Jaime Caruana: Contemporary issues in credit risk

Keynote address by Mr Jaime Caruana, Governor of the Bank of Spain and Chairman of the Basel Committee on Banking Supervision, to the Credit Risk Summit USA 2003, sponsored by Risk Magazine, New York, 27 October 2003.

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Introduction

I would like to thank Risk Magazine for inviting me to participate in this summit on contemporary issues in credit risk. Looking at the agenda, it is clear that, while credit may constitute the oldest risk in banking, it remains the most important and is still one where we have much to learn.

There is a Latin proverb that says ‘Danger can never be overcome without taking risks’. As a supervisor, I would tend to rephrase that by saying that managing risks properly is the best way to overcome danger. I think this idea is at the core of any modern, innovative and dynamic economy. The next two days will no doubt offer a sense of the rich abundance of research under way to identify risks, to improve our measures for them, and to find better ways to address them.

On this front, a risk manager and a bank supervisor share similar interests. A risk manager seeks the best risk measures and management techniques to protect a bank against losses, to hone its competitiveness, and to enhance its profitability and long-term growth. Supervisors advocate sound risk management practices to ensure the adequate capitalisation and prudent management of all banks. This, in turn, strengthens the financial sector’s resilience during periods of distress. I am convinced that when banking systems are adequately capitalised and well-managed, and risks are correctly assessed within the appropriate time horizon, the financial system becomes more stable, less procyclical, more resilient during periods of distress and therefore better able to promote sustainable growth.

In the light of our mutual interests, I am especially pleased to share with you some thoughts on the landmark efforts under way to revise the Basel Capital Accord. The Basel Committee embarked on this undertaking to promote the responsible pursuit of risk and rewards across the banking sector and, hence, to promote greater financial stability. This reform builds on trends in many countries to incorporate incentives into the regulatory framework encouraging banks to identify and understand the risks they face today, to consider what risks may arise tomorrow, and to respond actively and appropriately to both.

As you know, this has not been an easy task for supervisors or for bankers. Yet we have achieved considerable goals over the past four to five years, and I would like to begin with a brief look back to recall why bankers and supervisors decided that a New Basel Accord was needed. Then, I’d like to share with you the latest news on consultations with the industry and the Committee’s most recent decisions on the way forward to finalise, and then to implement, the new rules.

There is still much to be done: I’ll discuss as examples our efforts to reduce the complexity of the rules; to ensure that they are sufficiently risk-sensitive without being overly conservative; and to maintain a level playing field. Finally, I’ll conclude with thoughts on some longer-term and future efforts that the Committee may undertake to continue to align the system of supervision with the best practices of leading institutions and practitioners worldwide.

A Look Back

As we resolve the final questions and complete the text of the New Accord, it’s important to remember why all of us put our best into its success. The existing Accord was already considered a milestone achievement in banking, as it offered the first internationally accepted “yardstick” for capital adequacy and a simple measure of risk. It had received praise for reversing a downward trend in bank capital levels and for serving as a benchmark measure of a bank’s financial health around the world.

But the 1988 Accord was a blunt instrument that quickly fell behind the times. Innovations in technology, in banking products, and in risk management techniques changed the way that leading banks measure and manage their risks. By the mid-1990’s, bankers and supervisors agreed that the original Accord no longer provided a meaningful measure of risk for the largest and most sophisticated organisations.

As a result, by the late 1990's the Basel Committee and leading institutions worldwide began discussions on ways for supervision to incorporate more sophisticated and sensitive measures of the risks that banks face. The initiative for these discussions can be attributed above all to William McDonough, who was until recently the President of the Federal Reserve Bank of New York and my immediate predecessor as chairman of the Committee. Bill brought intellectual leadership, demanding standards, and tireless energy to a project whose size and implications became apparent only after bankers and supervisors had taken a long, hard look at how much the art of risk management had advanced in the short years since 1988.

Throughout the five years of work on the New Accord, Bill McDonough convinced leaders in the industry, in central banks, and in supervisory agencies that merely updating the rules would be unsatisfactory. Instead, Bill sought to advance the state of the art in risk management across the industry and thereby promote greater stability in the global financial system. This would benefit not just bankers, but also businesses and consumers in all walks of life.

It was truly a privilege to work with Bill on an initiative that would represent not just good banking policy, but most importantly good public policy, more broadly defined. Bill has since moved on to new challenges as head of the Public Company Accounting Oversight Board in Washington, but the U.S. delegation to the Basel Committee remains in excellent hands. Now I have the privilege of working with leaders like Roger Ferguson, the Vice Chairman of the Federal Reserve, and Jerry Hawke, the U.S. Comptroller of the Currency. Their hard work, and the hard work of the other supervisors participating in the discussions, have strengthened the quality of the capital rules. They and others have helped to ensure that the New Accord will be flexible, forward-looking, and fit for the service of twenty-first century banking.

The process of revising the rules has involved formidable challenges. That should come as no surprise. Capital requirements make up the foundation of the regulatory framework. Even more importantly, capital is a key ingredient to the health of the banking sector. The changes we are proposing to ensure that banks hold adequate capital will have broad implications not just for the banking sector, but also for financial markets and the broader economy.

But the new Basel Accord is about more than just capital, it is also about keeping a level playing field and about reinforcing incentives to foster sound risk management though three reinforcing pillars: risk sensitive minimum capital requirements, coordinated supervisory review, and enhanced market discipline through greater transparency. Supervisors and risk managers know that a bank's management and controls make up its first and most important line of defence. The New Basel Accord seeks to capture the relationship between capital adequacy and risk management.

Recent Developments: Status of Consultations and the October Press Release

In that vein, I'd like to discuss the status of our discussions and especially the proposals for managing credit risk. By now you've no doubt read that the Basel Committee agreed two weeks ago on a breakthrough plan to address the final issues raised in public consultations and to complete the new rules. This was a difficult task, as the Committee received over 200 comment letters from the industry and the broader public on the Third Consultative Paper, or "CP3". While we might have been somewhat surprised by the number of responses that we received, we were not surprised by the hard work that was evident in the letters. In addition, we will have further valuable information from national consultative processes such as that under way in the United States.

The comment letters were positive and offered constructive suggestions on a wide range of issues. Indeed, even among the most critical of respondents, one finds support for the introduction of the "three pillars" of the New Accord and its aim to align capital more closely to risk; for the development of greater consistency in the supervisory review of capital adequacy; and for strengthening the effectiveness of market discipline through enhanced transparency. It was, moreover, satisfying for us that most commentators acknowledged substantial improvements in the proposals since the release of the second consultative paper in early 2001.

The depth and quality of the responses demonstrate that many banks and industry associations understand the far-reaching significance of the New Accord. I would like to offer the Committee's sincere thanks to the many organisations and banking associations here in the United States, Canada, and elsewhere that invested considerable time and resources in the consultations. You shared important views through comment letters, gathered data for impact studies, and engaged in discussions such as those that will be held here over the coming days. If you've been following our work since the first consultative paper was released in 1999, you will know that the proposals have evolved and improved considerably thanks to the industry's candour, its creativity, and its drive to innovate.

At the Committee's meeting in Madrid earlier this month, all members acknowledged our responsibility to consider carefully your concerns and those of the broader industry. What is most important to the Committee is the quality and consistency of the new Accord. At the same time, we recognised the need to provide banks with as much certainty as possible while they plan and prepare for the adoption of the new rules. The members of the Committee agreed on the importance of finalising the New Accord expeditiously and in a manner that is technically and prudentially sound. We noted in a statement to the press that we expect to take account of the remaining issues and complete the text of the New Accord in the coming months and no later than mid-2004. This period of time will also allow us to take careful note of domestic consultations under way in some jurisdictions, including the process for the Advance Notice of Proposed Rulemaking in the United States.

Most of the comment letters that the Committee received focused on credit risk and the minimum standards in the first pillar. Respondents identified as one of the most important issues the proposed treatment of credit-related losses. As you know, with respect to the internal ratings-based treatment of credit losses, the CP3 calibrated regulatory capital on the basis of both unexpected and expected credit losses – or "UL" and "EL" in Basel terminology. This was intended as a practical compromise to account for differences in national accounting practices and supervisory authority regarding provisioning.

Many respondents – including quite a few here in the U.S. – cautioned against this approach, as they believed that it departed from the traditional view that unexpected losses should be absorbed by capital, while expected losses are best managed through provisioning. Based on those comments, and following additional research, the Committee now intends to align regulatory capital more closely to economic capital by calibrating it on the basis of unexpected credit losses alone. A supplementary mechanism will help to encourage banks to provide sufficiently for expected credit losses.

Details on our proposal can be found on the website of the Bank for International Settlements, and the Committee has invited public comment on the approach through the end of this year. In recommending this revision, the Committee seeks to ensure that risk management systems distinguish between losses that can be anticipated versus those that cannot. Moreover, the new framework would include explicit incentives for banks to address each kind of loss appropriately ensuring strong incentives for banks to provision properly against expected losses.

Since the proposal would require only modest revisions to the text of CP3 and would not alter the underlying system and data requirements for banks wishing to adopt an advanced approach to credit risk, we expect that the revised treatment will conform closely to the work that banks have already completed to prepare for implementation. The work plan to improve the framework discussed during our last meeting identified several areas in addition to this important EL-UL issue. We think that this work plan is perfectly compatible with the original time schedule to implement the New Accord by year-end 2006.

Other issues ahead: complexity

Beyond the "EL/UL" issue, the Committee has put at the top of its work plan for the next few months several other credit-risk related issues that emerged in consultations. Of these matters, I'd especially like to highlight three, namely complexity, conservatism, and competition.

Certainly, the complexity of the proposals continues to draw the public's attention. It is no secret: the New Accord offers a far more sophisticated view of risk than the far simpler 1988 Accord does. But that is indeed the point. The Committee is adopting the best measures of credit and operational risk being developed by leading institutions worldwide. Today's conference offers a good picture of just how sophisticated – and sometimes complex – the measures of credit risk are becoming. Loan officers and risk managers now have at their disposal a constantly evolving array of databases, software, credit risk models, and risk rating systems, all of which provide supplemental empirical insight into a risk previously not readily quantified. And all of these new tools were initially developed or refined to promote a bank's competitiveness and protect it against loss – and not just to respond to a regulatory mandate.

We seek a balance between complexity and risk-sensitivity, between complexity and the necessary room for diversity and between complexity and comparability. Where complexity in the rules fails to add much to the sensitivity of the New Accord's measures of risk, the Committee has worked to remove it. In the past, this has included eliminating the so-called "W" factor for credit risk mitigation and even shortening and simplifying the disclosure requirements of Pillar 3. Just two weeks ago, the Committee announced in our Madrid press release that we will simplify the proposals for securitisation exposures and replace the "Supervisory Formula" approach to unrated tranches with a simpler rule.

At the same time, the industry has asked the Committee not to sacrifice risk sensitivity where it makes sense, even if it means that the rules may become somewhat complicated. Indeed, the complexity of the New Accord stems partly from the options the industry requested to ensure that a blanket rule would not unfairly disadvantage a particular business or exposure. You need only read a few of the comment letters on our website to see that many of the latest suggestions would tend to increase the complexity of the New Accord even further. Nonetheless, the Committee is aware that it is easier to enforce a simpler rule than a complicated one. As we complete the text of the new rules, we will continue to simplify and streamline the framework.

Conservatism

A second important theme addressed in comment letters suggested that the Committee may have adopted an overly conservative approach to some aspects of the framework, resulting in much higher capital charges than banks feel are necessary. Respondents attribute what they view as excessive levels of conservatism to different sections of the New Accord, including, as I mentioned earlier, the calibration of capital requirements to both EL and UL. We have heard similar concerns about conservatism in the securitisation proposals, in the treatment of certain credit risk-related hedges, and in the recognition of insurance products within the operational risk proposals.

Questions about conservatism are important, as we are trying to align capital more closely to risk. This means that where the Accord treats exposures too harshly relative to their inherent risks, we expect to reduce the capital requirements. A good example would be the treatment of retail exposures, where the Committee found good economic evidence supporting a significantly lower requirement compared to earlier drafts of the new rules. But where the risk is greater, and where the existing rules fail to assign adequate capital, it should not be surprising that capital requirements are raised. We will continue to evaluate the assumptions in the New Accord and their relative degrees of conservatism in the final months ahead.

Competition and consistency of application

Conservatism in the framework raises concern in the industry partly because banks welcome the great flexibility they will enjoy in other areas of the New Accord. A key example would be the ability to develop their own risk measurement tools and use their own models to estimate the drivers of credit – or operational – risk. Yet the great flexibility banks will enjoy raises the concern among some that too much flexibility might allow competitors at home or abroad to employ methods subject to less rigorous supervision. This brings us to the final theme we noted in our consultations, namely the need to maintain a level playing field and promote competition.

Ensuring the consistent application of the New Accord in its entirety is a critical concern for the Committee. The minimum standards were developed to help ensure that global competition in banking markets will be driven by each bank's strengths, rather than by differences in each country's rules. Moreover, Pillars Two and Three were largely created to promote a more level playing field for banks.

For example, incorporating supervisory review – or Pillar Two – into the international guidelines represents a seminal achievement for all of us. By developing guidelines for supervisors' evaluation of a bank's internal capital allocation process, the Committee believes that supervisors and banks will engage in more focused, more consistent, and less burdensome discussions of the risks that banks face and the responses they adopt. National laws and regulations provide different avenues through which supervisors may conduct such reviews, and consequently Pillar 2 affords each jurisdiction the flexibility to accommodate those differences.

To advocate more consistent standards, the Committee created the Accord Implementation Group, or "AIG," precisely to share experiences and encourage shared approaches. This group, which is chaired by Nick Le Pan, the Canadian Superintendent of Financial Institutions, has already been long at work comparing notes on practical matters. We expect these discussions to help supervisors apply the New Accord more consistently at home, thereby providing a more level playing field across countries as well.

Based on the AIG's work to date, the Committee published a paper last August on the "high level principles for the cross-border implementation of the New Accord." In this paper, we reiterate our view that the traditional allocation of responsibilities to home and host supervisors will continue. Cooperation will be critical for effective supervision under the New Accord, especially considering the need for an internationally active bank to receive the approval to adopt, and then validate, advanced approaches to credit and operational risk at home and in host jurisdictions. Similarly, supervisors will need to find practical ways to cooperate in the evaluations of capital adequacy under pillar 2 and ongoing reviews of compliance with the minimum operational requirements of the New Accord.

At the same time, Pillar 3 - market discipline – draws on the power of markets to help ensure that banks do not hold unrealistically low amounts of capital for credit or operational risk. More generally, by emphasising principles in the rules – that internal measurement tools must be credible, that they must adequately capture risk, that they must be used by banks in the daily management of their operations and not just for regulatory capital purposes – enhanced disclosure and transparency may actually result in more consistency in the application of advanced approaches than detailed quantitative criteria.

Future Work: Full Credit Risk Modelling

The Committee will spend the next few months considering these and other themes carefully and finding ways to balance the complexity of the New Accord against the need for appropriate sensitivity to risk; to ensure that the assumptions supporting the rules are appropriately conservative, but not excessively so; and to apply the rules consistently to protect and promote competition in the global banking market.

But when the ink dries on the New Accord, rest assured that the Basel Committee will not be adjourning. Just from the comment letters we received, we can already identify a wide range of issues ahead to continue to find new ways to advance risk management, to promote greater transparency, and to strengthen the stability of the financial sector. I'd like to conclude by mentioning just two of the potential items on our agenda for future work once the New Accord is implemented.

The first would be to consider the benefits of full credit risk models in the calculation of minimal capital requirements. In theory, a bank's capital requirements would then reflect to the greatest degree the economic benefits of diversification in its balance sheet. In fact, the Committee did at one point evaluate whether advanced banks should be permitted to estimate the degree to which their assets might behave similarly or default together in the New Basel Accord.

As you know, we decided that we are not quite there yet. We know that some banks are making commendable progress in thinking about ways to estimate the value of diversification. Nonetheless, we remain concerned about the degree of confidence one might have in those estimates, given the relative lack of data available on which to base them and the consequent difficulties third parties would have to validate any estimates at this stage.

Likewise, we have not yet seen evidence that there is a critical mass of banks that today would consistently meet the "use" test spelled out in the New Accord. For example, we are not certain whether banks today consistently take into account in their valuations each asset's contribution to diversification as part of their daily monitoring and risk management practices, or use diversification estimates as part of their credit approval and review process.

Many members of the industry have accepted our decision as prudent for now. But you have also stressed the need to develop a treatment for credit risk that is more consistent with the existing treatment of market risk and the emerging practices for operational risk. That's why the work that so many of you do is so important to the future of banking: by finding ways to capture and measure risk in a manner that is increasingly comprehensive, accurate, and elegant in form, you are laying out a map for us to consider as we all traverse the landscape of risk management. In the coming years, and we can start very soon, we look forward to continuing this dialogue with banks, banking associations, and researchers to find ways to move Basel in the direction of full credit risk models.

Consistency of Accounting Standards and the New Basel Accord

A second area, where work has started and will continue, is the need to align the regulatory framework more closely with the converging standards in accounting worldwide. Many industry representatives have noted quite correctly that a greater "meeting of the minds" is warranted especially now that the New Basel Accord includes explicit disclosure requirements intended to promote greater insight into a bank's risk profile. Likewise, the Basel Committee's treatment of provisions and the valuation of financial instruments must keep pace with changes in the relevant accounting standards.

The members of the Committee believe that market discipline, and hence financial stability, is strengthened when accounting and disclosure requirements reflect sound risk management principles and are consistent with the control practices that banks adopt. Consequently, we recognise our responsibility to participate actively in the development of national and international accounting standards. Where the development of international standards is concerned, the Committee and its member organisations devote considerable resources and staff time to sharing our perspectives as supervisors with those who make the rules.

But the discussions between supervisors and accountants cannot be a one-way street. As supervisors on the Basel Committee have developed standards for the disclosure of components of capital, for loans, and for other topics of mutual concern, we have sought out the views of representatives of the accounting profession. This dialogue will continue. I should add that we are currently seeking new opportunities for discussion on issues of mutual concern with accounting standards-setting bodies and private sector accounting professionals.

Conclusion

By the end of this conference, I think that we will all have a better sense of our many worthy accomplishments to date in refining the measures and management of credit exposures. At the same time, we will no doubt develop a better understanding of the significant work ahead – in terms of developing more sensitive capital requirements, but also in terms of advancing our ability to control the risks we face.

With regard to the New Accord itself, the issues and themes you will discuss at this conference suggest that we've moved beyond a discussion of the principles behind the rules to a focus on preparing for their implementation. This seems appropriate, since we expect that, given the very good progress that we have noted in banks preparing to adopt the New Accord, supervisors and the industry will be ready to implement the new rules by the end of 2006. Indeed, banks that wish to be among the first to adopt an advanced approach to credit risk should already have begun to gather and process the data that is key to the IRB approach.

Adopting a more risk-sensitive treatment of credit risk will require significant work by all of us. What we learn about the factors driving losses from default, and how we can better measure and reduce our exposure to losses, means much more to all of us than simply a more favourable capital requirement. Instead, our efforts on credit risk, combined with advances on the operational and market risk fronts, will advance our understanding of the many risks banks face and improve our ability to navigate them successfully. For all of us, that offers the reward of a more stable banking system less susceptible to systemic risks and the business cycle and one better able to ensure the circulation of credit, the lifeblood of the economy, to businesses and consumers alike.