Basel II – Policy Implications and Implementation Challenges for Bosnia and Herzegovina

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Abstract

The financial sector and international banking environment in particular has changed dramatically over the past years. In order to reach and maintain stability and sustainability in the global banking system, decrease risk of insolvency, and to cover unexpected losses, countries (EU in particular) have started implementing the new capital adequacy rules (Basel II) following the worldwide consensus among G-10 central bank Governors by which banks' capital levels should be regulated to enhance global financial stability.

Since Bosnia and Herzegovina is still in the beginning of its path towards Basel II legislation and implementation, using detailed literature review and an in-depth analysis this study conducts a comparative analysis on the implementation of Basel II in Bosnia and Herzegovina, Slovenia, Croatia, and Serbia, with regard to both the qualitative and quantitative implementation details and issues which include the implementation stages, progress, and timetables and particular challenges faced by the countries.

Moreover, study reveals Bosnia and Herzegovina's unique situation, challenges and obstacles on the path towards full implementation of Basel II standards and puts an emphasis on how implementation and adoption will affect its banking and economic stability, future and conditions.

Keywords: Basel II, banking supervision, capital adequacy, Bosnia and Herzegovina, central bank, banking agency, risk, risk weight, challenge, adoption, implementation.

1. INTRODUCTION

The ultimate goal of all economies is to reach financial stability and to improve key elements of living standards within that economy. Financial markets, in that regard, are supposed to be active, liquid and trusted regardless of the threats, changes and complexities in the economy. One of the crucial players of the whole economic growth and stability process are banks. Their function has traditionally been to help or mediate funds transfer between those who have a surplus of funds and those who have a fund deficit.. As a consequence of banks' specific role for the society, their impact on the whole economy and their explicit functions, governments worldwide tend to regulate and supervise banks' activities, operations, and risk management in particular, in order to protect banks' customers, liquidity, themselves, but most importantly, to preserve economic stability. In addition to this, fast integration of global financial markets, innovations, and all other complexities highly affected banking sector and the way banks collect, measure and manage risks, and the way they regulate they capital requirements (Makwiramiti, 2008).

In writing of this work the author relayed mostly on Basel Committee on Bank Supervision (BCBS) official publications, scientific articles on Basel II, benefits, weaknesses and challenges. For analysis of BiH in terms of harmonization with Basel II standards, author used publications of Central Bank of BiH (CBBH) and annual reports of Banking Agencies and key banks in BiH. For comparative purposes, data on Basel II implementation stages in Slovenia, Croatia and Serbia was used, mainly from aforementioned countries' Central Banks, and available relevant publications.

These literature resources combined with one year working experience at USAID/PARE project, provided the author with the knowledge base for completion of this work. Due to internal regulation on sensitive information within USAID/PARE project, no report or case study produced by the project could be included in this work. Nevertheless, a significant part of this work is based on knowledge and experience acquired at USAID/PARE project.

2. THE BASEL COMMITTEE AND REGULATIONS

The Basel Committee ('the Committee'), established in Basel (Switzerland), was founded in 1974 by the governors of G-10 group countries and today consists of senior representatives of bank supervisory authorities and central banks from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, Netherlands, Spain, Sweden, Switzerland, United Kingdom and the United States (Sarlija & Gerec Z, 2008). The Committee is an international body that has an aim to harmonize banking supervision, formulate financial regulation policy at the international level and to create preconditions for intensifying international competition of banks (Plochan, 2007).

With increase of competition among banks and with continuing erosion of capital that happened in late 70s, regulators realized that approach to these problems on the international level and standardization of capital regulations was the only possible solution for securing the global banking system. As a result, a common framework for calculating the capital adequacy of banks was proposed. Although subject to implementation variations from one country to another, the Basel regulatory framework was and is being accepted and implemented in all major economies (CEPS Task Force Report, 2008)

2.1. Basel I

Basel I represented a revolutionary agreement whose core was to develop a common risk-adjusted capital standard that would be applied internationally, and by which banks would be obliged to put aside a certain percentage of its capital as reserve when providing loans.

Basel I had two fundamental objectives:

First, to "strengthen the soundness and stability of the international banking system" (by setting the minimum capital adequacy requirements); and

Second that the "framework should be in fair and have a high degree of consistency in its application to banks in different countries" (BCBS, 1988)

To achieve these goals, the Committee concluded that the minimum target standard ratio of capital to weighted risk assets should be set at 8% (of which the Tier 1 capital element will be at least 4%). This basically means that banks were to put aside 8% of the total amount of a loan in reserve when there is a 100% risk associated with that loan.. For simplicity purposes, the Committee decided that only five weights were to be used: 0, 10, 20, 50 and 100%.

Even though it was only "morally, not legally binding, the provisions of the 1988 Basel Accord quickly became the reference point for regulation on credit risk, not just in the original G-10 member countries, but also eventually in over 100 countries throughout the globe" (Ong, 2007).

2.2. Basel II

The Basel II framework is built on three mutually reinforcing pillars, which together should contribute to safety and soundness in the financial system.

The first pillar, covering minimum capital requirements, offers novelties in terms of credit risk quantification (standardized and internal rating based (IRB) approach of measurement); and introduces category of operational risk measurement in the calculation of capital adequacy ratio.

The second pillar concerns supervisory review process is intended not only to ensure that banks have adequate capital to support all the risks in their business, but also to encourage banks to develop and use better risk management techniques in monitoring and managing their risks. (BCBS, 2006)

The third pillar concerning market discipline is to complement the minimum capital requirements (Pillar 1) and the supervisory review process (Pillar 2).

While the Framework takes the form of an agreement among the BCBS members – and so the implementation is voluntary – in the EU, the framework is a part of legislation and is binding for all EU countries. EU, by the means of Capital Requirements Directive (CRD) required all financial institutions (regardless of size and geographic activity to fully implement the basic Basel II approaches by January 2008, which is when Basel II is compulsory for all approaches. (ECB, 2005)

3. BASEL II IMPLEMENTATION – COMPARATIVE ANALYSIS

3.1. Slovenia

Lessons that can be learned from the case of Slovenia are: due to the fact that Basel II can adversely affect SMEs and can be extremely costly for low profile domestic banks, the government (and Central Bank in particular) should consider introducing slight changes into legislation (as compared to original Accord) in order to protect businesses and banks within country, but also to preserve financial stability and prosperity of the country. Moreover, in order to overcome the problem with lack of skilled staff for implementation of Basel II, timely trainings and capacity buildings should be organized, so that institutions have people that can cope with all of the tasks and challenges the implementation and understanding of Basel II brings. (Jagric, Jagric, & Podobnik, 2008)

3.2. Croatia

Problems and challenges Croatia faced during Basel II implementations are similar to those already mentioned in the case of Slovenia. Nevertheless, Croatia can be used as an example of Country that managed to increase awareness of all benefits of Basel II through regular publications by National Bank that served as a "manual" for understanding Basel II theory, practice and all relevant surrounding issues. Moreover, it organized various workshops, seminars and trainings for banks even before adoption of Basel II, so that they were able to prepare for all of the challenges and tasks of it, and to be able to continue operating successfully. (Jakovcevic, 2003; CNB, 2008; CNB, 2011)

3.3. Serbia

The biggest problems banks in Serbia faced during the implementation of Basel II standards were primarily the costs of staff training and building information systems, improvement of information technology - the development of models and databases, as well as the lack of qualified staff (NBS, 2009). To solve the IT problem, a group of banks purchased ready software, while some banks began creating and designing their own software to be used in meeting the Basel standards. Another solution for overcoming this problem is a domestic product developed by Serbia Center for Investment and Finance that could be a unique and less expensive solution for the introduction of Basel II standards. (http://www.cif.co.rs/). This is not only a less costly solution, but also an easier way for the banks to employ, adapt and get their staff experienced with IT systems and software.

4. BOSNIA AND HERZEGOVINA AND BASEL II

Table 1 displays the total number of banks in Federation of Bosnia and Herzegovina and Republika Srpska over the period 2000 to 2011.

Year	FBiH	CAR*	RS**	CAR*
2000	N/A	26,3%	18	36,1%
2001	N/A	22,4%	16	37,5%
2002	29	19,8%	11	24%
2003	27	19,6%	10	24%
2004	24	18,6%	9	19%
2005	24	17,5%	9	19%
2006	23	17,6%	9	18%
2007	22	17,3%	10	16%
2008	20	16,4%	10	15,7%
2009	20	16,1%	10	15,8%
2010	19	16,2%	10	16,19%
2011	19	15,3%	10	N/A

*CAR – Capital Adequacy Ratio (calculated as ratio of net capital and risk weighted assets)

** + Organizational Units of Banks from Federation BH

Table 1 - Compiled from FBiH and RS Banking Agencies' annual reports

Current regulations in BiH (in both entities) are in accordance with Basel I. Since there are differences in legislation across entities and due to complexity of political and economic situation in BiH, it would be extremely hard to harmonize this legislation on the state level. Competent people from both agencies agree however that harmonizing with EU Directives and Accord Rules is much simpler and "painless" process that would eventually result in harmonization on the state level. Since 2008 the activities on preparation and adoption of Basel II were initiated. It is important to emphasize that while BiH is working on introduction of Basel II, Basel III is in the process of adoption and entry into force across the EU.

As of December 2008 in FBiH and February 2009 in RS, Banking Agencies adopted a strategy for introducing the Basel II standards. Both Agencies emphasized the fact that Bosnia and Herzegovina, as a country that strives to join the EU, is obliged to make preparations for full adoption of Basel II and EU Directives and that this is one of the conditions for becoming a candidate country. Furthermore, with a strong believe in positive impacts of implementation on banking sector, they concluded that transition is to be done cautiously, gradually and according to the principle "from simple to more complex", with insuring that banks gradually develop their capacities and capabilities to apply new frameworks and that Agencies develop capacities to design and implement the supervisory procedure defined by Basel II. (FBA, 2008; ABRS, 2009)

As of today, BiH is in the phase adopting legislation (draft legislation is prepared, but not published and adopted). Although all major banks (in accordance with parent bank requirements) in practice follow the EU requirements, they still create reports in accordance

with the domestic legislation and requirements, which without any doubt creates many complexities and increases uncertainty about banking sector of BiH.

4.1. Proposed Next Steps

Having in mind lessons learned from previously analyzed countries, the following suggestions can be identified:

In order to avoid resistance to change and further delays, educational component is very important. Besides regulators, a knowledge base for banks should also be created. This can be done either by organizing regular sessions and workshops, or by publishing manuals, as it was case in Croatia.

Bring consultants to take one bank (preferably domestic), guide it throughout the whole process of implementation, promote new models and reporting system, teach its people how to interpret data using new approaches and make them aware that these changes will not bring additional risks. Processes and exercises made with this bank can eventually serve as a template for all other banks across country.

Developing proper and common IT/MIS systems – since there will be need for ongoing coordination between the BSAs, CBBH and key regulatory institutions, and since it will be necessary to harmonize reporting formats and protocols, interactive IT systems will play a crucial role. As examples of Slovenia, Croatia and Serbia showed, this is a very expensive and challenging process, and it could be worth considering developing domestic IT solutions, as a less expensive solution.

Finally, it is necessary to emphasize the need for undertaking all these activities without disturbing and interfering with banks' everyday business. Customers should not be adversely affected by the transition period and should not bring into question the trustworthiness of the bank.

5. CONCLUSION

Effects of the implementation of Basel II/III to the banking sector in BiH will surely cause the reorganization of banks, whose capital requirements would be significantly increased. Moreover, pressure on banks to increase the amount and quality of capital would impose costs and lead to increased interest rates to customers. Even though these conservative policies and increase in interest rates would in the short-term lead to decrease in the number of granted loans, in the long-term, the successful implementation would lead to greater stability of the banking system and increase the competitiveness of banks in BiH with the banks in the world.

In the short term, the introduction of Basel II/III could endanger the competitiveness of weaker banks since the increase of the capital level is more expensive for them than for larger banks. When it comes to profits of the banks in general, they would also be decreased in the short-term, since a particular amount would be separated to meet the minimum credit requirements.

Nevertheless, a successful implementation of Basel II/III in BiH would lead to safer and more stable banking system. Improved and more formalized risk management would result in better assessment, quantification and greater awareness of risks in general. Also, bringing BiH banking sector regulations closer to the policies of EU banking would take BiH a step closer to the EU. Successful implementation of Basel II will unquestionably contribute to a more resilient and stable banking system that is capable of not only being a good intermediary, but also promoting sustainable economic growth. (Caruana, 2006)

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