

*4th Annual International Seminar on Policy  
Challenges for the Financial Sector*



Basel II – The International Banking System at the Crossroads

**Implementation of Basel II in Emerging Markets:  
An Industry Perspective**

Washington, D.C.  
June 1<sup>st</sup>, 2004

Jackson R. Gomes  
Banco Itaú S.A.  
jackson.gomes@itau.com.br

1

## **Agenda**



- 1. Impacts in the Brazilian Market**
- 2. Brazilian Financial Market and the  
New Capital Accord**
- 3. Practical Issues for Implementation – Pillar I**
- 4. Pillar II : Supervisory Review**
- 5. Credit Risk Model Implementation**
- 6. Operational Risk Model Implementation**
- 7. Perspectives**

2

# 1. Impacts in the Brazilian Market



## QIS 3 Results

### World-wide Results – overall percentage change in capital requirements

	Standardised			IRB Foundation			IRB Advanced			
	Average	Max	Min	Average	Max	Min	Average	Max	Min	
<b>Brazil</b>	8%			9%						
<b>G10</b>	Group 1 <sup>(†)</sup>	11%	84%	-15%	3%	55%	-32%	-2%	46%	-36%
	Group 2 <sup>(††)</sup>	3%	81%	-23%	-19%	41%	-58%			
<b>EU</b>	Group 1 <sup>(†)</sup>	6%	31%	-7%	-4%	55%	-32%	-6%	26%	-31%
	Group 2 <sup>(††)</sup>	1%	81%	-67%	-20%	41%	-58%			
<b>Other (***) Groups 1 &amp; 2</b>	12%	103%	-17%	4%	75%	-33%				

(†) Large, diversified and internationally active with Tier 1 capital in excess of €3bn.

(††) Smaller and, in many cases, more specialized.

(\*\*\*) The countries include in this grouping are: Australia, Brazil, Bulgaria, Czech Republic, Chile, China, Hong Kong, Hungary, India, Indonesia, Korea, Malaysia, Malta, Norway, Philippines, Poland, Russia, Saudi Arabia, Singapore, Slovakia, South Africa, Tanzania, Thailand and Turkey.

3

Source: Central Bank of Brazil & BIS

# 1. Impacts in the Brazilian Market



## QIS 3 Results

### Contributions to change in Capital - Standardised Approach

Portfolio	Brazil	G10		EU		Other Groups 1 & 2
		Group 1	Group 2	Group 1	Group 2	
Corporate	2%	1%	-1%	-1%	-1%	0%
Sovereign	0%	0%	0%	0%	0%	1%
Bank	1%	2%	0%	2%	1%	2%
Retail	-4%	-5%	-10%	-5%	-7%	-4%
SME	-1%	-1%	-2%	-2%	-2%	-1%
Securitized assets	0%	1%	0%	1%	0%	0%
Other portfolios	0%	2%	1%	2%	-1%	3%
<b>Overall credit risk</b>	<b>-2%</b>	<b>0%</b>	<b>-11%</b>	<b>-3%</b>	<b>-1%</b>	<b>2%</b>
Operational risk	11%	10%	15%	8%	12%	11%
<b>Overall change</b>	<b>8%</b>	<b>11%</b>	<b>3%</b>	<b>6%</b>	<b>1%</b>	<b>12%</b>

Source: Central Bank of Brazil & BIS

4

# 1. Impacts in the Brazilian Market



## QIS 3 Results

### Contributions to change in Capital – Foundation IRB Approach

Portfolio	Brazil	G10		EU		Other Groups 1 & 2
		Group 1	Group 2	Group 1	Group 2	
Corporate	0%	-2%	-4%	-5%	-5%	-1%
Sovereign	0%	2%	0%	2%	1%	1%
Bank	-1%	2%	-1%	2%	-1%	1%
Retail	-7%	-9%	-17%	-9%	-18%	-8%
SME	-1%	-2%	-4%	-3%	-5%	1%
General Provisions	-1%	0%	-1%	0%	-1%	1%
Securitized assets	0%	-1%	-3%	-2%	-2%	-2%
Other portfolios	6%	4%	3%	3%	5%	5%
Overall credit risk	-4%	-7%	-27%	-13%	-27%	-3%
Operational risk	13%	10%	7%	9%	6%	7%
<b>Overall change</b>	<b>9%</b>	<b>3%</b>	<b>-19%</b>	<b>-4%</b>	<b>-20%</b>	<b>4%</b>

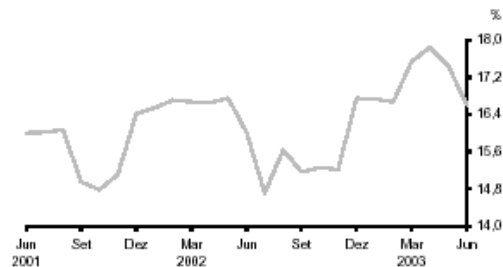
Source: Central Bank of Brazil & BIS

5

# 1. Impacts in the Brazilian Market



## Brazilian Financial System's BIS Ratio Evolution



As of June, 2003

Scenario	Below 11%	Above 11%	Total	Excess Capital
Initial	9,0	16,2	16,2	47%
Number of Banks	2	144	146	
Stress	9,6	14,3	12,2	11%
Number of Banks	38	108	146	

Source: Relatório de Estabilidade Financeira Banco Central do Brasil – Nov/03

6

## 2. Brazilian Financial Market x New Capital Accord



<b>Business</b>	<ul style="list-style-type: none"> <li>• Corporate segment very concentrated</li> <li>• Different credit portfolio profile and different stage of risk management practices among banks</li> </ul>	⇒	<ul style="list-style-type: none"> <li>• Large Banks use portfolio models (not allowed in Basel II)</li> </ul>
<b>Regulation</b>	<ul style="list-style-type: none"> <li>• Central Bank provisioning criteria based on internal rating system (general provision)</li> </ul>	⇒	<ul style="list-style-type: none"> <li>• Aligned to Basel II principles</li> </ul>
<b>Instruments</b>	<ul style="list-style-type: none"> <li>• New Central Bank Credit Information System enhance available public data and foster internal tools (e.g. transition matrix, payment behavior, consolidated exposure, ...)</li> </ul>	⇒	<ul style="list-style-type: none"> <li>• Support to Basel II implementation: model validation</li> </ul>

Critical issues: Data (availability)  
Process certification (cost/complexity)

7

## 3. Practical Issues for Implementation



### Pillar I: Standardized Approach

- Lack of independent ratings;
- Long-term (above three months?) banking exposures penalized :
  - Risk Weight = 150% rated x 100% unrated;
- Country Ceiling;
- Credit Operations heavily based on local funding:
  - External Rating based: Global Scale x Local Scale.

8

### 3. Practical Issues for Implementation



#### Pillar I : IRB (Internal Rating Based)

##### Foundation

- **First Proprietary Model experience ;**
- **Data Base enhancement: historical evolution and quality certification;**
- **Dissemination of advanced techniques of risk management.**

### 3. Practical Issues for Implementation



#### Pillar I : IRB (Internal Rating Based)

##### Advanced

- **Short credit history ;**

Local Regulation

Long recovering process

Difficulty to get LGD

- **Further studies required to estimate impact of stress LGD;**
- **Even new deadline (end of 2007) will not be enough.**

### **3. Practical Issues for Implementation**



#### **Pillar I : Operational Risk**

- **Only major Brazilian banks and some local subsidiaries of International banks started data collection for operational losses;**
- **Current database covers most important, but not all, risk drivers;**
- **Model implementation: AMA modeling complexity and lack of data will required extra work from the Brazilian Central Bank, local banks and subsidiaries of foreign banks.**

11

### **4. Pillar II : Supervisory Review**



- **Local Supervisor will probably need external support to implement new regulation and model validation processes, specially to fulfill the demand of home supervisors of foreign banks operating in Brazil;**
- **Implementation timeframe has to be established to coordinate efforts between banks and supervisor. It is key to success and to avoid unnecessary investments;**
- **Improvement of risk control techniques shall lead to a less conservative posture by the Regulator.**

12

## 5. Credit Risk: Implementation



### Challenges of Implementation:

- **Modeling;**
- **Data structure / Maintenance;**
- **Change in processes / Improvements;**
- **Credit Risk Mitigation – Quality / Value of collaterals;**
- **Well structured plan of implementation;**
- **Complexity of the project coordination.**

13

## 6. Operational Risk: Implementation

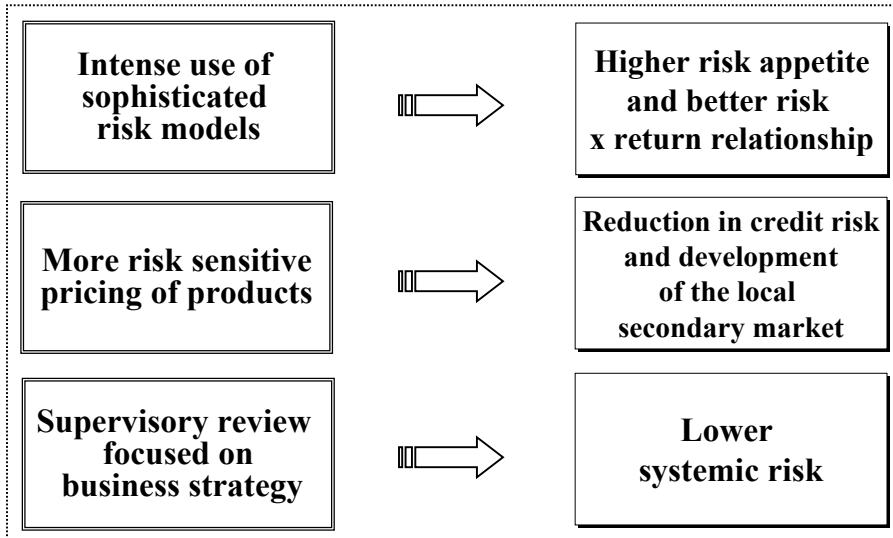


### Challenges of Implementation:

- **Multiple bank structure will probably require new calibration of the Standardized Model;**
- **Recovery and/or implementation data collection of recently acquired banks, in order to meet year-end 2006 requirement;**
- **Enhancement of the current database.**

14

## 7. Perspectives



## 7. Perspectives



### **New Bank Management Approach**

- **Less intuitive and more technically supported decision process;**
- **Long-term instead of short-term planning;**
- **More transparency of financial statements and less conservative accounting rules.**



**END**

**Jackson R. Gomes**  
**Banco Itaú S.A.**  
**[jackson.gomes@itau.com.br](mailto:jackson.gomes@itau.com.br)**