



# The Advisory Group on APEC Financial System Capacity-Building

**A Public-Private Sector Initiative**

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## **First Meeting 2007**

28 February 2007

The Grand Hyatt Seattle (Menzies Suite, 6<sup>th</sup> Floor)  
Seattle, U.S.A.

## **AGENDA ITEM 4.2**

### **PAPER 4.2-A**

#### **EXECUTIVE SUMMARY**

## **The Implementation of Basel II and Developments in Banking and Supervision in the Asia-Pacific Region: Report of a Public-Private Sector Dialogue**

*Jointly Organized by*

*The South East Asian Central Banks (SEACEN) Research and Training Centre*

*The Asian Bankers' Association (ABA)*

*The APEC Business Advisory Council (ABAC)*

*The Pacific Economic Cooperation Council (PECC)*

# **The Implementation of Basel II and Developments in Banking and Supervision in the Asia-Pacific Region**

## **REPORT OF A PUBLIC-PRIVATE SECTOR DIALOGUE**

Jointly Organized by  
*The South East Asian Central Banks (SEACEN) Research and Training Centre*  
*The Asian Bankers' Association (ABA)*  
*The APEC Business Advisory Council (ABAC)*  
*The Pacific Economic Cooperation Council (PECC)*

August 8-9, 2006  
Kuala Lumpur, Malaysia

### **EXECUTIVE SUMMARY**

#### **INTRODUCTION**

The dialogue, the second convened by SEACEN/ABAC/ABA and PECC, was sponsored and coordinated in conjunction with SEACEN's 8<sup>th</sup> Annual Conference of Directors of Supervision and was attended by around 90 representatives of regulatory agencies and banks operating in the region and international organizations, including the Bank for International Settlements (BIS) and the Asian Development Bank (ADB), and academic finance specialists from the region. SEACEN hosted the dialogue and provided excellent secretariat support and hospitality.

#### **MAJOR ISSUES**

The dialogue was of very high quality and clearly demonstrated the benefits that arose from a highly professional discussion between senior public and private financial sector and multilateral experts.

Improved surveillance across global financial systems and measures to prevent systemic crisis would enhance regional stability.

While at this juncture, it is difficult to judge that Basel II has led to a lowering of the risk profile of the banking in the region, there is near universal agreement that the framework for that to happen is coming into place as Basel II is implemented.

Longer-term success will be measured by the capacity of the region's supervisors and banks to handle stresses in conditions that will almost certainly be very different to stresses evidenced in past crises. Banks and supervisors will need to implement Basel II in a highly cooperative manner, learning from experience and from local conditions and with a clear understanding of emerging regional and global factors that may impact on finance.

Greater commitment to capacity building in the form of public-private partnerships is seen as vital and necessary to deal with the challenges posed in implementing Basel II and in handling risks that will inevitably impact on the region. Deeper levels of cooperation between home and host supervisors and with the industry they supervise are of utmost importance. The following summarises the main points of the dialogue:

- Economies and their regulatory agencies, financial institutions and regional and international organizations need to consider measures to minimize adverse impacts which may arise from the unwinding of major global imbalances.
- At this stage of the evolution of risk management within the Basel II framework, there are valid reasons for not allowing for lower capital charges on a conglomerate bank as a consequence of perceived risk diversification arising from the operations of its foreign subsidiaries.
- Good governance in banking systems is important due to the banking sector's pivotal role in the economy. Lessons from recent major governance failures in the region as well as the introduction of Basel II are spurring regulators and banks to undertake adjustments to improve governance.
- Considerable benefits are forthcoming from coordination between home and host supervisors through the supervisory colleges. However, more coordination is necessary, based on frank and open communications.
- The costs of complying with Basel II are high and raise questions on whether costs outweigh benefits. Overall, the dialogue assessed that the risk management framework and supervisory arrangements in the region's banking systems are improving, and this process should intensify as banks accumulate more data for credit analysis purposes.
- More work and experience is needed in implementing Pillar 3 of Basel II. While increased transparency and disclosure should impart market disciplines on banks and on supervisors, there are pros and cons about how much data needs to be disclosed and these needed to be sensibly balanced.
- Sophisticated risk models based on past experiences may be of limited value in rapidly changing environments, where risk is diffused and experiences with new products and technologies is limited. Emphasis ought to be on good processes and understanding of risk factors – current and prospective.
- Banks and supervisors are well advised not to rush to implement the Foundation Internal Risk Based Approach (F-IRB) or the Advanced IRB (A-IRB) until they have the systems and capacities in place. Nonetheless, they should seek to develop the Basel II framework.
- Basel II requires an enhanced level of information-sharing between home and host supervisors, especially with respect to the oversight of internationally active banks. A number of major common issues have emerged as supervisory authorities in the region prepare to implement the new framework across borders. These issues relate to governance, regulatory reporting, Pillar 2 implementation, the local applicability of global and regional models, local systems' capabilities, outsourcing of processes such as internal audit and data collection, and the supervision of banks using advanced approaches.
- In view of these challenges, the efficient flow of information has become crucial as key to the success of cooperation between home and host supervisors. There is a need to continue strengthening various arrangements for bilateral and multilateral cooperation in the region.

- More intensive efforts at building capacities in the region's supervisory agencies and in regional banks, as well as in building human resources skills remain a major priority and should be so recognized by APEC economies.
- The protection of consumers of financial services from unfair practices and fraud has become an important issue as a consequence of increasing complexity of financial products, technological advances and innovation and deregulation in the financial industry. In dealing with these challenges, regulators have focused on enhancing disclosure, promoting financial literacy and strengthening competition in the industry. However, regulation alone is not sufficient to address issues.
- Growing realization among financial institutions of the benefits to be reaped from adopting pro-consumer business strategies has improved the prospects of public-private sector collaboration to develop effective financial consumer protection frameworks.
- Increased attention has been paid to the protection of creditor rights in response to the expansion of cross-border business and the lessons of the Asian financial crisis. As part of various ongoing efforts, the ADB has developed a set of non-binding regional guidelines for informal workouts and an accompanying model agreement that is applicable within the region, as well as a number of reform and capacity-building proposals to facilitate the operation of a region-wide informal workout regime. [*Refer to Appendices B, C and D.*]

**KEY ISSUES FOR FURTHER CONSIDERATION BY PUBLIC AND PRIVATE SECTOR FINANCE GROUPS IN THE REGION AND BY REGIONAL AND MULTILATERAL AGENCIES**

- Major relevant regional and multilateral agencies and economies ought to consider ways to intensify monitoring and surveillance and promoting better disclosure of data on major imbalances which might impact on regional and global financial stability.
- Improved reviews should be undertaken by international banks of their branches' and subsidiaries' cross-border operations, aimed at ensuring that the appropriate infrastructure is in place to implement Basel II and that local boards are well informed and have the expertise to meet governance obligations.
- Banks and supervisors should carefully review the appropriateness of risk models they may be employing to ensure that they are compatible with the broad objectives of enhanced risk management and governance, namely to equip them to deal effectively with current and future prospective stresses.
- Deeper consideration should be given by supervisors and by the Basel Committee on Banking Supervision to ensuring that the disclosure and transparency requirements of Pillar 3 are compatible with the overall objectives of Basel II, are practical, and do not cause conflict over banks' obligations relating to confidentiality.
- Greater efforts are needed to deepen communication between home and host supervisors through supervisory colleges, with particular attention to the validation of capital required by a host supervisor and to ways to make more transparent definitions, as well as to clarify the process of approval and supervisory reviews relating to capital.
- Bilateral and multilateral cooperation between supervisory agencies should be emphasized. In this context, supervisory colleges provide a useful forum for

improving the information on which regulators base decisions, reducing duplication and inconsistency, improving subsequent bilateral dialogue, and increasing levels of trust among regulatory authorities.

- There remains an urgent need to undertake regional capacity-building activities involving public-private partnerships between economies and their regulatory agencies, financial business groups and regional and multilateral agencies, with the following objectives:
  - to develop best practices for supervisory colleges among member economies' bank supervisory authorities in the cross-border implementation of Basel II;
  - to assist developing economies in achieving progress in implementing Basel II;
  - to improve coordination in dealing with cross-border issues;
  - to develop a financial consumer protection framework and a platform for cooperation on financial consumer protection issues including in cooperation with the International Forum on Financial Consumer Protection and Education; and
  - to monitor the development and implementation of policies and regulations to promote good governance in member economies' banking systems.
- In order to enhance the region's legal infrastructure and to improve the investment climate, APEC member economies should consider endorsing and promoting – for wider adoption by economies and financial institutions in the region – the non-binding regional guidelines for informal workouts, the accompanying model agreement, and the reform and capacity-building proposals developed by ADB in cooperation with the ABA to facilitate the operation of a region-wide informal workout regime.

## SUMMARY CONCLUSIONS AND RECOMMENDATIONS

The sponsors of the dialogue have a strongly shared view that there is great value to be gained from continuing this series of dialogues. We see this as a significant contribution to financial system capacity building in APEC economies. We stress the importance of continuing to promote public-private partnerships of the form constituted for this dialogue to promote the strengthening of the region's financial systems.

### Recommendations

- *ABAC, PECC, SEACEN and ABA should distribute the Report and its 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 that recipients provide advice and observations on the report and on the key issues raised for further consideration to the Coordinating Group. In providing advice, recipients are specifically requested to highlight issues of particular importance relevant to the implementation of Basel II which could be considered at a third dialogue in 2007.*
- *ABAC should convey the report and recommendations to APEC Finance Ministers through the APEC official processes, requesting:*

- i) that it be made available to central bank governors and relevant officials of other appropriate regulatory agencies in their jurisdiction, for consideration and advice on the veracity and appropriateness of the report and its findings and on measures being implemented in response to the various proposals;*
- ii) that APEC Finance Ministers endorse continuation of this series of dialogues in support of the implementation of Basel II and in considering emerging regulatory banking supervisory issues in the region as an important capacity building initiative; and*
- iii) that the report and responses to it as requested above, be discussed with ABAC in forthcoming APEC Senior Finance Officials' Meetings.*