

**FIFTH MEETING OF THE ADVISORY GROUP
MONTREAL, CANADA, 9TH MAY 2006**

AGENDA ITEM 7

**REVIEW OF PUBLIC/PRIVATE DIALOGUE ON THE IMPLEMENTATION OF BASEL II
AND DEVELOPMENTS IN REGIONAL BANKING AND SUPERVISION, KUALA LUMPUR,
8/9TH AUGUST 2006**

Background

The Advisory Group and ABAC and PECC strongly support measures to promote the strengthening of the region's financial systems. To that end various initiatives have been implemented:

- a symposium on risk management, pricing and capital provisioning, organised by ABAC and PECC in Sydney, 16/17th May 2002
- a public/private dialogue on the implementation of Basel II, organised by ABAC, PECC, the Chilean Banking Association and the Chile-Pacific Foundation, Santiago, Chile, 3rd September 2004
- a public/private dialogue for the Asia-Pacific region on Cross-Border Implementation of Basel II and Emerging Regulatory Banking Supervisory Issues, Organised by ABAC, SEACEN, ABA and PECC, Kuala Lumpur, 4th August 2005

The reports and recommendations of these various initiatives have been provided to APEC Finance Ministers and widely circulated. Attachment 1 is a copy of the Summary and Recommendations of the dialogue held in Kuala Lumpur, 4th August 2005.

A further dialogue will be convened in Kuala Lumpur, 8/9th August 2006, essentially to:

- ***review the key issues raised in the first dialogue, as outlined in the summary and recommendations shown in the attached report.***
- ***to discuss with senior regulators and representatives of international agencies and private banks, their responses to the recommendations and to identify issues which may need to be developed further***
- ***to arrive at recommendations on how any existing weaknesses in implementing Basel II will be addressed***

- *to consider issues relating to Pillar 3 of Basel II*
- *to consider measures to advance proposals for a region-wide informal work-out regime the legal and policy environment that would facilitate its effective operation*
- *to consider consumer financial protection and the consumers' influence in modern banking*
- *to focus on issues relating to implementing risk management procedures and practices and on improving corporate governance in the region's banking systems*

(A copy of the draft program for the dialogue is shown in Attachment 2)

Recommendations

- Review and provide views and guidance on issues you deem relevant arising from the summary report and recommendations of the first dialogue, attached
- Review the draft agenda for the second dialogue and provide advice and guidance on matters you deem to be relevant.

Coordinator

24th April 2006

**PUBLIC/PRIVATE DIALOGUE FOR THE ASIA PACIFIC REGION ON CROSS-BORDER
IMPLEMENTATION OF BASEL II AND EMERGING REGULATORY BANKING
SUPERVISORY ISSUES**

**AN ABEC/SEACEN/PECC/ABA PUBLIC PRIVATE SECTOR CAPACITY
BUILDING INITIATIVE, KUALA LUMPUR, 4TH AUGUST 2005**

SUMMARY REPORT AND RECOMMENDATIONS

Introduction

The dialogue, proposed by ABAC, PECC and the ABA, was sponsored and coordinated with SEACEN and held in conjunction with SEACEN's 7th Annual Conference of Banking Supervisors. Around 70 people attended including banking regulators and public finance officials from the Asia Pacific region, a representative of the Basel Committee on Banking Supervision, private bankers from Asia, Europe and Latin America and academics from finance disciplines. SEACEN generously hosted the dialogue and provided excellent secretarial support and hospitality for participants. A detailed report of the dialogue is available on the ABAC web-site.

The dialogue sought to discuss four key issues:

- proposals on core principles on cross border implementation of Basel II, as proposed by Mr. Manuel Mendez of BBVA Madrid at a dialogue held in Santiago Chile in September 2004. (A copy of that proposal is attached to this summary)
- the challenges arising from cross-border implementation for banking supervisors and for banks in the APEC region and how these might be best dealt with
- emerging regulatory issues and how these might impact on the three pillars of Basel II
- the capacities in the APEC region in meeting the challenges of Basel II and likely areas of stress in both regulatory agencies and in banks

General summary of discussions on the key issues

- there was broad agreement around the principles proposed in Attachment 3 except that there was no definitive response to the proposal that greater recognition be given to portfolio diversification by a conglomerate, operating under the AMA, in its overseas branches and subsidiaries; ***this matter is an important one and deserves consideration by the Basel Committee on Banking Supervision***

- the dialogue did reveal that significantly more work is necessary in translating principles of cross-border implementation into actual practice – the central issues involved are identified later in this summary
- implementation of Basel II in emerging markets should be part of an overall financial system program
- there are some significant issues for regulators in enhancing home/host cooperation; for emerging market host regulators there are many challenge in building the necessary supervisory skills to implement Basel II and to engage effectively with developed home market supervisors
- imperfect coordination between home and host supervisors could be costly to internationally active banks, possibly increasing the risk of failure and impacting adversely on efficiency, competition, banking structures and ultimately, on costs and profits; regulatory capital requirements may not be optimal and few countries properly price benefits to banks arising from deposit insurance guarantees; convergence and consolidation of capital requirements is problematic where different financial functions are performed within a conglomerate
- home supervisors should lead coordination in cooperation with the host supervisor; there should be more cooperation between supervisors with legitimate interests to improve understanding on "national discretion" in jurisdictions, approval and validation processes of the IRB and AMA approaches, and judgment on significant subsidiaries
- consistency in home/host approach should be the goal; however total convergence should not be expected; a realistic approach is to find areas where common approaches are feasible and practical – this will require continuing discussion between home/host supervisors **and there would be benefit in regional cooperation to secure consistency**
- for banks there are challenges in complying with cross-border regulatory requirements – particularly for active international banks with operations in emerging markets and where the regulatory requirements between markets may well differ; banks, particularly those in developing markets face urgent challenges in building skills, acquiring reliable data and building risk management systems
- notwithstanding the challenges, regulators and banks strongly support Basel II and the contribution it should make to financial system stability; regulators and bankers agree that implementation should be gradual and allowing for capacity constraints of one sort or another – and that banks should demonstrate a compelling business case in seeking approval of advanced status; many banks in the Asian and Latin American APEC region, will begin implementation via the standardised approach
- banks from both Asia and Latin America exhibited a detailed awareness of the challenges and of the strategies necessary for dealing with complex issues, such as those arising from lack of data, from constraints imposed by small markets; some

are developing well constructed and balanced measures to deal with obstacles they are confronting

- ***capacity building needs are significant in both regulatory agencies and in banks in emerging markets and must be addressed if Basel II is to successfully implemented in those markets within a reasonable time-frame; needs include the development of infrastructure, for example, a sound legal base, convergence to internationally agreed accounting standards – as well as capacities to undertake advanced risk modelling and evaluation, stress testing and data collection***

Major issues and recommendations of relevance to regulators to enhance cross-border implementation

- there needs to be constructive information exchange between home and host supervisors and commitment at all levels if Basel II is to effectively implemented – central issues that need further definition include :
 - materiality and significance as these terms are applied to a subsidiary or branch operation in a host economy
- emerging markets tend to be dominated by banks and the consequential limited role of capital markets may well involve higher risk premiums in those markets and concepts of higher risk may impact on banks and impede lending to domestic growth activities; this factor requires greater deliberation in the context of "national discretion" as Basel II is implemented
- banks should improve their communications internally within the group, on their implementation plans and on risks that could materially affect the group

Major issues and recommendations of relevance to banks in cross-border implementation

- internationally active banks see cross-border activities as essential aspects of growth strategy; as part of their commercial strategies they manage and price risk as a permanent process of evaluation of economic, political and social factors
- some cross-border activities are not yet well defined by regulators, including international accounting standards, the regulatory approaches to corporate governance, money laundering and anti-terrorist activities and the need to standardise local classification and credit ratings and to give clarity to concepts of homogeneity
- there is a need for home and host supervisors to recognise the approaches of conglomerate financial groups as they seek to roll-out "home" IRS models adjusted for local credit over-rides in respect of their subsidiaries and branches in host jurisdictions,

and of the use of home based risk parameters in monitoring ratings in overseas markets for consistency in validating results and credit over-rides

- host supervisors should respect home supervisor guidance and only set minimum local requirements, and set incentives for banks adopting the AMA, for example, by accelerating new business approvals

Major recommendations of the dialogue

- the College of Supervisors should be encouraged to define areas on which common approaches can be developed, including recognition of the role of host supervisors, the level of accountability of local boards and senior management, the role of host supervisors in checking data integrity of local subsidiaries and their role in validating retail models and procedures
- the College of Supervisors should have as an objective the streamlining of regulatory requirements to assure sufficient homogeneity and to facilitate mutual recognition – issues of concern relating to existing principles, include:
 - definition and level of "**significant**" and "**materiality**"
 - clarification in terminology, for example does "**support**" equate with "**approval**" in para 656 of the June 2004 Accord
- the Accord Implementation Group should collate insights from the case study work undertaken by the College of Supervisors and disseminate this to regional supervisors and banks
- home supervisors should encourage the development of economy benchmarks on risk parameters for use in relation to Pillars 1 and 2, noting that G10 experiences may not always be relevant to emerging markets
- home supervisors should initiate more dialogue between banks and regulators and accelerate experience sharing with international banks and the IAG
- host supervisors should plan and launch real case studies with advanced international banks – these are preferred to IT vendors
- models of credit risk should be available on a regional basis
- home/host regulators should agree "Terms of Engagement" or Memorandums of Understanding with a view to reduce the compliance burden on banks in cross-border implementation ; (however, there was some questioning whether additional MOUs were necessary)

Summary Conclusions

The dialogue revealed a shared appreciation of the value of Basel II and its importance to rapidly changing circumstances in banking and the challenges arising from financial innovation and integration. Many challenges however were highlighted in cross-border implementation, including importantly

- i) the need for clarity and understanding of the ways in which the principles espoused by the Basel Committee are to be converted into practical measures that both regulators and banks can apply
- ii) the need for concerted capacity building initiatives to raise the skills base, to improve and share data and to develop appropriate modelling tools in emerging markets – both in supervisory agencies and in banks – to ensure the smooth implementation of Basel II

Recommendations

- ABAC, PECC, SEACEN and ABA distribute this report and Executive Summary to interested parties, including importantly, the regulators and bankers who participated in the dialogue and to the Basel Committee for Banking Supervision, requesting they consider the report, observations and recommendations and provide advice to the organising group on the following matters:
 - the desirability or otherwise of recommended actions and how specific initiatives might best be pursued
 - the identification of particular capacity building initiatives that should be considered on a region-wide APEC basis, to address impediments identified in the dialogue
 - further measures that could be given priority in ameliorating impediments in the implementation of Basel II, and ways in which these might be addressed, including through further collaboration between the parties involved in this dialogue
- ABAC and PECC convey this report and recommendations to APEC Finance Ministers, requesting that Ministers make it available to their central banks and appropriate regulatory agencies for their consideration and advice on appropriate capacity building initiatives to address impediments in implementing Basel II.

20th September 2005

GENERAL PRINCIPLES FOR BASEL II IMPLEMENTATION IN EMERGING MARKETS

This note sets out a number of principles that can be used to support debate between home supervisors of multinational banks and host supervisors in emerging markets, concerning the implementation of Basle II. The principles in question are listed and described briefly below. These could find expression in an agreement between national banking regulators and administered by the BIS.

PRINCIPLE 1: GRADUALITY & FLEXIBILITY

The application of Basle II must be an unavoidable medium-term objective in all countries, but the initial situation may vary in terms of the degree of sophistication of banks, the quality of information, etc.

The timing of adoption is a sovereign decision of the regulators and supervisors in each country. Likewise, it is important to admit adaptations to local conditions in the different environments, and not to expect 100% readiness to tackle the implementation of the Agreement.

Therefore, it must be considered that decisions taken by home supervisors of foreign banks operating in these countries have an impact in the local financial system.

It would be advisable to reinforce this principle with the mutual recognition of progress made. Thus, if a national regulatory authority determines that banks under its jurisdiction may evolve from the standard model to the advanced model and that it, the regulator, has the capacity to validate advanced models, this should be considered by regulators of other countries for the purposes of supervising organisations that operate internationally.

PRINCIPLE 2: HOMOGENEITY

To facilitate the implementation of the Agreement the major concepts (definitions of default, default probability, loss given default, etc.) must be consistent and must be respected utterly. Any local adaptations should be in the details.

Consistency of implementation (which is not incompatible with some degree of freedom) must stem from dialogue between emerging market regulators and supervisors and the Basle Committee. In this regard, home supervisors should play a significant role.

Attempts must be made to avoid various definitions. It makes no sense for local supervisors to use one set of definitions while at the same time different definitions are required by home supervisors. Developing databases with more than one definition is not only expensive but also tends in general to produce lower standards of information, possibly resulting in day-to-day management of organisations being separated from captured historical information. (1)

Assuring sufficient homogeneity should have advantages both for international banks with subsidiaries in the region and for home and host supervisors. For instance it could enable models to be validated almost immediately by one supervisor once another has given approval.

(1) For instance the recovery procedures at financial institutions are in general closely linked to the local definition of default, so loss-given-default figures using non-local definitions are hard to interpret from the point of view of actual management of an organisation.

PRINCIPLE 3: MAINTAINING CAPITALISATION

In many emerging countries current standards of capitalisation are high. This shows up in very high Basle ratios in comparison with developed countries (reflecting the higher level of risk in these countries).

In these cases the general principle of Basle II could be extrapolated to the different local financial systems. In other words the total capital requirements under Basle II can be kept similar to current levels.

This principle would eliminate some concerns about the New Accord, and would favour its implementation.

PRINCIPLE 4: NO DISCRIMINATION

This principle is based on the idea that organisations which compete in the same markets should be subject to the same rules.

For instance, if local organisations in an emerging country have the possibility to adopt the standard Basle II model, then subsidiaries of multinationals in that country should be allowed to measure local capital requirements in the same way.

This principle means reciprocity of treatment so that regulators in each country acknowledge that an international organisation may have advanced models in one country and standard models in another, at least temporarily.

PRINCIPLE 5: INCENTIVES

There must be medium-term incentives for organisations to tackle the developments needed to transit and to implement advanced models, and certainly to avoid disincentives.

Developing advanced internal models has major advantages for organisations in that it improves the risk management platform, and for supervisors in that they would thus obtain far richer information to carry out their mission.

For there to be incentives to use internal models one major requirement is to solve the confidence level problem. Thus, the confidence level implicit in models (99.9% related to an A- rating) is generally very demanding for these countries, so a solution would have to be found. (2)

Internal models and the consequent improvements in risk management must be a medium-term aspiration. However, it is also true that there is no need to rush: there are other matters that must be solved first in some countries before these models can be fully developed, such as accounting and legal aspects, information platforms, cultural matters, etc.

(2) The solution could be to provide lists of groups of countries according to sovereign ratings and to differentiate them based on confidence levels.

PRINCIPLE 6: RECOGNITION OF DIVERSIFICATION

Diversification must be recognised wherever it occurs, i.e. the lowest risk from diversification in an international group is found where risks are integrated, i.e. at parent organisation and/or consolidated level, and it makes no economic sense to distribute that diversification among subsidiaries.

This does not mean that diversification is not important to the local supervisor in the country where a subsidiary operates. On the one hand the subsidiary can be in turn a financial group which would have to take into account its own diversification. On the other hand the low level of recognition of diversification for international groups could affect the stability of financial flows to emerging economies, due to the impact that it might have on the capital required at parent organisation level.

PRINCIPLE 7: SOVEREIGN RISK TREATMENT

It is important to maintain the current treatment of sovereign risk as the lowest-risk investment alternative at local level. (3) Exemption of risk for the calculation of capital would apply to all options.

If this alternative is not selected, attribution of capital on the basis of sovereign risk could negatively affect the volatility of debt spreads and the stability of financing itself.

PRINCIPLE 8: DISTRIBUTION OF RESPONSIBILITIES

For the home supervisor of a financial group the most important thing is the capital at the parent organisation itself and the level of provisioning, while for the local supervisor the main points are the provisions set up and the capital of the subsidiary. In short, their interests converge, although with some nuances.

Once common criteria and principles of co-ordination are established this delimits the distribution of responsibilities between home and host supervisors.

There are clearly synergies between the jobs of the two groups of supervisors, and co-ordination to ensure the efficiency of the process is fundamental.

(3) There may be private companies with lower credit risk levels (eg. because of payments made in dollars) but with far less depth than sovereign debt as an investment alternative.

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*2nd Public/Private Dialogue for the Asia Pacific Region on
The Implementation of Basel II and
Developments in Regional Banking and Supervision
Kuala Lumpur, Malaysia, 8 – 9 August 2006*

**AN APEC PUBLIC/PRIVATE SECTOR
CAPACITY BUILDING INITIATIVE**

PRELIMINARY AGENDA

ALL SPEAKERS/SESSION CHAIRS – YET TO BE CONFIRMED

**Dialogue Venue:
Nusantara Ballroom 1 & 2, Sheraton Imperial Hotel, Kuala Lumpur**

Monday, 7 August 2006

Arrival of ABAC/ABA and PECC Delegates

Tuesday, 8 August 2006

08:00 - 08:30 Registration of ABAC, ABA and PECC delegates

08:30 – 09:30 SESSION 1: OPENING CEREMONY AND INTRODUCTION

Opening remarks by Session Chair

- The SEACEN Centre

Welcome remarks on behalf of ABAC Malaysia

- Tan Sri Dato' Azman Hashim

Introductory Comments

- Mr. Mark Johnson, Chairman, ABAC Finance Working Group

Keynote Address

- Tan Sri Dato Sri Dr. Zeti Akhtar Aziz, Governor,
Bank Negara Malaysia

09:30 – 09:45 GROUP PHOTOGRAPH SESSION

09:45 – 10:15 COFFEE/TEA BREAK

10:15 – 11:15 SESSION 2 (THROUGH SESSION 5):

***These sessions involve a review of developments of key issues raised in the cross-border implementation of Basel II, as identified in the first public/private dialogue, 4th August 2005
– see report and executive summary of that dialogue.***

(In addressing the issues shown under the various sessions below, speakers are asked to provide an assessment of progress and to identify issues which need to be developed further, together with suggestions to aid progress)

Issue (a) is any change in treatment of capital charges being considered under advanced modelling arrangements, in recognition of portfolio diversification by a conglomerate's overseas branches and subsidiaries?

Session chair:

- Mr. Ken Waller, Group Economic Advisor, Commonwealth Bank

Speakers:

- Mr. Manuel Mendez del Rio, BBVA, Madrid
- Representative, Basel Committee on Banking Supervision
- Professor Kevin Davis, Director, Melbourne Centre for Financial Studies

Open Forum

Closing remarks by Session Chair

11:15 – 12:30 SESSION 3:

Issue (b) consideration of developments in the College of Supervisors in defining common approaches in the region between home/host supervisors on the following issues:

- ***recognising (and defining) the role of host supervisors***
- ***the level of accountability of local boards and managers of banks***
- ***the role of host supervisors in checking data integrity of local bank subsidiaries***
- ***the role of host supervisors in their role in validating risk models and procedures***

Session chair:

- Dr. J.C. Parrenas, Senior Advisor to the Chairman, Chinatrust Financial Holding Company Ltd.

Speakers:

- Dr. Taris Watangase, Deputy Governor, Financial Institutions Stability, Bank of Thailand
- Mr. Brandon Khoo, Executive General Manager, Australian

- Prudential Regulatory Authority
- US Federal Reserve of Governors
- Mr. Toru Shikibu, Deputy Commissioner for International Affairs, Financial Services Agency, Japan

Open Forum

Closing remarks by session chair

12:30 – 13:45 LUNCH

13:45 – 15:00 SESSION 4

Issue (c) developments in cooperation between home/host supervisors in formulating common approaches and practices on key interpretations of Basel II, such as "materiality" and significance" as these terms are applied to a subsidiary or branch operation in a host economy – (Is cooperation effective and is risk reducing?)

Session chair:

- Mr. Yasuo Kanzaki, Special Advisor, Nikko Group Ltd

Speakers:

- Mr. William Ryback, Deputy Chief Executive, Hong Kong Monetary Authority
- Mr. Gunther Held, Advisor, Office of the Superintendent of Banking of Chile
- Mr. Choo Yee Kwan, Executive Vice President and Chief Risk Officer, Maybank Group
- Representative of Citibank Group

Open Forum

Closing remarks by session chair

15:00 – 15:30 SESSION 5

Issue (d) consideration of issues relating to the implementation of Pillar 3 in global and regional banking systems; does the pillar have credibility and what key measures are required to effect its implementation?

Session chair:

- Professor Kim Dietrich, University of Southern California

Speakers:

- Dr Nancy Wentzler, Deputy Comptroller and Chief Economist,

- Global Banking and Financial Analysis, OCC
- Mrs Tongurai Limpiti, Senior Director, Prudential Policy Department, Bank of Thailand
- Mr. John Winders, Managing Director, Asian, ANZ Banking Group

15:30 – 16:00 COFFEE/TEA BREAK

16:00 – 16:30 SESSION 5 (Continuation)

Open Forum

Closing remarks by Session chair

16:30 – 17:30 *SESSION 6: This session will focus on the strengthening of regional financial structures and in particular on the development of a region-wide informal workout regime and the legal and policy environment that would facilitate its effective operation*

Session chair:

- Ms. Clare Wee, Assistant General Counsel, Asian Development Bank

Speakers

- Mr. Richard Fisher, Partner, Blake Dawson Waldron, Lawyers, Sydney
- Mr. Sergio Edeza, Executive Vice President, Finance Markets Group, Rizal Commercial Banking Corporation
- Dr. Twatchai Yongkittikul, Vice Chairman, ABAC Finance Working Group, and Executive Director, Thai Bankers' Association

Open Forum

Closing comments by Session chair

19:30 – 21:00 Gala Dinner Hosted by The SEACEN Centre

Wednesday, 9 August 2006

09:15 – 09:45 SESSION 7 – Special Topic on “Developments in Consumer Financial Protection”

(THIS SESSION YET TO BE CONFIRMED)

This session will review developments in consumer financial protection and the consumers' influence in modern banking

Session Chair:

- Mr Nguyen H. Trung

Presenter:

- Mr. William Knight, Commissioner, Financial Consumer Agency, Canada

09.45 – 11:00 **SESSION 8: *This session will focus on the enhancement of risk management capacities in the region's banking systems as they move to implement Basel II; is risk mitigation improving; what key challenges remain; are sufficient resource available to enhance capacities in both public and private sectors; how should more resources be mobilised?***

Session chair:

- Dr. Jules Gribble, Ask!T Consulting

Speakers:

- Mrs Nor Shamsiah Yunus, Assistant Governor, Bank Negara Malaysia
- Mr. Robert McCauley, Chief Representative, BIS Asia Pacific
- Mr. Injoon Chaey, Deputy President, Chohung Bank
- Representative of Standards and Poors
- IMF Representative

Open Forum

Closing comments by session chair

11:00 – 11:20 **COFFEE/TEA BREAK**

11:20 – 12:40 **SESSION 9**

This session will focus on the enhancement of governance standards and principles in the region's banking systems – in both public agencies and in commercial banks – as Basel II is being implemented; how can progress be demonstrated; what are the best benchmarks; what capacity building initiatives will be most beneficial and are private sector directors' associations sufficiently involved?

Session chair:

- Mrs Juliet McKee, Company Director and Advisor on Corporate Governance; member of PECC New Zealand

Speakers:

- Head of banking supervision, Monetary Authority of Singapore
- Dr. Clare Wee, Assistant General Counsel, Asian Development

- Bank
- Dr. Jos Luhukay, President Director, Lippo Bank
 - Mr. Francisco Garces, Board Member, Banco de Chile

Open Forum

Closing comments by session chair

12:40 – 13:00 CLOSING COMMENTS:

- Tan Sri Dato Azman Hashim
- Mr. Dong-Soo Choi, Chairman, ABA
- Mr. Mark Johnson, Chairman, ABAC, FWG

CONCLUSION OF DIALOGUE – The SEACEN Centre

13:00 – 14:00 LUNCH

FREE

19:30 – 21:00 Closing Dinner hosted by The SEACEN Centre

Thursday, 10 August 2006

Post-Dialogue Sight-Seeing Tour organised and sponsored by
The SEACEN Centre
