Basel II: The Taiwanese Effect

In Taiwan, one potential consequence of the pending deployment of Basel II is consolidation in the highly competitive banking industry. What Basel II factors must Taiwanese banks consider before moving forward with implementation plans? And will the accord really fuel mass mergers? Niclas Hageback investigates.

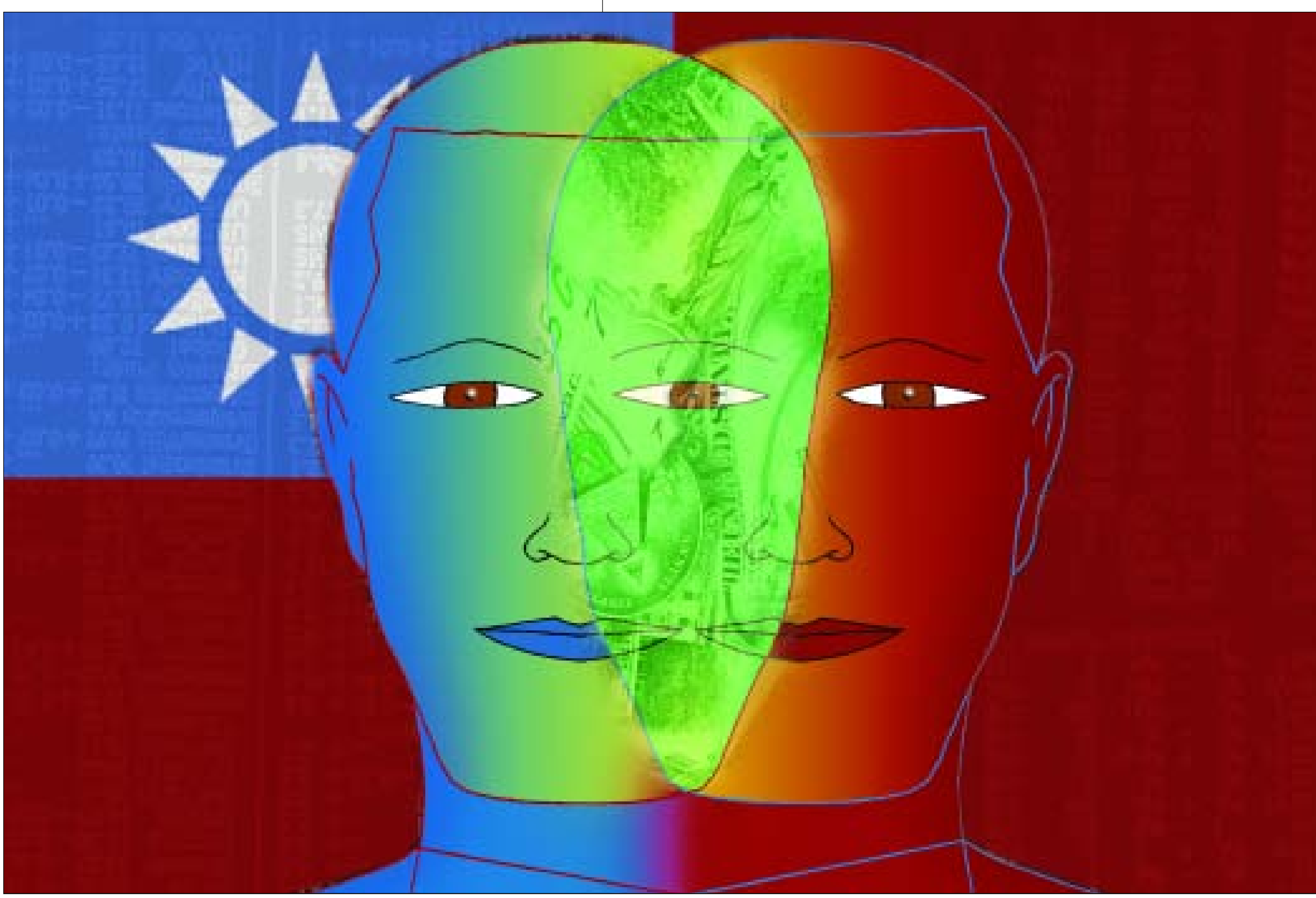
The Basel II capital accord may eventually stimulate consolidation in the overcrowded Taiwanese financial marketplace. Today, the Taiwanese financial sector is overflowing with banks embroiled in intense competition, and many banks have consequently suffered from eroding profit margins. But complying with Basel II will be a costly endeavor – even for banks that are adopting only the least sophisticated approaches of the global capital accord.

Taking into account the costs factor of Basel II and the imminent launch of new, local risk management rules that will complement the accord, there is little doubt that the Taiwanese banking landscape will be altered by sweeping changes over the next few years. The market has to date been fairly resistant to consolidation, but the heavy regulatory burden tied to Basel II will force banks to make tough decisions.

Some banks may ultimately decide to upgrade their operations to meet new standards for banking industry best practices, while others may merge with a competitor to gain a revenue base large enough to justify Basel II investments. Meanwhile, still other banks may ultimately choose to pull out of the market all together, recognizing their dim prospects of ever achieving long-term profitability.

Taiwanese Banking Sector: Recent History

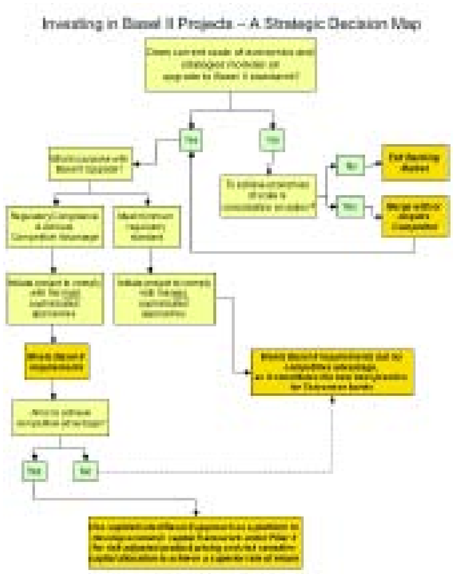
At the end of 2003, there were 51 domestic banks, 400 depository institutions and 36 foreign financial institutions



operating in the Taiwanese banking sector. While most of the domestic banks are small and operate in low-profit margin areas, they still account for the overwhelming majority of deposits and loans.

Taiwan has a population of 22 million, and the overcrowded banking market has not only eroded margins but also resulted in an increase in low-risk adjusted loans and poor asset quality. What's more, some ratings agencies share the view that Taiwanese banks' reported nonperforming loans and asset quality numbers are understating their economic realities and that the loan loss reserves are not supporting the actual exposures, even with a more rigid standard of NPL definitions being imposed by the regulators.

Basel II Flowchart



The stiff competition and low profit margins in traditional areas are forcing a lot of banks to explore new enterprises to diversify eroding revenue streams — a trend that has added new and unidentified risk exposures that most of the banks, given their lack of a modern risk management framework, cannot manage properly.

Basel II updates the 1988 Basel accord, establishing a more sophisticated set of standards for determining regulatory capital levels that are applied to banks internationally. Basel II is scheduled to be implemented by various countries' financial regulators by the end of 2006, but the preparation work needs to start long before. The broader impact of Basel II will be to bring competitive advantage to those financial institutions that can re-shape their operations in an effort to optimize their capital structure and allocations — as well as to align their internal processes with the external compliance standards.

There are a host of challenges in the Taiwanese banking sector: the most significant include the need for more accurate and comprehensive methods for identifying and measuring operational risks; the desire for enhanced sourcing and integration of data about credit exposures; and inefficient methods for sourcing the required data from many different transaction systems. These large implementation projects will have wide-ranging effects on banks' information technology systems, processes, people and businesses.

A recent study conducted by McKinsey & Co., a Chicago-based consulting firm, estimates that the average costs of implementing Basel II at diversified regional banks in the US is between $25 and $50 million. The study emphasized that much of these costs are likely to occur anyway, given that banks need to keep pace with industry best practice and ratings agency requirements.

For domestic banks in Taiwan, which generally have smaller operations than regional US banks, the costs for Basel II projects are expected to be lower, but would still be in the area of several million USD; these implementation costs, in addition to annual Basel II maintenance charges, will force banks to operate from a higher cost base.

In Taiwan, the largest implementation costs will most likely stem from investments in IT solutions and from consultant fees paid to third-party experts.

A Trio of Options

Given the costs and complexities of implementing Basel II, domestic Taiwanese banks have three strategic options to consider: (1) invest; (2) consolidate; or (3) exit. The first strategic option requires a bank to invest the capital necessary to upgrade its operations to achieve Basel II compliance. A bank that decides on investing to ensure Basel II compliance needs to take a long-term view on its participation in the Taiwanese banking market, realizing that drastic changes to its operations and the way it does business might be needed.

Before moving forward with a Basel II implementation project, one important question must be considered: Does a bank's Basel II strategy only aim to meet upcoming minimum regulatory requirements as a forced regulatory overhead cost of remaining in business in the Taiwanese banking market?

If the answer to that query is yes, the investment option is not really viable, because the bank is not intent on making the risk management enhancements necessary to distinguish itself from other banks. However, if Basel II is seen as an opportunity to achieve a competitive advantage, compliance with the accord's more advanced approaches is the preferred alternative; the advanced risk measurement approaches of

Basel II could help a Taiwanese bank separate itself from the pack, because most of its domestic competitors will be implementing only the less sophisticated approaches.

With the more sophisticated approaches serving as a platform, the development of risk-adjusted pricing tools under Pillar II is possible — and such tools will provide a better understanding of the risk-return trade-off for capital supporting specific businesses, customers, products and processes.

Banks with integrated economic capital pricing tools may be able to cherry pick and undercut loan pricing to gain market share on markets where loans were overpriced — and also may be able to exit under-priced loan markets. In contrast, banks that have not developed risk-adjusted performance measures could suffer from adverse selection, often as a result of accepting significantly under-priced loans.

Taiwanese banks that choose the second strategic option — consolidation — will merge with or acquire a competitor to achieve the sufficient economies of scale. If the burden of implementing Basel II requirements proves too costly for an individual bank and its view is that its profitability never can provide a reasonable return on capital, consolidation or exit are then the only plausible alternatives.

Merging with or acquiring a competitor makes sense for Taiwanese banks that will have very limited opportunities for organic growth in a post-Basel world, due to intense competition. However, banks that choose this route should proceed with caution.

Amalgamating different organizations' business operations and IT platforms is a complex and time-consuming task — and full integration needs to be achieved before a merged entity initiates a Basel II implementation project. Thus, given the deadline for Basel II deployment, banks that choose to consolidate may be limited by time constraints.

A complete exit from the banking market is one final option for Taiwanese banks facing Basel II. This option may be selected by a few banks that have very dim prospects of ever achieving profitability, because of the huge infrastructure investments they would have to make to achieve Basel II compliance.

Domestic banks with only very rudimentary risk management and IT infrastructures may gradually come to the realization that radical strategy and operations reforms are necessary to meet the demands of Basel II; these banks simply may have no choice but to close up shop, because the costs of upgrading would not justify the participation in a highly competitive banking market.

Breaking Down Basel

Basel II is a global capital accord comprised of three complementary pillars:

■ **Pillar 1: Minimum Capital Requirements**
Expands the 1988 accord by introducing a capital charge for operational risk, in addition to refining the existing provisions for credit risk and market risk. For the more advanced approaches, Pillar 1 also introduces sophisticated measurement models for regulatory capital calculation.

■ **Pillar 2: Supervisory Review**
Specifies the bank's own responsibilities for risk evaluation and capital adequacy, together with internationally harmonized regulatory review. It gives the board and senior management specific oversight responsibilities, reinforcing the principles of internal control as corporate governance principles.

■ **Pillar 3: Market Discipline**
Requires banks to disclose their risk assessment methods and capital adequacy calculations.

The timing of the Basel II implementation is a good opportunity for Taiwanese banks to consider their overall objectives and their rationale for participating in an overcrowded banking market. Unless banks are prepared to make investments and perhaps significantly reform their business model and operations, the implementation of Basel II will provide the impetus for many Taiwanese banks to consider merging with competitors. Indeed, for some banks in the post-Basel II world, consolidation will represent the only plausible way to achieve the economies of scale necessary to ensure long-term profitability and survival. ■

REFERENCES:
1. Basel Committee on Banking Supervision. *"International Convergence of Capital Measurement and Capital Standards: A Revised Framework,"* 2004.
2. Basel Committee on Banking Supervision. *"Implementation of Basel II: Practical Considerations,"* 2004.
3. K. Buehler, V. D'Silva & G. Pritsch. *"The Business Case for Basel II,"* The McKinsey Quarterly, 2004, Number 1.
4. Bureau of Monetary Affairs, Ministry of Finance, R.O.C. *"Annual Report,"* 2003.
5. KPMG. *"Basel II: A Worldwide Challenge for the Banking Business,"* 2003.
6. Moody's Investor Service. *"Rating Action: Moody's says outlook for Taiwan banks stable, but consolidation could prompt changes,"* December 19, 2003.
7. Moody's Investor Service. *"Taiwanese Financial Holding Companies: Moody's rating approach and outlook,"* February 2003.
8. The Central Bank of China. *"Annual Report,"* 2003.

✎ **NICLAS HAGEBACK** is a director in KPMG Asia Pacific's Bank & Finance Group. He can be reached at niclashageback@kpmg.com.tw.