

MERCER OLIVER WYMAN



The World Bank

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Basel II: What's Best for Emerging Markets?



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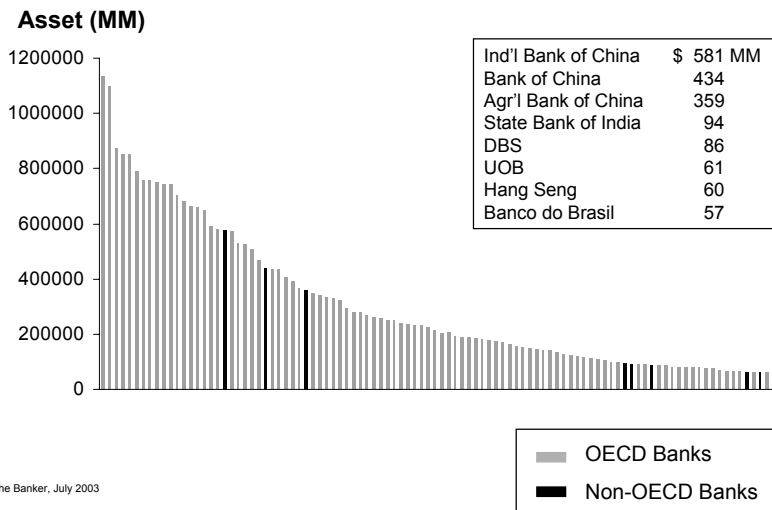
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Provocative View: Basel II Is Neither Necessary Nor Sufficient for Emerging Markets

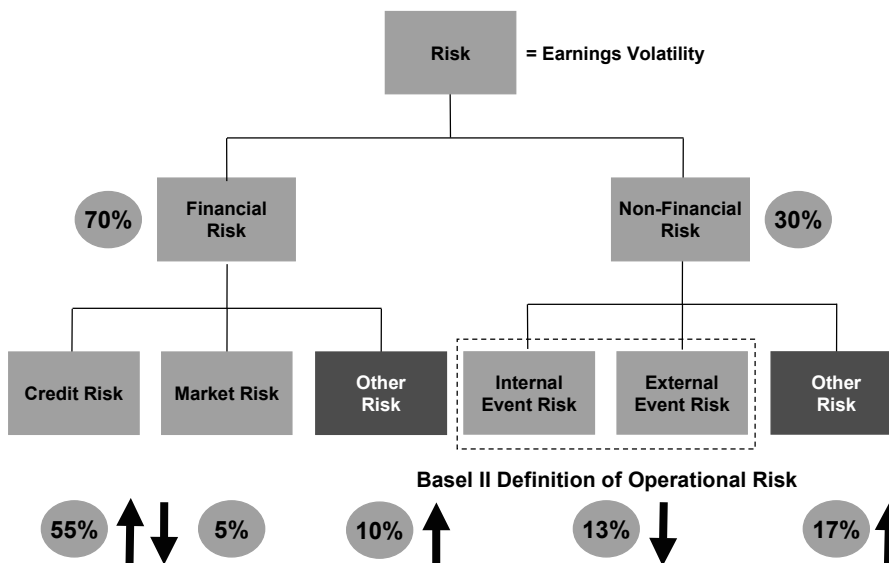
- Not necessary because parts of Basel II cannot be justified on a cost/benefit basis
 - Over-engineered rules for IRB implementation
 - AMA/models based approach for operational risk
 - Onerous data/IT requirements
 - Dual-track system for US banks
- Not sufficient because Basel II ignores critical risks, particularly for Emerging Markets
 - A/L risk
 - Liquidity risk
 - Currency convertibility
 - Political risk
 - Business risk
 - Franchise risk

Not Necessary: Cost/Complexity of Implementation

Global Top 100 Banks Ranked by Assets



Not Sufficient: Differing Risk Profiles in Developed vs. Emerging Markets



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Pragmatic View: Basel II Is the Only Game in Town

- Adoption within G10 is now assured
- Implementation is already well underway among Global Top 100 banks
- International banks active in Emerging Markets will be setting new standard
- Basel II metrics are likely to become universal ruler for assessing bank risk
- Lagging banks run risk of adverse selection and being closed out of international capital markets
- (Many) Basel II principles reflect 'best practices' and are in banks own interest

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Banks in Emerging Markets Should Adopt the 'Best of Basel'

- Internal Ratings: Primary Focus
 - No false comfort in Standardized or Foundation approaches
 - Meaningful ratings are achievable in Emerging Markets
 - Calibration open question in Emerging Markets
- Operational Risk: Second-Order
 - No false comfort in Operational Risk capital
 - Control environment (not capital) is what matters
 - AMA step too far
- 'Other Material Risks': Especially Important in Emerging Markets
 - No false comfort in Pillar I
 - Anticipate market, A/L, liquidity, convertibility, and political risks
 - Avoid Basel II 'crowding-out'

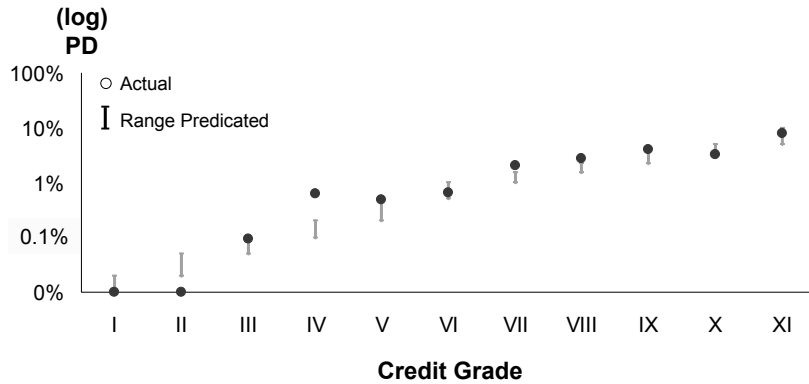
Focus on Internal Rating: Core of Effective Credit Risk Management



"It's Not Just the Law . . . It's a Good Idea"

Robust Rating Systems Are Achievable in Emerging Markets

Asian Bank Large Corporate and Middle Market Rating

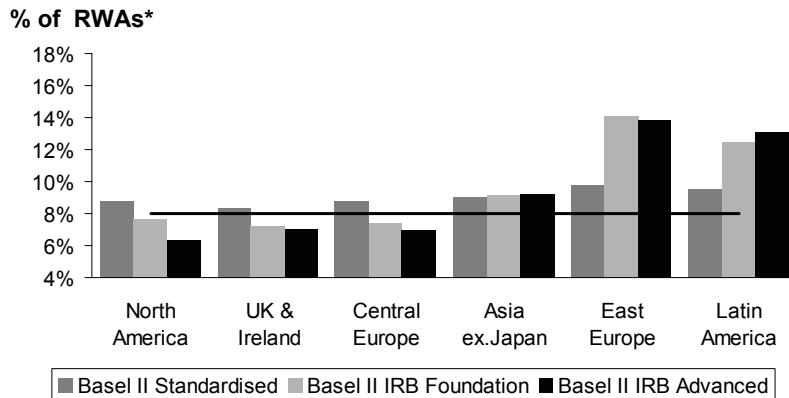


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Key Issue: Pillar I Adverse Incentives for IRB in Emerging Markets

Impact of Basel II



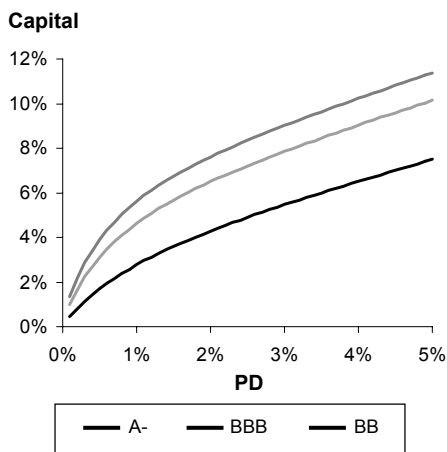
*Sources: QIS 3 formulae, MOW risk parameters and global asset map based on Central Bank data ** Sources: QIS 3 formulae, MOW risk parameters and global asset map based on Central Bank data

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Key Issue: Calibration of IRB Formula

IRB Credit Risk Capital at Different Solvency Levels



IRB Capital at PD = 2.0%

Rating	Confidence Interval	Capital
A-	99.9	7.6%
BBB	99.8	6.5%
BB	98.8	4.3%

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Closing the Gap

- Reducing high compliance costs
- Relaxing IRB validation standards
- Recalibrating IRB formula
- Rebalancing incentives: more carrot and less stick
- Reweighting importance of Pillar II vs. Pillar I

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