Jaime Caruana: Making diligent preparations for Basel II

Opening remarks by Mr Jaime Caruana, Governor of the Bank of Spain and Chairman of the Basel Committee on Banking Supervision, at the Thirteenth International Conference of Banking Supervisors (ICBS), Madrid, 22-23 September 2004.

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1. Welcome and overview

Distinguished guests and friends: as the Governor of the Bank of Spain, it is my pleasure to serve as your host at the Thirteenth International Conference of Banking Supervisors here in Madrid. I am also privileged to serve in a second capacity at this event as chairman of the Basel Committee on Banking Supervision. In that regard, it is my honour to launch our dialogue on the two main themes selected for this conference.

As you know, the Committee reached agreement on an historic revision of the international capital framework just this past June. So naturally an important focus for this conference will be on preparing for its implementation. In addition, because Basel II relies increasingly on the quantification of risk exposures to understand a bank's risk profile, it is more important than ever before to look behind the numbers and into the rules that define how exposures are measured. The second day of our conference will be devoted to the emerging issues in accounting and their relevance to banking supervision.

I am indebted to the Secretariat of the Basle Committee, the staff of the BIS, as well as to my colleagues at the Bank of Spain, for choosing speakers who will encourage a lively conversation on these two themes.

In my own remarks this morning, I would like to open with some thoughts first on the implications of "Basel II" for banking supervision worldwide. While much has been said about its sophistication, I believe that many have overlooked key principles in Basel II that are relevant to all supervisors and all banks in all markets. In that regard, it is important to remember that Basel II's success depends on a broad range of other preparations and measures that we undertake to strengthen safety and soundness; in the second part of my remarks, I will offer some views on the other mechanisms, that lie at the heart of a sound system of supervision more generally.

As I will mention, many of our safety and soundness goals are more easily achieved when supervisors apply these mechanisms more consistently: this makes it critical for the Basel Committee to continue to expand its ties and seek greater cooperation with the broader supervisory community. Finally, I would like to close with some brief thoughts on the rules that govern transparency and disclosure in our jurisdictions and on our responsibilities as supervisors to encourage their continued advancement.

With that overview, I would like to share some thoughts on the implications of Basel II for supervision, which is my first topic.

2. Implications of Basel II for supervision

When we last met as the community of bank supervisors in Cape Town under a brilliant South African sun, you may recall that the chairman of the Basel Committee at that time, Bill McDonough, described the revision of the capital framework as a "tremendous journey" for all of us. He was quite right. Our journey has lasted five years. Supervisors, central bankers, and representatives of the industry have spent countless hours researching and debating the paths to follow. The public and transparent nature of our consultations subjected our proposals to intense scrutiny. This made our journey a difficult one, but by testing our ideas, we found ways to improve the capital framework.

Today, two years and an ocean away from our mid-point meeting in Cape Town, I am privileged to announce that our journey to "Basel II" concludes a key stage here in Spain. For that, I would like to express my deepest appreciation to you, the members of the supervisory community, for your collaboration, your contributions, and your commitment to the new framework. Basel II emerged from the remarkable spirit of goodwill, cooperation, and dedication to financial stability shared by bank supervisors and central banks worldwide. By providing your perspectives and experience, you helped to ensure the relevance of the "three pillars" to many kinds of banks in many different economies.

Because of your assistance, the question before us today is not *whether* Basel II is applicable to a particular market. Instead, the important question is *when* Basel II should be implemented.

Only national authorities can answer that question. The text that we published this past June will now form the basis for national rule-making and approval processes. Yet adopting Basel II on the same timetable as the member countries of the Basel Committee may not be feasible for all countries. In fact, Basel II may be a lesser priority compared to other efforts to promote the fundamentals of safety and soundness in each country's banking system.

Regardless of when we intend to adopt Basel II in our countries, Cicero would have understood the task ahead for all of us: he wrote that, "In all matters, before beginning, a diligent preparation should be made." Indeed, the success of Basel II in promoting the health of our banking systems tomorrow will depend critically on the diligent preparations that we undertake today.

So now the journey begins anew for us. As we prepare for the next stage of our journey, all of us must encourage our banks to improve their management of risk. We must enhance our own skills as supervisors. And we must strive to make our markets more transparent. Cooperation and transparency will be key in this new journey and Basel II can play a catalytic role.

Basel II offers us an important way forward and provides us with tools for enhancing our supervisory systems. As we review the text of Basel II to consider our next steps, it is easy to be impressed by some of its advanced techniques for quantifying the risk of loss. But the formulas in Basel II are not revolutionary. The advanced approaches to credit and operational risk contained in Basel II reflect the tremendous advances in risk management achieved among some of the most sophisticated banking organisations. Indeed, rather than inventing something new, the Committee adopted many of the sound practices that the industry had already identified.

What is new in Basel II, and what matters most for supervision, is the marriage of two important trends. By building on these trends, Basel II will incorporate principles that are relevant for all supervisors.

2.1 First trend: qualitative assessments of internal controls

The first trend that is captured in Basel II represents a shift in the focus of safety and soundness evaluations. In the past, supervisors emphasised the use of backward-looking evaluations of a bank's performance to determine its financial condition. This drew our attention toward past results rather than future risks and a bank's readiness to manage them.

In contrast, today many supervisors focus more on qualitative reviews of the internal control structures that protect a bank against its specific risks. This represents a far more difficult way of evaluating a bank's safety and soundness. It requires that we look beyond the numbers and into the bank's internal processes. By deepening our insight into a bank's risk management, we gain a much better understanding of its strategies and controls. We learn what risks the bank believes are ahead and what measures it takes to mitigate them. We also develop a more refined sense of a bank's sensitivity and ability to adapt to potential conditions in the future.

This first trend of adopting a more "risk-focused" approach to banking supervision has a positive effect on banks as well. When we examine the quality of a bank's risk management, we demonstrate to management the importance that we ascribe to developing and maintaining safe and sound control structures. A risk-focused approach thereby creates implicit incentives for bank management to understand and to find better ways to control its risks. What results is not just a more proactive risk management function, but also a greater commitment to sound corporate governance across the bank.

2.2 Second trend: incorporate incentives into supervision

Basel II recognises this result and goes one step further by creating not just implicit but also explicit economic incentives for banks to improve the quality of their risk management. The inclusion of incentives directly in the regulatory framework represents the second important trend in supervision.

The proper use of incentives can help to align a bank's objectives more closely with public policy goals of safety and soundness. In recent years, supervisors have begun to move more generally toward a system of supervision that encourages prudent risk-taking through the offering of incentives rather than simply enforcing compliance with rigid rules. Internationally, the 1996 Market Risk Amendment to

the existing Basel Accord represented the first time that banks received explicit capital benefits for developing more sophisticated measures of risk, in that case market risk. Basel II continues this trend by extending incentives to the treatment of credit risk and operational risk.

2.3 Basel II embraces both trends

By stepping back a bit from Basel II's formulas, we can see that the new capital framework builds on two important trends to incorporate a new philosophy for banking supervision. It combines a risk-focused approach to supervision with incentives for prudent risk-taking into a coherent policy objective that seeks to promote adequate capitalisation. By incorporating in all three of its pillars clear incentives for banks to improve their management of risk, Basel II reinforces management's focus on control structures.

- For example, in Basel II's minimum capital requirements - or Pillar 1 - regulatory capital charges are aligned more closely to a bank's own measures of risk. This creates immediate incentives for banks to improve those measures.
- Likewise, Pillar 2 - supervisory review - emphasises that responsibility for evaluating capital adequacy lies with a bank's management. Supervisors will review and respond to those internal assessments, thereby creating incentives for banks to evaluate their exposures thoroughly and to plan their capital strategies carefully.
- Finally, Pillar 3 - market discipline - seeks to make a bank's risk profile more transparent to outside investors and market participants. This should better enable the market to reward banks that take a responsible approach to risk management and penalise those that do not. Market discipline can serve as a powerful incentive for prudent behaviour: indeed, markets are sometimes stricter than supervisors.

Basel II's combination of a process-oriented focus with incentives for banks to improve their risk management offers benefits both for individual banks and for the banking system as a whole.

For an individual bank, Basel II encourages management to adopt approaches that are relevant to the risks the bank faces and that are appropriate for its level of sophistication. That, in turn, ensures that the bank takes prudent steps to protect itself against losses, including making appropriate use of its capital resources.

The consequences are even greater at a macro level. I believe that, when risks are properly assessed and managed across all banks, our banking system becomes more stable, less sensitive to the swings of the business cycle, and better able to promote sustainable growth. This benefits not just individual banks, but also businesses and consumers alike.

3. Strengthening the foundation for Basel II

To achieve these benefits, supervisors must ensure that the foundation for Basel II is ready. Basel II's success in promoting improvements in risk management, and thereby in promoting financial stability, depends on the support of a broad range of other mechanisms and measures in the banking and supervisory structure. I'd like to turn now to the second part of my remarks and offer some views on the elements that comprise a strong foundation, not just for Basel II, but also for safety and soundness more broadly.

Basel II draws heavily on the well-known and well-tested structure of the 1988 Accord. It retains its definition of capital and its notion that capital requirements should reflect the risk of an asset. The Standardised Approach to credit risk in Basel II represents a modest revision of the existing Accord. And in some jurisdictions and for some banking organisations - especially smaller banks that engage in more traditional, lower-risk businesses - the 1988 Accord may remain a relevant standard.

So supervisors need not abandon the 1988 Accord in the near future. However, we have found that as banks engage in more advanced activities, the simplicity of the 1988 Accord quickly becomes a liability. Because it is a static rule, it is falling behind the pace of innovation and advances in technology, telecommunications, and risk measurement and management practices. Basel II provides banks and supervisors with a remedy, one that represents a more flexible and forward-looking approach to capital supervision. In that light, the question I hear from many supervisors is what else can they do to prepare for a future move toward Basel II? I believe that we must strengthen three

areas of supervision in particular that form the foundation necessary for Basel II - and that are, in themselves, equally crucial to safety and soundness.

First, a system of effective supervision must exist in a country. The Basel Committee has previously helped to identify 25 principles that contribute to a supervisor's effectiveness. They are enumerated in the *Core Principles for Effective Supervision* and outline the authority and resources that a supervisor must have to promote financial stability. They include having adequate legal authority to set and apply licensing criteria, prudential regulations and capital requirements; having the ability to conduct ongoing evaluations of a bank's operations and to respond when banks fail to meet regulatory requirements; and having the ability to apply this authority to the consolidated global operations of their banking organisations and to the domestic operations of foreign banks. When applying these principles to internationally active banks, supervisors must furthermore be able to share information with home and host supervisors as necessary.

Second, we must ensure that the market in which Basel II is to be applied is moving toward greater transparency and is subject to a clear set of rules. Sound accounting and provisioning standards must be enforced so that capital ratios - however calculated - reflect meaningfully the bank's ability to absorb losses. The legal and judicial system must make the rights and responsibilities of both banks and their counterparties clear and enforceable so that banks and borrowers can make the most effective use of collateral, guarantees, and other measures to secure credit.

Third, we must confirm that the banking industry is developing a sense of a "culture" of risk management. This is perhaps the hardest criterion to define. To a great degree, Basel II is intended to create incentives for the banks to renew their focus on a risk management culture. At a minimum, countries that seek to apply Basel II must ensure that their banks view risk management not as an exercise in complying with external requirements, but rather as a means for pursuing opportunities responsibly. We must all understand as well that risk management is an art, not a science: it is a way to approach business decisions, but it does not provide automatic answers. Its successful application requires that we constantly improve our skills and our expertise. It demands the use of the best tools and best data available to support our analyses. And ultimately, it requires that we apply our best human judgement to all significant decisions.

All of us can take immediate steps to strengthen our financial and supervisory infrastructure along these three areas. We must ensure the effectiveness of our supervisory systems. We must improve the transparency of our markets. And we must promote the development of sound risk management cultures. We do not need to implement Basel II formally to introduce or to strengthen the principles behind its three pillars. However, beginning to apply those principles can be an excellent way to lay the foundation for Basel II in the future.

For example, supervisors could consider or continue to focus on internal processes and move toward a system of risk-based supervision, to complement and enhance traditional supervision. We can improve our capacity to look beyond the numbers and evaluate the quality and capabilities of a bank's risk management and measurement. At the same time, supervisors can nurture a "risk management culture" by emphasising that banks are responsible for evaluating their capital needs and for developing a strategy to maintain their capital levels, in line with the principles of Pillar 2. Finally, to improve market discipline along the lines of Pillar 3, some supervisors may wish to begin by ensuring a basic level of disclosure across all banks. They could discuss with banks, investors, and other marketplace participants what information they need to understand a bank's risk profile and then work to establish relevant reporting requirements.

Clearly, we have many diligent preparations to make in the coming months and years as we prepare for Basel II. Later today, Nick LePan will share more detailed perspectives on the challenges ahead. Our workshops this afternoon will consider how to plan our transitions to Basel II, to prepare for the adoption of advanced approaches to risk management and the implementation of Pillar 2, and to strengthen cooperation between home and host supervisors.

With regard to this last topic of cooperation, I believe that our safety and soundness goals can be achieved more easily when supervisors adopt more consistent approaches. In particular, Basel II will have the greatest impact if supervisors work in concert rather than in a vacuum. This makes it critical for the Basel Committee to build its ties and to encourage cooperation with other supervisors.

Indeed, as I suggested earlier, many of the improvements to the Basel II proposals resulted from discussions with other supervisors and central banks. The quality of our dialogue illustrates the very good state of relations between all banking supervisors today. This event, for example, represents one

of the most important opportunities for an exchange of views among Committee members and other supervisors. But what begins here must translate into other avenues for communication on both multilateral and bilateral levels.

In this regard, the Core Principles Liaison Group, or CPLG, serves as the main forum for exchanges between Basel Committee members and other supervisors. This working group includes representatives from Committee member countries, 16 non-G10 supervisors, the International Monetary Fund, and the World Bank. Earlier this year, I chaired a very productive special session with this group. I learned first-hand the views of CPLG members on ways to build the Committee's rapport with other supervisors. I also received valuable suggestions on the Committee's projects.

The Committee will continue to rely on the expertise of the CPLG to provide non-G10 reactions to many of its main initiatives. For example, the Accord Implementation Group, which is chaired by Nick Le Pan, the Vice Chairman of the Committee and Superintendent of Financial Institutions in Canada, holds regular meetings with the CPLG to bring attention to non-G10 issues in implementing Basel II.

Beyond this standing group, the Committee seeks other avenues for formal and informal discussions with other supervisors. The CPLG itself has recently suggested that regional groups of banking supervisors strengthen their activities so that they may serve as another channel for greater communication, cooperation, and commitment to shared objectives. The Basel Committee has long supported the development and mission of these regional groups. These groups foster regional cooperation as well as continued dialogue with the Basel Committee and other supervisors. More than a dozen of these regional groups exist, most of which met here yesterday. I encourage all of them to continue to develop programmes of their own. At a meeting between the Committee and the principals of the various regional groups, we discussed additional ways to strengthen future interactions between the Basel Committee and regional groups.

One other formal effort that the Committee and its members support includes those events sponsored by the Financial Stability Institute of the Bank for International Settlements. The FSI provides technical assistance to supervisory agencies worldwide in enhancing the quality of their supervisory systems and the skills of their staff. The Basel Committee and its member agencies remain committed to the activities of the FSI and to working together with fellow supervisors in an efficient and transparent manner. It is one of my highest priorities as chairman of the Committee to strengthen our outreach and communication with fellow supervisors.

4. Accounting

Our overarching goal in these discussions is to help ensure that our supervisory framework keeps pace with evolution in the industry and remains relevant to banking in the twenty-first century. This is, of course, a constant challenge for supervisors in an industry as innovative as the banking sector. Yet we must furthermore look beyond the immediate issues to consider more broadly the many changes in our markets and practices that are relevant to banks' safety and soundness. In recent years, one of the most important reforms that affects not just banking, but in fact nearly all businesses, is the drive toward harmonised accounting standards globally. It is impossible for us to improve transparency and promote stability without examining the changes underway to the mechanics that define how financial data are recorded and reported. I'd like to conclude my remarks this morning with some preliminary thoughts on accounting and supervision and on our responsibilities in this field as supervisors.

I mentioned earlier that the application of sound accounting and provisioning standards is a key element that we must build into the foundation for Basel II. When accounting rules are weak or poorly enforced, neither bankers, nor supervisors, nor marketplace participants can have much faith in their ability to evaluate the safety and soundness of a bank's operations.

No matter how sophisticated a bank's risk management systems may be, they are ultimately worthless if we are unable to determine the worth of the bank's assets and liabilities confidently. Even when standards are enforced nationally, substantial differences in accounting standards between jurisdictions can complicate the ability of global markets to exercise discipline effectively and to allocate capital efficiently across borders.

In our efforts to strengthen financial stability, central banks and supervisors have a legitimate interest in the quality of accounting standards and their effective implementation. We believe that, in order to contribute to strengthening the banking system, accounting standards should support - or at least be consistent with - sound risk management and control practices in banks. In addition, they should

facilitate market discipline by promoting transparent reporting of banks' financial position and performance, risk exposures and risk management activities. Finally, accounting standards should facilitate the effective supervision of banks.

Because of this view, the Committee has sought to participate actively and constructively in the international debates on accounting. Given our interest as well in promoting a more level playing field, ensuring the effectiveness of market discipline, and seeking the efficient allocation of capital across borders, we support the objective towards convergence in accounting guidelines.

During tomorrow's discussions, Dr. Arnold Schilder, Executive Director of the Bank of the Netherlands and Chairman of the Committee's Accounting Task Force, will share some of the Committee's thinking and most recent work on emerging issues related to accounting, Basel II and supervision. After his remarks, we will have an opportunity to meet in smaller groups to discuss issues and the work ahead for supervisors to help promote sound practices with regard to loan accounting, regulatory capital, and fair value accounting, as well as to incorporate the role of external auditors and accountants effectively in the supervisory process.

But these discussions mark only the beginning. Our focus on accounting from the supervisory perspective, and our dialogue with the accounting profession, must continue to grow in the years to come.

5. Conclusion

In my remarks today, I have tried to make clear that, in our new journey, challenging work remains ahead to ready our banks, to build our skills as supervisors, and to promote greater transparency in our markets. As we consider the preparations we must make, we might recall the words of the Spanish author, Miguel de Cervantes. In his world-renowned novel *Don Quixote de la Mancha*, he wrote nearly 400 years ago that, "To be prepared is half the victory." The other half, I think, will be cooperation.

Likewise, the preparations and hard work that we undertake today to prepare for Basel II will, at the same time, strengthen the financial and supervisory infrastructures in our countries more generally, even before we implement Basel II. These preparations are important in helping to ensure the effectiveness of our supervisory systems, to enhance the transparency of our markets, and to develop the sense of a risk management culture in the industry. Together, they will contribute to the promise of greater financial stability in our markets.

That is surely a goal worthy of the preparations we will demand of our banks, of our markets, and of our own agencies. We must recognise that, just as banking is becoming an increasingly complex business, the job of bank supervisors will only become more challenging in the coming years. To promote sound banking and risk management practices on a national, regional, or global level, we will need to work together and cooperate even more in the future. Your participation in this conference speaks to your interest in finding ways to deepen our cooperation as we move into this next journey for supervisors. "El trabajo compartido es mas llevadero," as we say in Spanish: "Many hands make light work" - and, looking around this hall, you will see many hands ready to cooperate.

And so, in closing, I encourage you to make the most of this unique opportunity to build contacts and working relationships and to share views on how we can work together toward greater financial stability in the future.