



Australian and Chinese supervisory perspectives on governance and risk management in implementing Basel II

China Australia Governance Program

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Governance provides incentives for boards and management to pursue objectives that are in the interests of banks and their shareholders

To prudential supervisors, governance is an essential element in the safe and sound functioning of a bank

“... risk management process (including Board and senior management oversight) to identify, evaluate, monitor and control or mitigate all material risks and to assess their overall capital adequacy in relation to their risk profile. These processes should be commensurate with the size and complexity of the institution” (Core Principles for Effective Banking Supervision October 2006)

Note: the important concept of proportionality and the ‘link’ to capital rather than Basel II specifically



Each jurisdiction must make its own Basel II implementation decisions

With the benefit of hindsight would APRA implement Basel II differently?

Are there lessons (for China) from Australia's experiences?

(Common) challenges following the introduction of Basel II

But: each banking supervisor has its own legal responsibilities



- Banks in the business of taking risks
- Banks want to hold capital
 - as protection against unexpected loss (and expected losses where provisions are insufficient)
 - to provide them with financial flexibility
 - as a sign of strength to their customers
- Banks manage their own capital levels
 - they have the skills and the incentives
- But there is also a need for regulatory capital
 - for systemic reasons
 - statutory obligations eg depositor insurance or in Australia's case the Australian Banking Act states "It is the duty of APRA to exercise its powers and functions for the protection of depositors"



Regulatory Capital

Depositor protection and system stability

Economic Capital

Maximisation of stockholders wealth - the maximum amount of unexpected losses potentially arising from all sources that could be absorbed while a bank remains solvent, with a given level of confidence over a given time horizon.

Rating agency capital

The minimum level of capital the credit ratings agencies require a bank to hold in order for the bank to maintain its desired credit rating.



| | | Standardised | Advanced |
|-----------------|---|---|--|
| Pillar 1 | Minimum capital requirements for credit, market and operational risk | <p>Credit risk: greater granularity + ratings (where applicable)</p> <p>Operational risk: 'crude' and 'mechanistic'</p> | <p>Credit risk - use of own risk estimates - probability of default, exposure at default, loss from default</p> <p>Operational risk - use of own risk estimates and models</p> |
| Pillar 2 | Supervisory review: banks demonstrate they have capital targets consistent with their overall risk profile and current operating environment, with supervisors ensuring that banks have sound internal processes in place to assess the adequacy of their capital | a 'cruder' approach than that expected of the advanced ADIs | Internal capital adequacy assessment process + supervisory 'review' |
| Pillar 3 | Market discipline | Easily provided capital and credit quality information | Detailed qualitative and quantitative disclosures on capital and risk estimates |



Timing

Staggered or simultaneous implementation of all (the various) Basel II approaches

Tailoring Basel II

Greatest scope for purely domestic banks adopting the standardised approaches

Limited scope for internationally active banks adopting the advanced approaches

Process for approving advanced approaches



Bank supervisors have long pushed banks to improve governance and risk management

Basel II strengthens the link between regulatory capital and risk management

Especially for banks adopting the advanced Basel II approaches under which banks use their own risk estimates (and some models), 'best practice' governance and risk management becomes even more critical



Form and basis of the existing relationships - prescriptive?

- risk-based?

Especially for banks adopting the advanced Basel II approaches, supervisors must develop a better understanding of how banks govern themselves and how they measure and manage their risks

“.... move towards a system of risk-based supervision, developing skills in assessing the quality of a bank’s risk management and its ability to assess risk exposure.” Jaime Caruana
June 2004

Issues of consolidated (domestic and cross-border) supervision of international banking groups through home/host supervisory arrangements



Basis of application for approval to adopt the advanced Basel II approaches

Supervisory approval process

Use and experience

Dealing with the varying state of Basel II readiness of applicant banks - qualitative, quantitative, data, documentation - 'supervisory challenge'

Basel II reporting

Estimating/dealing with potential changes in the level of regulatory capital

Implementing Pillars 2 and 3

Home/host issues



For the banks adopting the advanced Basel II approaches there will be detailed disclosure of risk estimates. That will highlight

- Differences in risk estimates between banks

- Differences in supervisory approaches

The Basel Committee and its working groups are committed to assisting with 'educating' the market