William J McDonough: Implementing the New Basel Accord

Remarks by Mr William J McDonough, President and Chief Executive Officer of the Federal Reserve Bank of New York, before the Global Association of Risk Professionals, New York, 11 February 2003.

*   *   *

1. Introduction

Thank you for that kind introduction. It’s a pleasure for me to be here today in my capacity as Chairman of the Basel Committee on Banking Supervision and President of the Federal Reserve Bank of New York.

The topics to be discussed at this conference certainly are timely. One need not look any further than recent news headlines to understand why the work of a risk management professional matters so much. Current events remind us that when companies lack the commitment to manage their risks prudently, they will quickly fail to uphold their responsibilities to their shareholders, to their employees, and, ultimately, to the public at large. Those failures are felt not just as a loss of jobs, or investments, or savings, but also as the loss of public confidence in the soundness of our economy.

Sound corporate governance only comes about when there is a genuine commitment to do the right thing and to manage risks in whatever form they arise. Risk managers must provide timely, objective and accurate information to their senior management. In turn, senior management and a bank’s board of directors need to ensure that there is an atmosphere of transparency within the firm - one that promotes healthy, disciplined risk taking.

The challenge of managing risks in the financial sector is made greater by the tremendous spirit of innovation that fuels growth and healthy competition among banks and other firms. Bankers have long competed on their abilities to tailor products and services to each client’s unique needs. New opportunities for profit often change the nature of the known risks a bank may face - they may also expose an institution to unknown pitfalls.

As a former commercial banker, I know that responsibility for understanding and managing risks and potential pitfalls rests with senior management and its board of directors. As a supervisor, I believe that we should create incentives to help motivate responsible behavior within firms. Further, as Chairman of the Basel Committee, I see the work of the Committee as helping to foster safe and sound banking systems by creating incentives for banks to improve their understanding and management of risk, and, in turn, to contribute to greater stability within the financial sector.

Encouraging the improvement of risk management in banks, is, indeed, the overarching goal of the Committee's efforts to revise the Basel Capital Accord. In my remarks today, I’d like to focus on the challenges associated with implementation of the new framework now that the revision process is coming to an end. First, I'll spend a few moments discussing the evolution and structure of the New Accord. Then, I would like to provide some insights into the preparations banks and supervisors are making to implement the new framework - both internationally and here in the U.S. I’ll end my remarks with some thoughts on where we are in the Capital Accord revision process.

2. Objectives for revising the Capital Accord

As you may know, the Committee’s process to revise the Capital Accord began in the late 1990s. It became clear at that time that the original Accord was becoming outdated. Its broad-brush nature - where required capital generally does not differ by degree of risk – has had a tendency to discourage certain types of bank lending. It has also tended to encourage transactions whose sole benefit is regulatory capital relief.

Further, banks have been developing new methods for monitoring and managing risk in a manner that the 1988 Accord did not anticipate or address. It is due to the hard work of risk professionals and the ideas advanced through organizations like GARP that banks today have an ever improving tool box for identifying, measuring, and controlling risk. In light of those new tools, it is quite clear that the current Accord provides internationally active banks, for which it was originally intended, with less meaningful measures of the risks they face and of the capital they should hold against them.

To respond to these challenges, the Committee has sought to develop a more flexible and forward-looking capital adequacy framework - one that better reflects the risks facing banks and encourages them to make ongoing improvements in their risk assessment capabilities. The Committee believes that all banks should be subject to a capital adequacy framework comprising minimum capital requirements, supervisory review, and market discipline. As you know, these are the three "pillars" of the New Accord. Each is an essential element for ensuring the safety and soundness of banks worldwide. In contrast, the current Accord only has one pillar - minimum capital requirements.

As we all agree, risk management is a dynamic process and one that will continue to evolve. Consequently, the New Accord is designed to accommodate future changes in the way banks measure and manage their risks by giving banks a range of options for calculating capital charges and incentives for using best practices. Banks will be expected to apply the option most appropriate to the complexity of their own operations and risk management capabilities.

For credit risk, the range of options begins with the standardized approach and extends to the internal ratings based (IRB) approach. The standardized approach, as you know, is structurally similar to the 1988 Accord, where banks are required to differentiate their exposures into broad categories, such as loans they have made to corporate and sovereign borrowers or banks. It improves on the 1988 Accord by aligning risk weights with a borrower's creditworthiness as indicated by an external credit rating.

The IRB approach goes further and is one of the most innovative features of the New Accord. It has been constructed to build upon and further encourage investments banks are already making in their internal risk management systems. As you know, these systems have been developed and further refined to promote a bank's competitiveness and to protect it against loss - and not just to respond to a regulatory mandate.

Banks using the IRB approach will be permitted to quantify key measures of a borrower's creditworthiness in determining the corresponding capital requirement. This will include estimating the likelihood that the borrower will default. Many banks will also be able to provide internal estimates of other key variables, such as the recovery rate if a borrower were to default and the likelihood of a credit line being drawn upon. While banks adopting the IRB approach will have the flexibility to rely on their own estimates of key risk parameters, those estimates will be subject to a set of minimum operational requirements. The aim of these standards is to ensure that these critical inputs have integrity and are the product of a system the bank relies upon to perform its day-to-day operations. Further, through pillars two and three, the new framework builds in additional checks and balances to ensure that banks' systems will generate accurate and timely credit assessments.

The Committee believes it critical to complement the more risk reflective capital requirements with the added incentives of supervisory review and market discipline. The second pillar of the new framework focuses on the need for banks to conduct their own assessments of the amount of capital they should hold relative to their risk. Supervisors will be expected to review and respond to these assessments. I believe that discussions between bankers and their supervisors will create added incentives for management to assess its risks carefully. No longer will the emphasis solely be on whether a bank complies with regulatory minimums. Rather, banks will be expected to manage their economic needs and operate with a capital buffer at levels above the regulatory minima. Accordingly, there will be a need for strong capabilities by banks and supervisors alike to evaluate banks' level of risk appropriately.

Market participants also will play an important role in evaluating the adequacy of bank capital. Greater disclosure of key risk elements and capital by banks will provide important information to counterparties and investors, who need these data to develop an informed view of a bank's risk profile. By bringing greater market discipline to bear through enhanced disclosures, I believe the third pillar of the New Accord, the market discipline component, can produce significant benefits. It will help to encourage banks to manage their risks prudently and, by supplementing official supervision, thereby also improve financial stability.

3. Implementation of the New Accord

(a) Overview

Today, the Committee is close to finalizing the new capital framework, and I know that many banks and supervisors in different countries have already begun to think about the practical implications surrounding implementation. This second stage of the Basel II effort is close on the horizon, and both banks and supervisors must give serious thought to what they need to do to get ready. I'd like to spend a few moments describing some of the efforts currently underway.

It is no secret that implementation of the New Accord will require a substantial resource commitment on the part of banks and supervisors alike. I think it is important to emphasize that the efforts banks will need to undertake to comply with Basel II build on the efforts that some large and well-managed banks already had in train before the new framework was contemplated. I know that many banks are devoting more attention to enhance tracking and assessment of the quality of the loans they make. Further, banks have been looking to strengthen their credit assessments by employing experts who do not stand to gain from overly favorable reviews. Time and effort has also been invested in working to pull all of this together in a management information and control system that produces timely and accurate reports for senior management review. I expect that much of the cost to banks of adopting the advanced approaches of Basel II will come from precisely these types of initiatives.

While it will not be inexpensive to achieve these capabilities, particularly for a very large and diverse organization, I believe that it is essential for the largest and most complex U.S. banking organizations to continue down this path. We know all too well the costs to society of bank weakness and ultimately bank failures. As our largest banks continue to grow, to prosper and to pursue new opportunities, they must simultaneously make the investments required to manage themselves appropriately.

Likewise, the new framework is providing supervisors with an opportunity to enhance their ability to identify and respond to sources of banking risk, and to share this knowledge within the supervisory community. The Basel Committee was established precisely to maintain an open and constructive dialogue among banking supervisors. This spirit of communication will be more crucial than ever as the new framework is adopted across national jurisdictions. To help ensure that market competition is driven by each bank's strengths, rather than by differences in each country's regulatory capital rules, the Committee established the Accord Implementation Group. This group, comprised of senior line supervisors, is responsible for promoting the consistency and quality of implementation of the New Accord. Further, the group has been established to facilitate the exchange of information among national supervisors about bank and supervisory practices. This is something that I view as being critical to successful implementation of the New Accord.

(b) Challenges for banks

Within the United States, supervisors have long considered how the new framework will apply to our banks. Recently, our efforts have focused on the preparations and challenges ahead for some of the largest U.S. banks as they look towards implementing the IRB approach to credit risk. Among other important topics, the dialogue has focused on application of the minimum standards for entry and on-going use of the IRB approach.

Our sense from this interaction is that banks have both the desire and commitment to continue to develop their internal ratings systems in a manner consistent with the ideals embodied in the IRB framework. The discussions with the industry have also highlighted a number of areas where banks may need to expand their efforts in preparing for implementation. These include the design and structure of rating systems; the availability and quality of credit data; and the role of corporate governance in evaluating bank assessments. I will touch on each of these in turn.

Rating system design

The design of a risk rating system is key to its effectiveness. The Basel Committee believes that banks' internal rating systems should accurately and consistently differentiate between degrees of risk. The minimum IRB standards in this area build on leading risk management practices observed in the industry. For example, many organizations either already have, or are in the process of developing, a ratings system that captures both the risk of borrower default, as well as transaction-specific factors that shed light on the amount that could be collected if things were to go poorly. In other words, these banks' systems are generally oriented to capturing the essential components in estimating credit risk.

As the methods for measuring credit risk improve, we expect that banks will incorporate these new insights in their ratings practices. For example, banks may look to expand the number of ratings categories to more finely distinguish between exposures of different credit quality. However, the challenge is for banks to clearly and objectively define the criteria for these ratings categories in order to provide more meaningful assessments of both individual credit exposures and, ultimately, their overall risk profile. The clarity and transparency of the ratings criteria will be critical to ensuring that ratings are assigned in a disciplined and reliable manner.

It is also important to note that it is not enough to have a well-designed internal risk rating system - it must also be an integral part of a bank's day-to-day credit risk management processes. The expectation is for banks to rely on their internal risk rating systems not just when making decisions about whether to extend credit. We also encourage banks to incorporate ratings information into other key processes, such as pricing and reserving determinations and when allocating economic capital internally. The more a bank makes use of its risk rating system, the more confidence supervisors are likely to have in the results of the banks' assessments of their capital needs.

Data requirements and validation

Clearly, a system is only as good as the inputs that go into it. Accordingly, banks using the IRB approach will need to be able to measure the key statistical drivers of credit risk. The minimum Basel operational standards provide banks with the flexibility to rely on data based either on internal experience or generated by an external source, as long as the bank can demonstrate the relevance of the external data to its own exposures. Regardless of source, sound data are critical for formulating meaningful internal risk assessments. From a broader risk management perspective, access to high quality data will enable a bank to evaluate the performance of its internal rating and risk estimation systems in a consistent and meaningful manner.

The Basel standards outline the data history banks will need to use the IRB approach. The Committee recognizes that banks may not currently have all of the required information on hand. For this reason we have continued to engage market participants in a dialogue on this issue. As implementation of the New Accord approaches, we encourage banks to consider their data needs very seriously and to comprehend fully the techniques they will need to use to derive appropriate estimates of loss based on those data. Critical to this process is the need for banks to understand how the estimates produced by their internal ratings systems compare with the actual performance of a borrower. In practical terms, banks will be expected to have in place - or be actively developing - a data "warehouse". By data warehouse, I mean a process that enables a bank to collect, to store, and to draw upon loss statistics in an efficient manner over time.

Corporate governance

I mentioned earlier that responsibility for managing risk lies squarely with senior management and its board of directors, and I know that the involvement of senior management will be critical to the successful implementation of the New Accord. This will be particularly true for those banks seeking to adopt the more advanced approaches to calculating regulatory capital. As a bank's capital requirements will more closely reflect the actual risk to which the bank is exposed, there will be a need for its board of directors and senior management to gain a deeper understanding of their bank's internal rating systems.

How will this be put into practice? It will be the responsibility of bank management to expose its board members to the key elements of the organization's ratings process. Members of the board will need to be fully aware of whether the system complies with the Basel standards, makes use of the necessary data and produces reliable quantitative estimates. Ensuring that everyone understands the nature and level of risks facing a bank will depend on the timely delivery of the right information. We expect many banks will need to make greater investments in their reporting systems with the aim of facilitating the flow of information about a bank's ratings practices to senior management and directors.

(c) Challenges for supervisors

I've focused on the challenges banks may confront in implementing the new Accord. Let me now spend a few moments discussing how our supervisory approach is also likely to evolve over time.

The New Accord will present supervisors with an opportunity to re-evaluate and further develop their current approaches to looking at banks. Going forward, supervisors, like banks, will have to take a more dynamic view of risk management. Change will occur in response to the new Basel framework. I must add that change would also occur as part of the natural evolution of banking supervision. Basel II's emphasis on risk management strongly supports our current effort to make evaluations of banks' internal processes the heart of a more forward-looking supervisory approach.

In terms of credit risk, we will focus less on point-in-time assessments of financial condition, and much more on internal processes and control structures that are intended to help safeguard the health of banks. Some of the conventional, static metrics that we now use - such as those to judge asset quality and to assess the adequacy of credit loss reserves - are likely to be supplanted by more quantitative and more sophisticated measures. Supervisors will increasingly have to assess the bank's ability to properly rate all exposures across the spectrum of its internal rating grades - not just its classified or problem assets. In addition to ensuring the integrity of banks' internal rating assignments, supervisors will also need to understand how these ratings feed into the models and tools used by banks to manage credit risk. They will also need to understand the implications of using these new tools.

I also see a significant shift on the horizon in our examination approach to operational risk, as we bring together operational risk management assessments with operational risk capital analyses. Examiners will have to understand, and be able to evaluate critically - much more so than today - how banks combine qualitative and quantitative techniques. Here I am thinking of the need to consider self-assessments banks may make of their control environments, as well as their processes for data collection and statistical analyses.

It clearly will be important to devote the necessary supervisory resources - in terms of skilled personnel, technical training, and a targeted strategy - to these new supervisory efforts. As we prepare to traverse this uncharted regulatory landscape, there is an opportunity for supervisors to take a fresh look at how they do their work. In doing so, it is important that we not lose sight of one of the longer-term goals of the New Capital Accord - that it will enhance the capabilities of banks and supervisors to better understand and address risk.

4. Next steps in finalizing the New Accord

Most of my remarks today have been centered on implementation of the new framework. I'd like to conclude by spending a few moments discussing where we are in the process to finalize the New Accord.

As you may be aware, the Committee has just finished gathering data from the industry for its third impact study. The aim of the study was to collect and to analyze information from banks worldwide regarding the capital impact of the new proposals on their existing portfolios. The results are under review and will help us to determine whether any adjustments will be needed prior to release of the final consultative package this spring. This information, as well as feedback received through our ongoing discussions with industry participants, will be critical in shaping the final document. It will also help to ensure that the final framework meets the objectives the Committee has set out for itself in developing the New Accord. I'm very pleased to say that the preliminary indications from all of our efforts suggest that we look to be on track in meeting our primary goals. That is, not to introduce large changes in the aggregate amount of capital currently held in the banking system while at the same time to provide tangible incentives for banks to adopt the most advanced and sophisticated approaches to capital adequacy.

As we near completion of the New Accord, I am reminded that the tremendous progress we have made is a reflection of the steadfast commitment that so many have put forth to see the revision process through to its completion. The success of the New Accord will be directly attributable to the enormous support and assistance provided by both bankers and supervisors. Yet a Chinese proverb reminds us that, "On a journey of one hundred miles, ninety is but halfway." I suppose the last miles of any marathon are the toughest to finish. The wisdom of that proverb is borne out by the critical nature of the tasks ahead of us to complete, and then to implement, the new capital framework.

Adopting the New Accord will be a challenging but also an exciting undertaking for us all. The potential benefits are many - including improving the management of risk, enhancing transparency and promoting greater financial stability. In short, this new framework will make all of us - bankers, supervisors and others - better at what we do.

Thank you very much.