Jaime Caruana: Chairman of the Basel Committee discusses Basel II

Reuters interview with Mr Jaime Caruana, Governor of the Bank of Spain and Chairman of the Basel Committee on Banking Supervision, Basel, 8 September 2003. Interviewed by Stella Dawson and Thomas Atkins.

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New bank rules to smooth economic swings - Caruana

New capital rules for banks worldwide should smooth economic swings and strengthen the financial system, making it easier for central bankers to set interest rates, the new head of the Basel Committee said on Monday.

In his first major interview since taking over the mammoth job of pushing through the “Basel II” bank capital accord, Jaime Caruana told Reuters that he doubts the complex risk-based capital requirements will worsen business cycles.

Instead, he said inserting more regulatory oversight into assessing how much capital a bank sets aside against possible loan losses, and increasing the amount of information banks must make public, should make banks much safer and better prepared for economic downturns.

“It is a completely new approach. In that sense it is a kind of revolution,” said Caruana, who is also governor of the Bank of Spain.

Some bankers and politicians have criticised the reforms, which aim to lessen the risk of banking crises and are scheduled to take effect at the end of 2006.

But Caruana said that requiring banks to run their capital through a stress test to assess what impact worsening economic conditions will have on their loan portfolios, and requiring bank supervisors to evaluate those models independently, increases the safety of the bank.

“This is one of the measures that will help the banks to be less pro-cyclical because they will have taken into account the whole (business) cycle,” he said.

The Basel Committee on Banking Supervision, which groups supervisors from major industrial economies, released the new rules earlier this year. The rules, dubbed Basel II because they replace a 1988 accord, were open for comment until July.

Critics have said the Basel II accord, by requiring banks to increase capital reserves as loans get riskier, will withdraw credit from the economy exactly when it is most needed, creating a credit crunch and making business downturns more severe.

While Caruana said that badly capitalised banks that have not assessed their risk properly certainly will face problems, he does not view it as endemic. Rather the banking system overall will be better capitalised so less vulnerable to shocks.

This in turn will reduce the need for central bankers to keep interest rates low for protracted time periods to help offset credit crunches, as the Federal Reserve did in the early 1990s U.S. banking crisis.

“The fact that the banks are well capitalised and sensitive to risk, it will make monetary policy if anything easier,” said Caruana, who took over the Basel Committee in May. Caruana also sits on the Governing Council of the European Central Bank which sets euro zone interest rates.

Less blue sky or rain?

His top assistant Daniele Nouy, who is secretary general of the Basel Committee, was even more insistent, saying in the same interview that the new accord should help to smooth economic cycles.

“I am personally absolutely convinced that it will be much less pro-cyclical than the old accord,” Nouy said. The new accord will require banks to make better decisions earlier about how much capital they need, thus reducing risk and economic volatility.

“Right now we move from blue skies to full storm (in bank lending activities),” she said. “This could easily disappear. We will have much more light grey and dark grey. I know it is very hard to convince people in advance, but I have zero doubt on that.”

As for the pressure the new accord will place on bank regulators, Caruana said he was impressed by how well prepared they are in general. Many bank analysts have said that relying on a patchwork of different national supervisory structures to implement the regulatory pillar will highlight weaknesses, for instance in emerging markets.

“You would be very surprised. There is tremendous supervision there,” he said.

Bank regulators have progressed immensely in the past five years in their sophistication in risk management assessment and are well equipped to implement the accord, he said.

Moreover in the European Union, where the ECB lacks a formal bank regulatory role, Caruana said he sees no need for changes in the system.

“We are talking about national supervision with very good contact with national central banks, which are part of the euro system. This is a structure that is working now, and I don't think the Basel II will affect this structure. Certainly it makes it extremely necessary that supervisors and banks have a good relationship and risk-focused supervision, but this is already there.”

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New Basel Committee head opens door to rules delay

A top global regulator thrashing out new banking rules left the door open on Monday to delay the “Basel II” accord, which will force sweeping changes in how banks set aside capital for unforeseen hazards.

In an interview with Reuters, Jaime Caruana, the new chairman of the Basel Committee on Banking Supervision, defended the controversial accord, saying he was more concerned with getting it right than with meeting the committee's self-imposed deadline of end-2003 for a final draft.

The committee would decide at its next meeting in mid-October whether it would be possible to meet the original timetable, he said.

“There are some concerns that the tight timing that we have may jeopardise the quality we have in the accord,” he said in his first major interview since taking over the committee in May. “The first consideration is going to be the quality of the accord. Still, we are working with the same timetable.”

A storm of criticism from banks, academics and politicians in recent months has strengthened expectations that the final draft will not be completed until some time in early 2004, instead of end-2003 as planned. Critics blast the rules as fearsomely complex, too prescriptive and incurring costs far greater than the potential benefits.

Some areas require more work, such as risks posed by highly diversified banks and on credit derivatives. Regulators were prepared to adapt the accord as they gained a better understanding of new risk modelling techniques, said Caruana.

“Certainly there will be issues that will be important that we cannot manage now,” he said. “We have recognised that the Basel II process is an evolutionary approach.”

The Basel II accord, so named because it will replace the 1988 Basel Accord, would update existing rules on how much capital large international banks must hold to remain sound and reflect changes in financial services over the last 15 years.

Due for implementation in 2006, it would set standards for how bank capital is supervised and what type of financial disclosure institutions must make.

Experts say that a delay in publishing the final draft of even several months could throw the target implementation date back by a full year if it means domestic rule-making and legislative deadlines in Europe cannot be met. Caruana, the Bank of Spain governor, has become the driving force in one of the most controversial regulatory efforts in decades, said he was prepared to intensify efforts to convince those affected of the accord's merits.

“There is a unanimous understanding of the need for Basel II,” he said. “It is a completely new approach and in that sense you could say that it is a kind of revolution.”

To the ramparts

Caruana defended the accord, saying the U.S. decision to apply the new rules to only the top 10 banks - instead of all banks as Europe intends - met the spirit of the accord because U.S. banks already met high regulatory capital standards.

“We respect their decision. We think this is perfectly compatible with Basel II. Europe has taken a different decision,” he said.

Caruana rejected concerns that it could dry up some capital markets, as banks fear, as some market activities could be assigned a higher risk weighting under the new accord.

“Frankly speaking, we don't think that this is a problem. The strategic decisions that banks have already taken are based on economic capital and the accord should not change this,” he said.

Daniele Nouy, secretary general of the Basel Committee and Caruana's top assistant, said in the same interview that banks already assigned a cushion of economic capital to their different areas of activities, including market activities. The new accord should broadly follow existing practices.

“We don't anticipate as many changes as people believe,” she told Reuters. “The important thing is that economic capital will be close to regulatory capital.”

But Caruana did acknowledge the need for further study, especially on how diversification of banks' activities across business lines and economic zones.

“We do not recognise properly all the diversification that a bank has when it has exposure to several markets,” he said. “We need to know what the best practice is so it can be incorporated.”

Potential future risks posed by credit derivatives exposure would also require more work, Nouy said. “There are many different practices in the industry and we simply do not yet know which is the best one going forward,” she said.

Consolidation not a goal

Caruana distanced himself from speculation that the new accord could drive sweeping strategic changes in the financial sector, including mergers and acquisitions, saying it was not the committee's goal to drive consolidation among banks.

Some banks, however, may conclude on their own that the new accord will increase pressure on them to join forces with other players in order to improve their business models under the new accord, he said.

"I think this will be more based on decisions taken by the industry," Caruana said. "We don't have this as an objective."

Caruana also rejected criticisms that the accord could punish banks in some developing nation markets because they lack the sophisticated risk-measurement techniques used by the world's biggest banks.

Indeed, the accord could smooth the punishing volatility of capital flows in and out of emerging markets as banks and investors better understand lending risks by applying the new rules. "Good risk management should also support emerging markets," he said.

Caruana said he welcomed China's announcement in August that it would delay adoption of the new accord, introducing its own rules in the meantime as its capital-weak banks struggled to modernise and reform.

"It was perfectly consistent with what we were saying...a right timing and a proper sequencing was important, not to rush," he said.

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Caruana, man of simple taste, faces complex Basel II

Bank of Spain Governor Jaime Caruana is a man of simple tastes.

A recent visitor to the Bank of Spain commented on the elaborate chandeliers in a conference room, a mass of coloured glass grapes. "I love those chandeliers," the visitor said. "Personally I find them rather excessive," Caruana replied.

For a fan of the simple, it's no small irony that Caruana is driving a highly complex rewrite of global bank safety rules as the head of the Basel Committee on Banking Supervision, in one of the most dramatic and controversial financial reforms ever.

In his most difficult job to date, Caruana took control of the committee at a time of unprecedented criticism for New Basel Capital Accord or Basel II, designed to replace the 1988 accord that set out how banks allot cash to buffer against surprise risks.

The agreement being drafted by global regulators is now under fire from banks who say it is convoluted, expensive, heavy-handed and poorly tested, and who now seek to stall or derail it.

Not devoid of a dry sense of humour and with a shy smile, Caruana is known as a diligent and rigorous technocrat, a fan of teamwork who avoids showiness.

"The core of the issue is whether Caruana will be able to demonstrate his leadership in the next couple of months," said one committee member who works directly with Caruana, who spoke under the condition of anonymity.

"It's not easy to guide such a group of self-confident people," the committee member said. "He's just trying to fight his way."

Part of the problem is that Caruana's predecessor, New York Federal Reserve Chairman William McDonough, left large shoes to fill. McDonough's unexpected retirement in June left critics wondering whether his successor would be able to hold together a global project.

"There were definitely advantages in having a superpower in charge of this committee," said the Basel Committee member.

Karel Lannoo, head of the Brussels-based think tank Center for European Policy Studies, said Caruana is a strong player with anti-establishment nuances who should be able to push through the accord and even impart some Spanish character to it.

“Caruana is, in the Spanish context, very well regarded,” said Lannoo, a frequent adviser to the European Commission and a member of the academic European Shadow Regulatory Commission.

“He was a broker. He knows market risk. He worked on the trading floor,” Lannoo said.

Lannoo and the shadow committee are critics of the accord, saying its overly complex nature may in fact heighten systemic threats by “capturing” regulators who would be required to take a more active role in banks' daily operations.

Revolution in the making

The new accord, now over five years in the making, represents a revolution for the banks who will adopt it. It leaves the first accord's simple dictates behind and offers a menu ranging from basic to complex.

A second Basel Committee member, who also requested anonymity, said he had few doubts that the technocrat Caruana was the right choice for the job due to his expertise in such a complex field. “This is not new territory for Jaime,” he said.

Indeed, some critics of the accord say a technocrat like Caruana is just who is needed to make sure that the byzantine draft is moulded into shape before being finalised by the end of this year.

Caruana, a 51-year-old Valencian, studied telecommunications engineering and then qualified as a government economist.

Those who have worked with him say he is a real technology fan, which given his studies is no surprise.

The current controversy over the Basel reform is probably a source of discomfort for Caruana, who keeps himself to himself. “He is very simple and discreet, and shys away from limelight,” says a former colleague.

Some feared that the independence of the Bank of Spain might be brought into question when Caruana was named governor in July 2000, given his links to the ruling conservative Popular Party.

However he has carved out a reputation as a hard worker who has kept his head down, remained polite and attentive, and has helped his credibility as head of the central bank. “He likes teamwork, and is very close to those he works with,” one former colleague says.

Caruana worked for the Trade Ministry from 1979 to 1987, including a three-year stint in New York, and then spent 10 years first as chief executive and then as chairman of private brokerage Renta 4.

He was named Treasury Secretary at the Finance Ministry in 1996, when the Socialists were voted out, and was in that post for four years under the Popular Party before heading the Bank of Spain's supervision department.

In July 2000 he took over from highly-respected Bank of Spain governor Luis Angel Rojo, under whom he had worked as supervisor.