

## NEW APPROACHES TO BANKING REGULATION

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It is probably typical that the first important event held in the new building of the National Bank of Slovakia was a one-day workshop devoted to the topic of the present status and future of the regulation of the banking sector in Slovakia. On 12 June 2002, organisers welcomed almost 100 participants to the workshop in the new congress hall.

The up-to-date relevance and importance of this event is also indicated by the fact that it was presided over by Mr. Ivan Šramko, the Vice-Governor of the National Bank of Slovakia, but also by the large number of participants from among senior managers of Slovak banking institutions. The agenda of the workshop was divided into three integrated parts. The first one dealt with the issue of the so-called New Basel Capital Accord (hereinafter the "NBCA"), which is in the pipeline. The second one related to international accounting standards, particularly to IAS 37 and 39, as well as their implementation in Slovakia, and the third one was about the legislative environment governing the business of banking and its regulation, as well as the current activities and prospects of banking supervision.

### From Old to New Basel Capital Accord

The whole morning session and four presentations were dedicated to the first area. In his introductory presentation, Lubor Malina of the Banking Supervision Division of the National Bank of Slovakia discussed the driving forces leading to an effort to change the still valid Basel Accord and to make the NBCA subject of a broad international discussion. In order to understand the present development and its prospects it is very useful to apprehend the factors leading to the adoption of the original Basel Capital Accord (hereinafter the "BCA"). At the beginning, there was the Group of Ten at the IMF (G-10) created at the level of finance ministers of the ten most developed countries in the world. As early as in 1974, upon the disintegration of the Bretton-Woods system, this group referred to a one-off creation and adoption of an integrated monetary system as something impossible. This period saw the beginning of the evolutionary process of its establishment, at first involving smaller groups of states and through them, impacting an ever-enlarging area. One of the first and key agreements made was the BCA. Although its formulations are an outcome of an inevitable compromise, it is the most important international initiative in the business of banking and, later on, finances following the break-up of the Bretton-Woods system. Even though its application is only obligatory in internationally active banks seated within

the G-10 countries, its impact is global. The comparatively close co-operation between the EEC (now the EU) and the group of G-10 countries, and specifically in the area of banking regulation the co-operation between the Basel Committee on Banking Supervision and the European Commission is not insignificant. This makes it possible to minimise the so-called regulatory arbitrage, i.e. where advantages are won by one institution operating in various countries with different regulation of banking and financial activities. This issue is becoming more and more topical in Slovakia, mainly due to the fact that nowadays a majority interest in almost 90% of the banking sector is held by owners from abroad.

From the moment of its entry into force in 1988, the BCA has become the subject of more or less heavy criticism. Its overriding importance rests in the unification of approaches to understanding the notion of risk and a general methodology for its measurement, and the specification of certain special types of risks as key risks. Concurrently it sets a degree to which owners and shareholders are to bear the consequences of risks undertaken by them, the well-known requirement on the so-called capital adequacy of 8%. The methodology was comparatively simple and was to be equally applied to all relevant banking institutions. This, of course, did not suit especially advanced institutions with a high standard of "technology". That is why, as early as in 1997, a decisive change of approach was adopted, constituting a starting point for a newly proposed NBCA at the same time. The Basel Committee for Banking Supervision, and, through it, the G-10 group, adopted an individual approach to assess the risk profile of each individual institution and the principle of compensation as a basis for performing banking supervision. In its substance, the principle of compensation makes it possible to reduce the required level of capital to cover against risk in return for a higher standard of the risk management process.

In 1997, this principle could only be applied to a portion of a bank's business (the so-called banking book), but the NBCA has already surpassed this limitation, allowing for this principle to be applied to all the business.

Since the publication of its first draft in 1999, the development of the NBCA was relatively complex and sometimes even turbulent. This draft abandoned the simplicity of the original BCA and might appear highly complicated and technical at first sight. Nevertheless, it would be a great mistake to reduce it to a kind of a technical manual. As a matter of fact, its great importance lies in its philosophy. It conceives the process of regulating the whole financial sector, not only the banking sector, as a standard, but com-



prehensive risk management process, with interpretation rules for defined types of risks involved in the process. In formal terms, it is divided into three pillars. Pillar I is represented by the minimum capital requirements, Pillar II by the process of supervision and Pillar III by market discipline, implemented via the disclosure of information on an institution and of the risks associated with its business.

Pillar I has been dedicated to credit and market risks, which were a part of the original BCA accord, and a new type of risk, namely operational risk. We are not going to discuss the credit risk, since it was covered by one of the following presentations. The operational risk is a newly introduced type of risk, which is being widely discussed at present. In particular when it comes to the required degree to which owners and shareholders are to bear the adverse consequences of the risks undertaken by them. The community seems to be heading for a consensus, but the whole issue is not yet concluded.

In this context we would take the liberty of making a small terminological remark. In Slovakia, the English term “credit risk” is frequently translated as “úverové riziko”. In our opinion this is not right, and it only takes the first possible translation of the word “credit” into consideration. At any rate, this type of risk relates not only to loans, but to any kind of relationship where one party has a claim against another. Credit risk is not only present in the case of a loan, and it rather denotes any risk with regard to trustworthiness of the counter-party. We shall therefore consistently use the term “kreditné riziko”.

Pillar III, market discipline, is something new, and will probably become the most sensitive issue during the practical application of the NBCA. Its application should result in the disclosure of aggregate information of the kind presently contained in the so called prudential monitoring reports submitted to national regulators by regulated institutions in respect of their activities. Once again, the aforementioned principle of compensation will apply here: the more information in the required structure and quality an institution discloses about itself, the lower the capital required to cover against the risk undertaken.

Unlike the BCA, the NBCA is applied on both consolidated and unconsolidated basis, and not only to internationally active banks, but also to bank groups or financial groups comprising banks, as well as, for example, to securities dealers and, in certain instances, also to insurance companies.

In order to get an idea on the possible impacts of versions of the NBCA being proposed, the Basel Committee on Banking Supervision has been preparing the so-called impact studies since 2001 (Quantitative Impact Study – QIS). At the present time, the third edition, QIS 3, is being prepared. Slovakia did not participate in the previous studies, but in conclusion to his presentation, the speaker acquainted the participants in the workshop with the NBS’s intention to ask all the banks within the sector to get involved in this important international activity.

## Process of Supervision by Regulator

The second presentation was made by Nick Kerigan of the EBRD. He devoted the first part of his presentation to the content and role of Pillar II of the NBCA, that is the process of regulatory supervision. In the process of supervision, a regulator must assess the quality with which an individual institution manages its risk control process, and its adequacy relative to relevant risk positions. Its role therefore does not solely consist of monitoring the capital adequacy against defined risks, but in fact of overseeing the process in its entirety. One of the key requirements is the application of the principle that a determined level of capital adequacy is a minimum and, depending on the institution’s risk profile, supervisory authorities have the authority to raise this level even above this minimum. This requirement is not an end in itself and draws upon several facts. It goes without saying that credit risk, to which a substantial portion of Pillar I is dedicated, has been a pivotal point from the publication of the first draft of the NBCA in 1999. However, there are still certain significant risks, which either are not covered, or are only partially covered by Pillar I. This, for example, holds true for interest rate risk, which falls fully within the scope of authority of national regulators, or business cycle risk. Although the operational risk is partially included in Pillar I, some of its aspects form a part of Pillar II. In determining the capital necessary to cover against the credit risk, the so-called “w” factor (with a proposed value of 0, or 0.15) has been specified. It was meant to be used in calculating the capital to cover against the so-called residual risks. Its determination today falls within the scope of the authority of national regulators, that is in Pillar II.

Comparison between the BCA and the NBCA in terms of the supervisory process brings us to a conclusion that the original accord did not deal with this area at all. However, in 1997, the Basel Committee for Banking Supervision published twenty-five Core Principles for Effective Banking Supervision and one year later it also published a methodology thereto. In their assessment programs (FSAP), the IMF and the World Bank put great emphasis on the way in which the process of supervision is performed. This is one of the reasons why Pillar II primarily includes decisive factors that influence the risk management process in every financial institution:

- accountability on the part of top management for the process of managing the risk exposure of an institution;
- risk-oriented performance of supervision;
- level of capital adequacy set by a regulator on an individual basis, depending on the institution’s risk profile;
- pro-active approach and prompt corrective action on the part of supervisors.

The whole Pillar II of the NBCA is characterised by the observance of four basic principles. First in the order is the principle that capital adequacy be assigned depending on the institution’s risk profile and its strategy for maintain-

ning the levels of capital adequate to the risk exposure undertaken. It consists of a requirement that banks should be able to show to their regulator that their own internal capital targets are well-founded and are consistent with their risk profiles. The first principle therefore does not encompass any strict rules, but rather is about key elements to be covered. Apart from other things, these include the manner in which the top management oversees the risk management process and its tasks, a sound risk assessment and measurement process, the necessity to cover all more relevant risks, and the like.

The second principle is that a regulator is to oversee the risk management process, monitor it and assess its adequacy. In the event that he does not consider it as adequate, he is to take steps to redress the situation. In this sense, the supervisory authority must review the internal methodology and risk analysis in use in each of the institutions supervised. To this end, a general interview with the top management will not be enough. The authority must review the completeness and adequacy of the risk management process used in the given institution, the quality of management information, the manner in which unexpected events are considered and the compliance with minimum standards as defined for Pillar I. This especially relates to the prerequisites for approving an authorisation to apply more advanced methods for calculating credit risk exposure, etcetera.

The third, and very important principle that must be observed, is that banks are to operate above minimum capital requirements and the supervisor must be able to lawfully require an institution to hold capital above the minimum set. However, there is an observation associated with this principle: capital is not always a sufficient guarantee of an adequate risk management process. It also includes the process itself and the quality of its performance. To put it in figurative terms, any problems with regard to controlling the processes inside the bank need to be resolved through identification of the problem and not by raising the volume of capital.

The last principle is that a supervisor should intervene before any serious problem arises and require rapid remedial action. In terms of powers, this involves an authorisation for a regulator not only to increase monitoring, require more capital, or changes in the bank's controls, but also require changes in its management body.

It is evident that the required significant increase in supervisory discretion will, on the other hand, raise substantially higher demands on the level of the supervisor's accountability and the transparency of his procedures. This means that criteria used in supervision should be publicly available, equally as the reason why the given institution is required to hold a greater volume of capital, and if there be any problems occurring in this institution, it should be told why the supervisor is concerned and the reasons.

The statements made above can be concisely summed

up in the form of the following most important conclusions to be drawn by the regulator and banks: the necessity to put greater emphasis on covering individual risk exposures by capital and greater accountability of the top management. Likewise, they will include a need to really understand the relationship between risk undertaken and capital and the necessity of regularly reviewing the whole process of risk management, and the degree to which the responsible employees have understood it. This can be achieved by making the banks already now study the proposed NBCA and other published documents, and to motivate their employees to understand the new conditions. Banks would start to review and analyse their internal control mechanisms and structures and consider the possible approaches they might apply to credit risk and what capital requirements this may result in.

As for the regulator, the conclusions are almost complementary. He should study in detail the proposed NBCA and relevant documents and raise awareness of the new conditions internally, analyse which knowledge and techniques will be needed, and consider the co-operation with partnership supervisory authorities that will be needed in the future. Key consequences of the NBCA for supervisory authorities consist of an ongoing shift towards a risk-oriented performance of banking supervision, greater power for national regulators in selecting different options, but also greater requirements as to the necessary standard of knowledge, skills and experience. What is definitely not negligible, are increased demands on the transparency of the process of supervision and the degree of responsibility following from its performance.

Outstanding questions which remain to be solved concern some of the potential impacts of the application of the NBCA. The ones that need to be mentioned include a likely development towards global banks, reliance on rating agencies and the questionability of their quality (Enron), reliance on the quality of credit risk models and the procyclicality of such an approach, that is less capital in "good times" and more capital in "bad times", and an increase in the risk and accordingly in the capital required when debtors' problems mount up.

### **Preparation for Implementation of NBCA in the UnitCredito Italiano Group**

A highly interesting presentation that followed was made by Elio Berti of UnitCredito Italiano (hereinafter the "UCI"). As opposed to the preceding presentations, his contribution presented the issue as viewed from the perspective of a regulated institution. In the introduction to his lecture, he briefly reminded the audience of the basic framework for the pending regulation of the banking, and to a certain degree, also of the financial sectors. Then he discussed its impacts on the operation of the UCI and how this banking group is preparing for the implementation of the NBCA.



The implementation of the pending regulation already now requires a considerable mobilisation on the part of banks and in particular banking groups such as the UCI. Whether it is in the area of economic resources or human capacities. During the process, time and available resources in general will be a limiting factor. One of the serious problems is represented by the necessity for a profound revision of the bank's current information systems. This problem must be addressed already today, since in order for the application of the majority of more advanced approaches that at the end of the day would result in lowered capital requirements to become possible, specific data in a time series of at least 3 years will be needed. This data should be available before the implementation of the legislation which is in the pipeline. This means that the definition of necessary data and its collection, especially the data concerning the operational and credit risks, should start no later than on January 1, 2003.

The UCI banking group has been actively involved in the preparation of consultative documents for the NBCA proposal. Both through its participation in the preparation of the QIS and activities pursued in task forces organised by the International Institute of Finance – IIF, namely those on capital adequacy, operational risk and country risk. The preparation of data for the QIS impact study was a process of evolution. For example, the preparation of data for the first two QIS editions required three months of work by three employees of the credit risk management section and one IT person. On the basis of experience with the first edition of QIS, special procedures for retrieving the required data from information systems were developed and two people from the credit risk management section and one IT person have been involved for a period of three months in the preparation of data for the last edition, QIS3. However, it was necessary to engage employees from the whole banking group in the preparation of data for the QIS impact study focused on operational risk. The work was centrally co-ordinated at the level of the credit risk management section and collection of data was conducted at the level of independent legal entities, or business units, who are members of the group. Apart from employees at lower levels, 5 to 10 employees working at the central level were involved in the preparation of this data. Experience has shown that the key problems consist of the identification of points at which the operational risk arises, as well as effective data collection.

As for the credit risk, the UCI banking group drew upon its internal risk measurement systems using the so-called internal models. The intended extension of their applicability and new requirements that need to be fulfilled in order for the bank to be able to use its own models necessitated their revision. Today the UCI has its own rating system and credit portfolio model to measure the credit risk. The internal rating system has been developed for the following segments: loans to large corporates, loans to corporates, loans to small business and retail. The present

review of the whole process of capturing the credit risk has two objectives. It aims to complete the existing credit rating system so as to also include the bank and sovereigns ratings on the one hand, and to extend the existing portfolio model so as to make it also cover foreign exposures of the banking group, securitisation and exposures from derivatives on the other.

In 2001, the banking group created a new internal model of operational risk. The UCI aims to become ready as a group for the fulfilment of requirements that would entitle it to use advanced risk measurement variants - not only for the credit risk, but also for the operational risk, the application of which should ensure the group the lowest capital requirements possible. It is still possible to note a comparatively huge difference between the regulatory and economic capital required.

To sum up the envisaged impacts of the NBCA implementation, the most important ones (both negative and positive) include:

- a gradual effective integration of risk management systems into the day-to-day operations of banks;
- the NBCA creates uneven conditions for market participants, where banks with more advanced technology will be allowed to meet lower capital requirements;
- in order to be able to manage their overall risk effectively, banks will probably be forced to separate production areas (where they manage their credit and market risks) from distribution areas (which theoretically only encompass operational risk);
- it is very difficult to estimate the cost of implementation;
- the NBCA focuses on a sole risk management model within the banking system, which, as a result, may increase the system risk;
- and finally, the implementation of NBCA may cause cyclic fluctuations.

### Specific Features of CEE Countries and Credit Risk

The next lecture was delivered by Petr Kříž of the consulting company PriceWaterhouseCoopers of Prague. In his presentation, he mainly focused on Pillar I of the NBCA and some specific features of the countries of Central and Eastern Europe.

In introduction, he briefly described the current status in respect to the preparation of the NBCA, including the expected time schedule. In this connection it is necessary to use the word “expected”, since the NBCA was originally scheduled for implementation from 2004 onwards. Due to some unclear issues and inconsistent positions of members of the G-10 group, this deadline has been postponed and today the implementation is expected to happen during the course of 2006. Critical issues that still remain to be solved prior to the publication of the definitive NBCA version during the course of 2003 are credit exposures and

the issue of small and middle-sized enterprises, the question of preferential treatment of short-term exposures compared to long-term ones, securitisation, the issue of project financing, calibration in the case of a basic and advanced approach using internal ratings. Previous editions of QIS impact studies highlighted the excessive nature of some of the original capital requirements. This even enhances the importance of the third edition of QIS 3, since based on the results presented therein, the Basel Committee on Banking Supervision, and subsequently the EU, will adopt a definitive version of the NBCA, or an EU directive on its application.

Certain specific features can be observed in the countries of Central and Eastern Europe. The majority of banks in the European Union have already chosen their approach and a prevailing part of the middle-sized and large banks have opted for the so-called basic approach based on internal ratings. Just to refresh the reader's memory: whereas in the case of the so-called standard model, risk weights are defined by the national regulator, in the case of the basic approach employing internal ratings of banks, the risk weight is composed of two parts. One of them is defined by the national regulator, together with the authorization to apply this approach for a particular bank. In the case of an advanced approach, the national regulator gives the bank an authorization to determine this risk weight fully based on its own model.

Quite naturally, great attention is being paid to the area of operational risk, since it generates a lot of vague points. Let us recall one of them, the question whether a quantitative or a qualitative issue is involved. Who should deal with it, the risk management unit or operational units? The seriousness of this problem is shown by the fact that more than half of the banks in the EU have allocated no small resources to its solution. A distinct characteristic feature of the region of Central and Eastern Europe is that the national banking sectors are under majority control of foreign owners. In some of the states this control has effectively reached almost 100%.

In his presentation, the speaker also underlined one point which is sometimes neglected. That is, the application of the NBCA has a marked impact not only on banks, which are the ones who are being mostly mentioned, but also on debtors. It will become a stimulus for the latter to create a market-oriented internal organization and will bring the necessity to develop a corporate culture which would also facilitate the disclosure of information on one's own business. At the same time, it will make it possible to actively use a potentially good rating obtained from a lending institution for marketing purposes, and the like. It is obvious that some businesses will be forced to look for alternative sources of capital and tools to reduce their risk exposure.

What are the specific challenges for the region of Central and Eastern Europe? In the first place, some banks miss satisfactory rating systems and techniques. Since only

a few entities possess an external rating from a renowned rating agency, an increase in capital requirements with a subsequent increase in the cost of lending can be reasonably envisaged. The employment of capital to cover against operational risk will raise demands on capital, without any compensation in the case of other types of risk. Today it is only possible to guess what impact the implementation of the NBCA will actually have on the structure of clients in the banking sector, investment in foreign countries and the overall structure of banking portfolios.

National banking supervisors are faced with problems of no lesser degree. On the one hand, they will have to retrain their employees in procedures necessary for the validation of the approaches chosen by the banks, and on the other hand, they will have to deal with the requirements of head offices of foreign banks operating within the national banking sectors. In conclusion, the impact of some credit risk mitigation techniques was demonstrated using a specific example of the calculation of capital required to cover against credit risk.

### International Accounting Standards and the Situation in Slovakia

The afternoon session of the workshop was devoted to two areas. The first of them concerned international accounting standards and the situation in the SR and the second dealt with the legal framework under which the NBS banking supervision operates, as well as the strategy for future development.

The first presentation was made by Richard Farkaš of KPMG Slovakia in Bratislava. It discussed the topic of application of international accounting standards in Slovakia. In introduction he briefly characterized the situation in the EU. In this context he mentioned that banks in Slovakia are currently one of the few real forces promoting the course of transparent financial statements. This is shown by the fact that, almost without any exception, all the companies compiling the so-called full scope IAS (International Accounting Standards) financial statements under, do so at banks' request. Financial statements complying with the Slovak legal standards are compiled by approximately 60 000 businesses. Only about 550 to 750 entities compile these statements in accordance with legal standards other than the Slovak and several hundred try to do so when asked, by their foreign head offices, to supply their results of operations as of the end of an accounting period in accordance with regulations other than the Slovak. It still needs to be mentioned that only 50 to 70, or 100 to 150 companies in Slovakia compile financial statements under IAS, either in the full scope or at least using the so-called consolidation package forms.

In the next part of his presentation, the speaker analysed some of the reasons why financial statements made according to the Slovak accounting standards do not enjoy such a trust as those made under IAS. The reasons mentioned



also included quality. Although the Accountancy Act declares the necessity to reflect the situation fairly and truly, what constitutes such a fair and true picture is specified by other legal acts. As a result, the conceptions of a fair and true picture under IAS and the Slovak standards are diametrically different. Moreover, the Slovak standards are still prevalingly oriented towards taxation rules and are frequently not observed in practice. This leads to what needs to be done in such a situation. It is undoubtedly necessary to separate accounting and taxation records, as well as to shift the powers relating to accounting regulations from a government authority (the Ministry of Finance of the SR) to an independent body – no matter what name such a body would be called. The IAS standards are not a cure for all ailments and there is no need to glorify them, but currently they represent the best of anything created by the professional community so far.

In the presentation to follow, Sandra Dreimane of Price-WaterhouseCoopers Slovakia discussed in particular two IAS accounting standards, IAS 37 and IAS 39 in greater detail.

### **Strategic Goals and Activities of the NBS Banking Supervision**

The third and last area discussed in this thematically rich workshop was the activities of banking supervision at the NBS. In the first presentation, Peter Baláž of the NBS Banking Supervision Division talked about a legal framework for pursuing business within the banking sector in the SR and for performing banking supervision at the same time. Apart from other things, he acquainted those present with the procedures and time pitfalls accompanying the proposals of the so-called NBS decrees – from the moment of drafting a proposal by the banking supervision through to its adoption by the NBS Banking Board.

The second presentation within this section was delivered by Miloš Švantner, also belonging from the NBS Banking Supervision Division. He introduced the core principles of the strategy for performing banking supervision based on two important documents approved by the NBS Banking Board in December 2001 and May 2002. The former defines the basic plan for developing the banking supervision in the direction of greater effectiveness and making it ready for changed conditions for its performance. In the latter, a basic strategy for achieving the set objectives has been determined, together with the particulars to be contained therein – whether in the form of policies or very specific working procedures. The direction taken on the whole is driven by an effort to make a shift from the so-called mandatory performance of banking supervision, relying on a general control of compliance with legal standards, towards the risk-oriented performance. This method takes into account the specific risk profile of the given bank and, depending on this profile, it treats each of the banks on an individual basis – of course, in compliance with all legal standards and observing the principle that the same problem or risk must receive equal treatment in different institutions.

The entire, and judging by the response received from some of the participants, also successful workshop, was devoted to key issues faced by the financial sector not only domestically, but also globally. It is more than evident that their solution will gradually evolve and will require quite an effort to be made not only on the part of financial institutions, but also by all regulatory authorities. Understanding the issue and the process involved is always the first prerequisite for an effective solution. This workshop with international participation, organized by the National Bank of Slovakia, brought an impulse in this direction.