or existing business lines. The implementation of an economic capital management framework can act as a mechanism for the ongoing management of this process.

Hence, economic capital management helps to identify value-creating business activities to optimise the use of a bank's capital.

Economic capital management requires the linking of risk to capital. Linking risk to capital requires:

- Identification of all material risks and measurement of these risks on the basis of defined methods;
- Aggregation of all risks; and
- Specification of the risk-taking capacity and the tolerance for risk within the bank.

Risk Adjusted Performance Management ("RAPM") allows banks to link their risk to their capital. By linking risk to capital, RAPM contributes to the creation of shareholders value by facilitating the deployment of resources to those businesses whose value/ earnings significantly exceed the risk profile of their activities. A RAPM culture will enable banks to:

- Assess the profitability of their businesses with different risk profiles and different market conditions on a consistent basis;
- Make objective decisions on a comparable basis for the allocation of capital across businesses;
- Identify "value eroding" businesses;
- Evaluate performance on capital consumed by businesses;
- Set target returns for businesses on a risk adjusted basis; and
- Evaluate the economic viability of growth/acquisition ventures.

Economic Capital Management **-** *A Case for Malaysian Banks*

The imperative for economic capital management in Malaysia is evident by the performance of Malaysian banks when measured on a risk-adjusted basis. The risk-adjusted performance of Malaysian banks was analysed using the following methodology:

$$\text{Risk-Adjusted Return on Capital ("RAROC")} = \frac{\text{Net Profit Before Tax}}{\text{Risk-Adjusted Capital}}$$

where Risk-Adjusted Capital or economic capital is calculated based on the sum of the banks' exposure to credit, market and operational risk, i.e.:

- Credit risk economic capital – Calculated as 8% of Risk-Weighted Assets;

- Market risk economic capital – Calculated using Value-at-Risk ("VaR") concept based on the respective bank's trading book size and assuming exposure is on 3 month KLIBOR with a volatility of 4.51%, and the VaR is multiplied by a factor of 3 as per Basel's requirement; and

- Operational risk economic capital – Calculated using Basel II Basic Indicator Approach assuming an alpha of 15%.

It should be noted that these figures are proxies for these banks' exposure to credit, market and operational risk, as we do not have accessed to their true risk exposures and are using publicly available information to arrive at these figures.

The RAROC of the 10 anchor banks, Bank Islam Malaysia Berhad and Bank Muamalat Malaysia Berhad based on their respective financial year-end from 30 June 2002 to 30 June 2003 is summarised in Table 1.

Table 1

Ranking	RAROC
Lowest	-4.79%
Mean	13.46%
HIghest	36.70 %

Further analysis of the results shows the following:

- Two banks' RAROC is below the risk-free rate. This means that the returns that these banks generate from their assets are insufficient to compensate for their risk exposures. The banks' return will be better by just simply invested in government bonds;
- Seven banks' RAROC is below the mean.

Conclusion

In light of the recent financial crisis, where we saw a capital shortage in the financial system, and the high level of competition that Malaysian banks are likely to face in the future, Malaysian banks must look towards gaining competitive advantage through implementing an effective risk management and economic capital management programme.

Furthermore, under the Basel II initiative, effective risk management and economic capital management is no longer a business imperative, but also a compliance obligation. In this respect, KPMG 2003 Basel II readiness survey found that banks generally are behind schedule in their preparation. In the case of Malaysia, while Malaysian banks are progressing well towards compliance in some aspects, they are significantly behind time in other aspects. Hence, Malaysian banks should review their progress towards compliance and take the Basel II initiative as an opportunity to improve their risk management to enhance their shareholders value, as we believe the Basel II initiative is a ***"risk management revolution disguised as regulation".***

I.G. Chandran
Tel : +603 20953388
E - mail : igc@kpmg.com.my

Dr. John Lee
Tel : +603 20953388
E - mail : jhhlee@kpmg.com.my

Wisma KPMG Jalan Dungun Damansara Heights 50490 Kuala Lumpur
Telephone : +603 20953388 Facsimile : +603 20950971