Jaime Caruana: What's next for Basel?

Remarks by Mr Jaime Caruana, Governor of the Bank of Spain and Chairman of the Basel Committee on Banking Supervision, at the "Basel II: Reality Check" Conference, sponsored by Financial Times Business and the Banker Magazine, London, 10 November 2004.

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1. Introduction and overview

I would like to thank the Banker magazine and the Financial Times Business for inviting me to join this important discussion today on the practical implications of the new capital framework for banking organisations. It is an honour to represent the Basel Committee on Banking Supervision at this event.

The organisers have selected a provocative and highly appropriate title for this conference. As I will discuss this morning, the "real" reality checks for Basel II lie just ahead. Basel II's effectiveness in encouraging improvements in risk management, and in motivating banks to hold adequate levels of capital, will depend principally on the degree to which it reflects the true risks and rewards facing banks. That is the focus for banks and supervisors now as we work toward the implementation of the new framework.

Will Basel II be effective in promoting sound risk management? I am confident that the answer is yes on at least two levels. On the microeconomic level, I believe that Basel II will help to increase the rigour and comprehensiveness of an individual bank's decision-making. As I will explain in the first part of my remarks, the three pillars of Basel II introduce a coherent system of checks and balances - or perhaps reality checks - into the supervision of capital.

Basel II will likewise contribute to the resilience of the banking system on a macro level. In the second part of my remarks, I will discuss some of the factors that suggest that Basel II will more broadly become an effective tool of public policy.

Of course, for Basel II to be effective at the micro and macro levels, we will need to undertake considerable work in the months ahead to prepare for its consistent implementation.

In the third and final part of my presentation today, I'd like to share an update on what supervisors are doing currently to prepare for the implementation of the new capital framework. I'll include as well some thoughts on additional things that banks can do to promote a smoother transition to the new framework.

2. Will Basel II promote sound risk management within individual banks?

To begin, I would like to discuss why I believe that Basel II will promote reasonable and realistic decision-making on a microeconomic level with regard to each bank's capital needs. This effect is critical now that qualifying banks choosing an advanced approach to credit or operational risk will be allowed to apply some of their own assessments of risk in the calculations of their minimum capital requirements.

We might view the entire three-pillar structure of Basel II as a series of built-in reality checks for management's decision-making. In this regard, the three pillars of Basel II are intended to make sure that management assesses and controls its risks carefully and that it takes the steps necessary to allocate the appropriate capital.

As you know, in the first pillar, the minimum capital requirements focus management's attention on identifying, assessing and quantifying risk within a specified framework. This puts the onus of analysis and decision-making on the right set of shoulders: bank managers are in the best position to evaluate their risks and are ultimately responsible for responding to them. When banks consider their risks more comprehensively and work to evaluate rigorously the magnitude of losses that they may face, they are improving the quality of the information at their disposal. That, in turn, should improve their ability to arrive at sound decisions regarding the amount of capital that they may need to weather potential losses in the future.

Considerable attention has been paid to some of the formulas and techniques that we have adopted in Pillar 1 to help quantify the potential for losses related to credit and operational risk exposures. We

must remember that these formulas are not revolutionary. In fact - in one of many examples of how Basel II seeks to reflect reality - the new framework draws on the tremendous advances that many firms have already achieved in quantifying their exposures to credit and operational risk. This reflects as well one of the Committee's goals to build the new framework on sound risk management practices in use today and to provide sufficient flexibility for it to evolve with advances in the future.

At the same time, the Committee knows that mathematical formulas and financial models are only as good as the assumptions they make. At best, therefore, they serve as supplements to our insight: they do not replace our need for expertise and judgement. Even Einstein warned of the dangers of confusing mathematical certainty with reality. He said once that, "As far as the laws of mathematics refer to reality, they are not certain; and as far as they are certain, they do not refer to reality."

Reasonable supervisors and bankers know that we cannot rely purely on the apparent mathematical certainty of models and formulas to make decisions for the uncertainty of the future. Likewise, some banks may engage in unique activities that are not captured in the minimum standards. To guard against overdependence on quantitative models, we have included qualitative provisions to ensure that strong risk management and internal controls are adopted throughout the organisation and to ensure the involvement of boards and senior management. The New Accord also stresses the importance of independent assessments and audits. On top of that, and to ensure that banks are evaluating all of the risks they face, the Basel Committee has incorporated two other reality checks into the new framework, namely Pillars 2 and 3.

Pillar 2, supervisory review, requires each bank to apply its best human judgement to capital planning. Every bank is responsible for assessing its own capital needs, including whether any activities or exposures may incorporate more risk - and hence may require more capital - than is assumed in Pillar 1. Supervisors, in turn, must evaluate the bank's judgement and processes; moreover, they must respond if any bank's capital planning seems unrealistic.

Similarly, Pillar 3 - market discipline - provides another external check by offering greater insight into a bank's risk profile to investors, counterparties, rating agencies, and others. Marketplace participants are then better able to assess whether a bank's management is engaging in the reasonable and responsible pursuit of opportunity and profit. They are better able to reward companies that are well managed and to penalise those that are not. That, in turn, encourages all banks to consider their current risk exposures carefully and to make appropriate plans for risks that may be on the horizon.

Let me also briefly take this opportunity to recall that the new framework also imposes principles of transparency on supervisors as well as on banks. Pillar 2 requires supervisors to carry out their obligations in a transparent and accountable manner, for example making publicly available the criteria they use in the review of banks' internal capital assessments, and explaining to banks why any remedial actions are considered necessary. So we see transparency as an effective tool and reality check for ourselves too.

The three pillars together can thus be seen as a series of checks and balances that seek to promote reasonable and realistic approaches to risk management and to capital management in banking organisations. The efforts that banks take to identify and assess their risks rigorously, and to evaluate and implement measures necessary to protect themselves effectively, represent not just good steps toward maintaining capital adequacy, but also important steps toward improved corporate governance on a broader scale.

3. Basel II will become an effective standard at the macro level

I believe that Basel II will likewise serve as an effective standard at the macro level, which is the second topic I'd like to address today. Supervisors and central bankers are increasingly interested in standards that will strengthen the stability of the banking system and of the financial system more broadly. Indeed, just across the street from us here at Grocers' Hall, the Bank of England is an example of a central bank that is explicitly charged with promoting financial stability. Another example would be my own institution, Banco de España.

In my mind, three factors will drive Basel II's success as a public policy standard.

I have already hinted at one relevant factor. The new framework contains explicit incentives to motivate prudent risk management. Banks that qualify to use the more advanced approaches will rely increasingly on their own measures of credit and operational risk exposures when calculating their minimum capital requirements. Because these more advanced approaches will align capital

requirements more closely with the risks that banks actually face, I expect that banks will seek to develop and improve their risk management processes individually.

I would like now to stress the need for an appropriate time horizon, the need to introduce forward-looking approaches, and the importance of avoiding excessive short-termism when assessing risks. It means that risk managers should be very conscious of how risk-drivers change through the cycle and in stress conditions, and incorporate these elements into their decision taking processes.

Basel II has been sensitive to these concerns and has incorporated a number of elements such as long-term average calculations, the need to use longer time horizons in the design of internal rating systems and also the need to incorporate stress tests and calculations into downturn conditions.

I believe that when risks are correctly assessed, within the appropriate time horizon, and banking systems are adequately capitalised, the financial system as a whole becomes more stable, less sensitive to the ups and downs of the business cycle, and better able to serve as a source of credit and growth to businesses and consumers alike.

A second factor that suggests Basel II will be an effective standard relates to the process that the Committee used to develop the new framework. The new capital framework emerged from a process involving intense public scrutiny. We conducted three major public global consultations on the new framework and several impact studies. Over nearly six years, the Committee received hundreds of formal comment letters from bankers, supervisors, central bankers, academics, politicians and many other industry observers. We heard countless more informal views in meetings and discussions.

Many of you and your institutions participated quite actively in those exchanges. Likewise, the *Banker* magazine, the *Financial Times*, and other industry journals plus the mainstream media contributed greatly to this dialogue by publishing thoughtful articles and opinion pieces on the issues that arose in these discussions. The members of the Committee are deeply grateful to all who participated in our discussions, who aired views on the proposals, and who contributed data to help assess their likely impact.

In total, the consultations on Basel II represented what might have been an unprecedented degree of public scrutiny for such a technical global agreement. This made the review of the proposals more comprehensive, but also more arduous for everyone involved. Yet steel is forged only at high temperatures. Because of your comments and suggestions, the Committee was able to clarify many of the rules to achieve a better balance between complexity and risk sensitivity. Our discussions with the industry moreover helped to align the requirements with the components of risk that matter most. Likewise, the global consultations increased the relevancy of the new framework to many kinds of banks in many different banking systems around the world. Because of these debates, the rules contained in Basel II are better grounded in the state of the art of risk management today and better prepared for likely advances on the horizon tomorrow.

This leads directly to the third factor that I believe will help to drive Basel II's success. The new framework builds on the practices that leading banks already employ. I mentioned earlier that it incorporates advances in risk quantification and modelling. Beyond those advances, it recognises other techniques used to reduce the risk of loss, such as the taking of collateral and guarantees, which were not well-integrated into the existing capital framework. By reducing the gaps between regulatory approaches and the reality of banks' own internal processes, I believe that we are making our capital framework more relevant and more responsive to the needs of banking in the twenty-first century.

So, together, what will make Basel II effective as a supervisory standard includes the incentives built in to motivate responsible behaviour; the extensive testing and public consultation that helped to strengthen and clarify the rules; and the incorporation of sound practices already in use, along with the flexibility to evolve as sound practices do. All of these factors reflect the design and intent of the new framework as well as the process that we followed to develop it. The third and final topic that I would like to address this morning concerns what supervisors are doing right now to prepare for Basel II's implementation - and what banks can do as well.

4. What are we doing to prepare for Basel II's implementation?

Now that the framework has been published, the Basel II project has entered a new phase focusing on implementation. Over the coming months and years, reality checks will continue to play a role for both bankers and supervisors in ensuring Basel II's validity and feasibility as we implement the new framework. For our part, I believe that we can divide supervisors' preparations into three main areas of

focus. These include reviewing the calibration of the new framework; adjustments to the framework to reflect advances in risk management practices; and fostering a more consistent application of Basel II across jurisdictions. I'll take a few moments to outline our work in each area.

a) Evaluate calibration of Basel II

First, the Committee has long expressed its commitment to ensuring that the framework performs as intended before it is implemented. This includes reviewing whether the framework delivers the amount of capital that we believe is necessary to protect the safety and soundness of individual banks on the one hand, and the broader banking system on the other.

In some jurisdictions, national supervisors will conduct additional field tests to determine whether the new rules deliver the levels of capital we expect. Similarly, in all jurisdictions, there will be a period of time during which banks will calculate their capital requirements in parallel under the 1988 Accord and under Basel II.

National field tests and the period of "parallel running" of the new framework will serve as some of the final reality checks for Basel II prior to its implementation. We recognise that these tests and reviews will demand resources and substantial efforts from both banks and supervisors. Yet I must emphasise that neither banks nor supervisors will be able to evaluate the calibration of the new framework - and hence its effectiveness - if banks do not participate fully and seriously in the national field tests or in the periods of parallel running. I urge you to devote your best efforts and resources to these undertakings. Only you can provide the data that all of us will need to ensure that Basel II functions as we intend.

b) Monitor ongoing advances and clarify and provide guidance for selected rules

A second area where supervisors are active is in monitoring ongoing advances in risk management while clarifying and providing supplemental guidance for some of the rules. Like the development of the framework itself, this work will require a great deal of communication and co-operation between banks and supervisors.

Consequently, our dialogue did not end with the publication of the Basel II text this past June. Indeed, it cannot cease, because, as I mentioned, one of the Committee's underlying goals is to develop a framework that can adapt to future advances in risk management practices. Supervisors are committed to monitoring and discussing these developments with the industry. The Committee will make adjustments to the framework to reflect the state of risk measurement and management when necessary.

I am pleased to say that the Committee is already honouring this promise. One topic that we are studying carefully concerns the treatment of "double default." Some representatives of the industry believe that Basel II takes an overly conservative approach to the risk of loss associated with exposures covered by guarantees: they suggest that the risk of both a borrower and a guarantor both defaulting on the same exposure is lower than the risk of just one party defaulting. The Committee believes that the new framework should recognise double default effects, and a working group is currently considering all of the implications, including those associated with measuring the effects, before we agree on a solution. We remain dedicated to finding a sound treatment of double default prior to the implementation of the new framework.

Other groups are discussing potential improvements to Basel II's treatment of certain trading-related exposures. Industry representatives had expressed the view that while many important advances had been achieved in the management and measurement of various risks arising from trading activities, neither the existing market risk capital rules nor Basel II went far enough in recognising them.

We are now evaluating these views. Because the treatment of the trading book is of great interest to banks and to securities firms, we are collaborating with the International Organization of Securities Commissions (IOSCO) to clarify the Basel II rules and to find risk-sensitive capital treatments for certain trading book exposures that are compatible with Basel II.

Just last month, for example, the joint working groups completed a survey of trading book exposures in banks and securities firms, focusing on three main topics. The first concerns the criteria that firms use to determine whether an exposure qualifies for inclusion in the trading book versus the banking book. The second deals with the practices banks and securities firms use to value and measure the risk of trading positions. The third part sheds light on the treatment of counterparty credit risk issues

related to repo-style transactions, securities financings and unsettled trades and credit derivatives. Our working groups are currently evaluating responses to the surveys and will draw on the surveys to help inform their discussions on clarifications and guidance that the Basel Committee can offer to banks and supervisors regarding the treatment of the trading book.

c) Home-host co-operation

A third area of focus for supervisors that I would like to highlight concerns our efforts to promote a more consistent application of the new framework across jurisdictions. Certainly one of the goals for any international framework is to foster a more level playing field for internationally active competitors. The Basel Committee wishes to ensure that competition between internationally active banks is driven by each bank's individual strengths, rather than by differences in each country's rules. I know that banks are deeply interested in this topic as well. Representatives from many internationally active banks have impressed on me their concern that supervisors must work to avoid large differences in the adoption of Basel II and, more specifically, in the use of advanced approaches across jurisdictions.

While we in the Committee share this concern, we have to be pragmatic; I believe that all of us need to stop to make a quick reality check of this matter as well. Basel II is intended to promote a more level playing field for internationally active banks. Yet Basel II cannot and should not be expected to create perfect harmonisation across all jurisdictions. Differences in legal systems, market practices, and business environments in each country make it an extremely difficult task - and, indeed, an impossible one - to level all distinctions across all borders.

Our goal for Basel II should instead be to facilitate the application of minimum standards and to work together, across borders, to promote a more consistent implementation and application of the new framework. With or without Basel II supervisors need to enhance co-operation in a world that moves towards larger scale cross-border activities and a greater presence of systemic foreign banks in domestic economies. This enhanced co-operation is a process that will promote consistency and convergence of supervisory practices. It will help to avoid performing redundant and unco-ordinated approval and validation work in order to reduce the implementation burden on the banks and conserve supervisory resources, and will therefore contribute to a more level playing field for internationally active banks.

In this regard, the Committee's Accord Implementation Group continues to encourage practical work among supervisors on applying Basel II effectively and efficiently to internationally active banking organisations. Chaired by Nick Le Pan, the Superintendent of Financial Institutions in Canada, the AIG is currently working with supervisors in non-member countries as well to conduct a number of "real case" studies to gain better insight into the practicalities of co-operation between home and host supervisors that will be essential for Basel II's successful implementation.

So far, the AIG has identified at least two findings that are relevant to banks interested in the cross-border application of the new framework. One is that the ability of supervisors to make plans to co-operate across borders, and thereby to reduce the regulatory burden on an individual bank during the transition to the new framework, depends to a great degree on the clarity of a bank's own implementation plans.

Another finding is that in some cases the overseas branches and subsidiaries of the bank may know very little about its own plans to adopt Basel II. This may be true even in some institutions that plan to adopt advanced approaches. Because the bank's local managers may lack knowledge of how Basel II will be implemented internally, supervisors in the host jurisdiction may be uncomfortable with the bank's overall readiness for Basel II. It may simultaneously increase the host supervisor's need to contact the bank's head office or its home supervisor for more information - something that might duplicate requests for information.

The bottom line is that for home and host supervisors to work toward a more consistent application of Basel II, each bank's own plans for adopting the approaches in the new framework should be clear and comprehensive. Equally important, banks should communicate those plans not just to their supervisors, but also to their own overseas branches and subsidiaries.

And now, if you will permit me, before concluding my remarks today I would like to put on a different hat for a moment, and speak from my perspective as a banking supervisor from a European Union country. I strongly believe that Europe is in a unique position to lead the way in the cross-border implementation of Basel II and to make faster and more tangible progress than is currently possible on

a wider international basis. We need to seize this opportunity with both hands, because it will not just benefit us in the EU but, I believe, also have a positive impact beyond our borders.

We have two major advantages in this respect. Firstly, within the European Union, we have a set of single market legislation in the banking field, founded on harmonisation and mutual recognition. Furthermore, the division of supervisory responsibilities between our countries is embedded in this common legal framework and has been in place for some time.

Secondly, from a practical perspective, we also now have the Committee of European Banking Supervisors - CEBS. This committee is directly charged with promoting convergence of supervisory practices and co-operation between supervisory authorities, and has a key role to play in the implementation of Basel II in Europe.

For these reasons, I believe that we can - and must - be more ambitious and go further than others may be able to go in our efforts to ensure consistent implementation of Basel II and effective supervision on a cross-border basis. We should not only move faster, but also go deeper in our search for convergence. We could deliver results, on matters like model approval, on reporting, on the enhanced role of the consolidating supervisor, even on supervisory disclosure. Therefore, I very much support the work which is under way in fora such as CEBS in these areas. After a few months of existence the work done is already very encouraging. And I think that by making rapid and real progress, we can also promote greater convergence beyond the EU, as others may find our experiences of benefit to the wider search for greater international consistency in the implementation of Basel II.

5. Concluding thoughts

Over the rest of the day, we will hear additional perspectives from bankers and supervisors regarding the realities of the work ahead for all of us as we prepare to adopt and implement the new capital framework. In thinking about the preparations that all of us 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.”

In my remarks this morning, I have tried to highlight why I have great confidence in this victory. It will no doubt require that we continue to dedicate our resources, our staff, and our talent to realise the benefits of Basel II in the coming months and years. Those benefits extend to much more than simply a more favourable capital requirement for qualifying individual banks. I believe that, when all banks have the proper incentives, Basel II will improve our abilities in risk management more broadly; it will ensure that capital supervision continues to serve effectively as a cornerstone to safety and soundness in the banking system; and it will strengthen the stability of our financial system overall. Those benefits are worthy of all of our efforts.

Thank you.