John Palmer: Basel II and beyond

Opening address by Mr John Palmer, Deputy Managing Director of the Monetary Authority of Singapore, at the MAS Risk Conference, Singapore, 12 July 2004.

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Introduction

Good morning. Welcome to the MAS Risk Conference, and for visitors to these shores - welcome to Singapore.

The Conference is held at an opportune time. It was only two weeks ago that the Basel Committee on Banking Supervision released the Basel II capital framework.

This is enough time for all of you to have read the full text, and recent enough for you to remember most of what you have read.

Not surprisingly, my remarks this morning will be focused on Basel II. They are drawn from my perspectives as a policy maker who actively supported the development of the Basel II framework, and as a prudential supervisor now faced with the challenge of implementing this new framework.

I intend to offer a perspective on Basel II, some of the challenges that remain to be addressed and offer some thoughts on the future evolution of capital adequacy rules for banks.

Later in the conference, my colleague, Low Kwok Mun, will discuss MAS' approach to Basel II implementation, including requirements for local banks and some important home/host supervisory issues.

Why Basel II? What is good about it? And what are the implementation challenges?

Developing Basel II turned out to be an immense challenge. Implementing it will be no less challenging. But the challenges are necessary ones, as I see it.

Basel II was made necessary and inevitable by the evolution of the banking sector following the introduction of Basel I, particularly the growth of internationally active banks and improvements in their risk management practices.

Global trends and banking sector developments

A number of factors over the last two decades have resulted in bigger, more international and more diversified banking institutions.

Many banking institutions have seized the opportunities presented by liberalisation and globalisation to expand beyond their home bases and traditional lines of business. At the same time, rapid technological advances, particularly in computing, allowed for the streamlining of operational processes and made possible the effective management of large international financial conglomerates by reducing some of the inefficiencies of scale.

Many, though certainly not all, of the banking institutions that expanded in this way have been quite successful. They have benefited from economies of scale. Furthermore, the broader product range and presence in multiple economic zones have helped to smooth product and economic cycles.

Advancements in risk management

But, expansion has brought with it significant risk management challenges. The growing size of these institutions, their spread across geographic boundaries, and their diversity of products and customers, have made it necessary for decision-making to be decentralized, at least to some extent, in order to be responsive to the needs of customers. But with more autonomous units, an internationally-active and complex bank has to expend more effort to identify, measure, and control the risks arising from its diverse and far-flung activities. Traditional rules of thumb used by management and supervisors to assess risks and to ensure the adequacy of capital to buffer risks are no longer adequate. And continuing financial success depends critically on how a bank responds to the risk management challenges.

In response to these challenges, the successful banks have developed enhanced tools for measuring risks. These can be grouped into two broad categories. The first category of tools are those that give a bank the ability to discriminate among risks by differentiating the riskiness of customers, and of various banking facilities and products. The second category of tools includes those that give a bank an enhanced capability to quantify risks.

The end of the road for Basel I

In and of itself, the enhanced capability of institutions to differentiate and measure risks has been a welcome development. But, the increasing sophistication of institutions in risk management meant that the crude system of risk weights under Basel I became less meaningful in ensuring the adequate capitalisation of large, complex banking institutions.

By the mid-1990s, less than five years from the official implementation of Basel I,[1] it was apparent that Basel I was becoming less relevant for some banking institutions.

A widening gap was opening up between the requirements of Basel I and the way in which banks, particularly the large, internationally active banks, and some of their unregulated competitors, were thinking about risks. This placed banks at a competitive disadvantage vis-a-vis some of those unregulated competitors, and was leading to extensive capital arbitrage by banks.

The sophisticated approaches under Basel II were devised as a solution to this problem. The underlying philosophy of Basel II was simple and sensible:

(i) Where possible, rely on the risk management practices of banks as the basis for setting more risk sensitive capital requirements.

(ii) Provide incentives to banks to continuously improve their risk management practices.

As this idea began to take shape, and the Basel Committee began to fall in love with it, we persuaded ourselves that it would lead to a supervisory nirvana, at least for the well-managed institutions, with less work for supervisors and less supervisory intrusion for those deserving banks.

But, idea and reality do not always coincide. So far, an immense amount of work has gone into development of Pillar 1 of the framework, which contains the nuts and bolts of Basel II's risk sensitive capital requirements. The result is a far more complex system than we ever dreamed we would be putting in place. But in the end, we have met the objective of creating a more risk-sensitive supervisory system for measuring capital adequacy of banks, that is better aligned with the way in which banks manage their own risks.

Good risk management as a competitive advantage

The importance of Basel II lies not just in aligning capital adequacy requirements more closely with the way banks measure economic capital. The real payoff will be the positive impact it will almost certainly have - indeed is already having - on the risk management practices of institutions.

Improvement in risk management will tend to enhance the competitiveness and financial success of banks. As suggested earlier, good risk management practices allow a bank to take more risks and improve profitability. Such practices foster better understanding of risks and allow the managers of banks to establish proper tolerances for the risks they assume. Good risk management allows banks to weather the unexpected shocks that occur from time to time. The danger, of course, is that as risk management practices improve, a bank's risk appetite may increase disproportionately. Bank directors and supervisors must be vigilant against this possibility.

[1] Basel I was officially implemented in 1992.

Main benefits of implementing Basel II improvement in risk management will materialise

The risk management standards and practices embodied in the more sophisticated approaches under Basel II are real and are drawn from the best practices of large internationally active banks. They reflect many insights gathered through practical experience, including both successes and failures in risk management.

Even for institutions at the forefront of risk management capabilities, we think the Basel II standards will be useful. Because the standards represent a comprehensive compendium of best practices, even the best-managed institutions will have to improve in some areas to take full advantage of the various approaches offered by Basel II.

For institutions whose risk management practices are not leading edge, the benefits of Basel II implementation will be even more obvious. The Basel II framework contains many useful lessons and can serve as a good roadmap on how to improve internal risk management.

With the exception of small banks with relatively simple business models, the risk management practices and standards under the more sophisticated approaches of Basel II will be useful for all institutions.

Admittedly, not all aspects of Basel II will be of use to every bank. For example, some of the quantification tools used in large complex institutions may not be necessary for the smaller and less sophisticated institutions. But, common tenets of good risk management embodied in Basel II - such as good processes to identify risks, the exercise of sound judgment to assess the extent of threats to solvency posed by the risks, and the discipline to control risks if they are disproportionately high - are equally applicable to all institutions, large or small.

Basel II and financial stability

One of the criticisms of Basel II is that capital cushions required under Pillar 1 will tend to become more cyclical, dropping at the peak of economic cycles and increasing at the bottom of cycles when capital can be more scarce and expensive. If not addressed, this pro-cyclicality could erode the solvency cushions that banks should be holding against the effects of economic downturns. Addressing this is one of the most important remaining challenges of Basel II and is particularly associated with the implementation of the more sophisticated approaches of the new capital framework.

Despite reassuring noises from the Basel Committee, this is not going to be an easy problem to address. Few people, and definitely not banking supervisors, can foresee the peaks and troughs of economic cycles. But our inability to perfectly foretell the future should not be a pretext for inaction.

An effective supervisory review process will be critical to create a counter-weight to the cyclical tendencies of the new capital framework, in order to prevent increased incidences of failures and financial instability.

Managers of banks and bank directors have an even more important role to play. They have the primary responsibility for identifying and assessing various threats to solvency of their own bank, including the risks that are partially covered or not covered at all under Pillar 1 of the framework. They also need to be cognizant of the cyclicality arising from their quantitative tools and should have sufficient compensatory mechanisms against the cyclicality of regulatory capital requirements.

These issues are referred to in Pillar 2 of Basel II. This is what we refer to as “Supervisory CAR”, to address risks not covered or not fully covered by the formulae in Pillar 1. One of the biggest challenges to supervisors now is to develop more detailed guidance for the implementation of Pillar 2 and to follow that guidance in a consistent and coordinated manner across the supervisory community. Despite work done by the Basel Committee to encourage coordination among supervisors in this area, there remains a significant risk of inconsistent approaches and resulting supervisory arbitrage.

While the rollout of the Basel II principles will be extraordinarily demanding, I am heartened to observe that there is momentum gathering among banks and supervisors around the globe to meet the challenge.

Beyond Basel II: what would further installments look like?

Even though the ink is still drying on the final version of the new framework, and we are just starting to tackle the implementation issues, it is not too early to think about how Basel II capital framework might evolve in the future. Because we can be sure that Basel II is not the "End of History" as far as regulatory capital requirements for banks are concerned.

Greater applicability of risk quantification techniques

Beyond Basel II, there may be greater scope for use of quantitative tools in setting minimum regulatory capital requirements. The most promising areas are quantitative tools for interest rate risk in loan portfolios and concentration risk.

Three robust pillars

I also think, despite my fears about inconsistency and arbitrage, that over time supervisors will develop more consistent approaches to Pillar 2 of the capital framework, and greater harmonisation of supervisory reviews across jurisdictions. This will equip supervisors to deal with the future evolution of Basel II in a constructive and coordinated way.

I also foresee greater transparency surrounding the risks faced by banks, and in how banks are measuring and controlling them. In the future, I expect banking supervisors to place greater emphasis on the techniques of securities regulators by requiring more information to be disclosed to the markets and the public. We will likely place even greater reliance on market processes and corporate governance to ensure that banks are soundly managed and well capitalised.

Sound precepts of risk management and prudential supervision

While there will inevitably be ongoing challenges to the vision of capital adequacy embodied in the new framework, particularly to its more technical aspects, I have no doubt that the sound precepts of risk management and prudential supervision that underpin the new framework will be an enduring feature of future versions regulatory capital requirements for banks.

Alas, the requirements and modeling of certain types of risks may get excruciatingly complex. Indeed, for some of us, they have already reached that point. But in selecting and imposing such requirements, supervisors will be practical, and will look to the best risk management practices of banks and other financial institutions as the basis for setting risk sensitive capital requirements. And as supervisors become confident that the risk management processes of an institution are appropriate to match its risk appetite and operations, minimum capital requirements will edge downward.

Nevertheless, a level of conservatism in minimum standards will be retained, which any responsible and prudent banker would no doubt agree with, at least in principle. Models are an abstraction of reality. Supervisors will continue to maintain a healthy sense of skepticism. Despite good intentions and best efforts, predictions made by models are never exactly right and sometimes very wrong.

Conclusion

In conclusion, we should not look at the release of the final version of Basel II as the end of the process to set more risk-sensitive capital adequacy requirements for banks. It is really the end of the beginning. Basel II is a milestone on a longer journey. One that will occupy the energies of bankers and prudential supervisors for many years to come. This is not meant to be a discouraging note. Quite the contrary. Because this journey will be one of continuous improvement that can, if we do our work well, lead to stronger banks and more resilient financial systems.

I wish you all useful discussions on the major challenges to be addressed, and on the important benefits that await us as we continue this journey.