Jaime Caruana: Overview of Basel II and its reflections on financial stability

Speech by Mr Jaime Caruana, Governor of the Bank of Spain and Chairman of the Basel Committee on Banking Supervision, at the International Conference on Financial Stability and Implications of Basel II, Central Bank of the Republic of Turkey, Istanbul, 16 May 2005.

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Introduction and Overview

Thank you, Governor Serdengeçti, for your kind words of introduction and your opening remarks on what promises to be a timely and interesting conference. I am honoured to have the opportunity to share with you some thoughts on two related topics that are near and dear: financial stability and the Basel II capital framework.

As I will be discussing this morning, the financial sector and banking supervisors are in the midst of a period of great change. Change and growth must be second nature to this great city on the Bosphorus, where the remains of the Roman, Byzantine, and Ottoman Empires reside within a modern, forward-looking city. Istanbul has thrived over the centuries in the face of constant evolution, and today serves as a bridge between Europe and Asia, east and west, ancient and modern. Of course, the challenges of Basel II cannot truly compare to the development of a city with almost 3,000 years of history, but certainly Istanbul seems to me a very appropriate place in which to discuss the role of banking supervisors in a rapidly changing world.

My talk this morning will address several issues. First, I will talk about why the Basel Committee developed the Basel II capital framework and what it intends to accomplish. Second, I will share some thoughts on how prudential banking supervision contributes to the stability of the financial system. Next, I will discuss how I see Basel II contributing to financial system stability. Finally, I will offer some thoughts on steps countries can take in preparation for adopting Basel II.

But let me advance the main conclusion of my presentation:

In a nutshell, I think that the new capital framework represents a significant step towards achieving a more comprehensive and risk sensitive supervisory approach. Basel II is about much more than just setting better quantitative minimum capital requirements. It is about establishing incentive-based approaches to risk and capital adequacy management, within a comprehensive framework of three mutually-supporting pillars. In my view, the combination of better risk management, a stronger capital structure and improved transparency standards in the banking system can significantly improve financial stability.

Why Basel II?

Let me begin with an overview of the Basel II capital framework, which was released in June last year. As you may be aware, Basel II has probably attracted more public attention than any other banking supervision reform. While I will not go into the details of the new framework, it is important to spend a few minutes talking about what the Basel Committee hopes to achieve with Basel II.

Any discussion of Basel II should probably start with the 1988 Basel Accord, which established the first internationally accepted definition and measure of bank regulatory capital. In many ways, the 1988 Accord was a tremendous success story. It was adopted in over 100 countries, and contributed to the strengthening of bank capital at a time when a number of countries had experienced problems in their banking systems. It has become one of the benchmark measures of a bank's financial health.

While the simplicity of the 1988 Accord helped to foster its widespread acceptance, that simplicity has become a liability for some banks and supervisors. Almost 20 years later, industry developments in risk measurement and management have widened the gap between the regulatory capital measure under the 1988 Accord and the internal capital measures used at many internationally active banks. More sophisticated technology and telecommunications, as well as market innovations, have enabled banks to better measure and manage their risks. As a result, the Basel Committee determined that a new capital framework was needed that would address these developments for the most complex and sophisticated banks, but that would also be appropriate for less complex banks. The Committee also determined that the new capital framework should provide incentives for banks to improve their risk management practices without reducing the overall level of capital held in the banking system.

Basel II, in my view, is fundamentally about better risk management and corporate governance on the part of banks, as well as improved banking supervision and greater transparency. It is also about increasing the stability of the global financial system, to the benefit not only of banks, but also consumers and businesses.

The new capital framework attempts to achieve these objectives with three mutually reinforcing pillars. The first pillar aligns minimum capital requirements more closely with banks' actual underlying risks. Qualifying banks may also rely partly on their own measures of those risks, which will help to create economic incentives to improve those measures. In concept the first pillar is similar to the existing capital framework in that it provides a measure of capital relative to risk. What is new are the second and third pillars.

The second pillar – supervisory review – allows supervisors to evaluate a bank's assessment of its own risks and determine whether that assessment seems reasonable. It is not enough for a bank or its supervisors to rely on the calculation of minimum capital under the first pillar. Supervisors should provide an extra set of eyes to verify that the bank understands its risk profile and is sufficiently capitalised against its risks.

The third pillar – market discipline – ensures that the market provides yet another set of eyes. The third pillar is intended to strengthen incentives for prudent risk management. Greater transparency in banks' financial reporting should allow marketplace participants to better reward well-managed banks and penalise poorly-managed ones.

That, in sum, is what Basel II is all about. I believe that the incentives for better risk management that are built into the new capital framework, and the flexibility to adapt the framework to local needs, will ensure its validity. I also believe it marks a major step forward in the right direction, and that it will contribute to a more resilient and stable banking system that is capable of promoting sustainable economic growth.

The Committee recently announced its intention to verify that Basel II meets our long-stated objective of maintaining the overall level of capital in the banking system while keeping incentives to adopt the most advanced and risk-sensitive approaches. As a result we intend to conduct a fifth Quantitative Impact Study, or QIS 5, in the last quarter of this year. It is important to understand sooner rather than later what the impact of the framework will be. The Basel Committee will continue its work based on the existing timetable, and supervisors and bankers planning to implement Basel II should continue their preparations accordingly.

Banking supervision and financial stability

Let me turn now to my second topic, which is the link between effective banking supervision and financial stability. I'm sure we can all agree that a stable banking system is critical to the long-term growth of an economy. But discussing financial stability issues is always a challenge because we don't have a framework for financial stability as comprehensive as in the case of price stability. However, in recent years, we have learned more about the concurrent need for macroeconomic stability and a stable financial system. That concept includes the need for businesses and consumers to have access to credit on fair and reasonable terms through all stages of the business cycle so that they can build and grow. We need an efficient and resilient payments system to maintain the flow of funds through the economy at all times. We need financial markets that remain active, liquid, and trusted regardless of events in the economy.

The challenge for supervisors is to promote the health of the banking sector with a broad range of tools. We have certainly found that problems in the banking sector tend to have a "ripple effect" across the wider economy. Therefore, it is in everyone's interest that a country's banks should be able to manage their risks today and respond to challenges tomorrow. This is first and foremost the responsibility of the banks themselves, but supervisors also have an important role to play in ensuring that banks are prudently managed and capitalised.

Banking is fundamentally about trust. Banks are charged with a special public trust to safeguard customers' wealth. We have all seen what happens when customers lose trust in the ability of individual banks or the banking system as a whole to protect their savings. This puts a special onus on banking supervisors to ensure that banks operate soundly. No bank can maintain public trust for long if it lacks sufficient capital, so supervisors impose capital requirements to safeguard the banking system. Since capital is the last line of defence against bank insolvency, regulatory capital requirements are one of the fundamental elements of banking supervision.

I should note that strong banking supervision is not enough to ensure financial stability. While I believe that a sound financial system requires robust regulatory and supervisory frameworks, there are many other potential sources of financial instability outside the financial system. Many financial crises have not resulted from shocks arising in the financial system. Any regulatory or supervisory framework must be built on a series of preconditions and on the foundations of a sound supervisory system.

With respect to preconditions, there is a set of issues that may be considered. Firstly, I think there is a broad consensus among all of us about the importance of promoting the implementation of **appropriate macroeconomic policies** consistent and sustainable over time. Secondly, an **appropriate institutional framework is also needed**. In particular, a set of mercantile and civil laws must be in place to safeguard agents' property rights. A legal and judiciary structure which provides legal security must thus be in place, together with the so-called **safety net** institutional arrangements**, core principles. etc.** Moreover, it will be necessary to consider **microeconomic aspects related to payment-system and market structures**.

All these considerations allow us to underline the notion that the achievement of financial stability must be based on a broad range of tools which we should all seek to strengthen. Achieving a coherent approach to financial stability may be challenging, if only because it requires a consistent combination of macro and micro elements and because of the large number of interested and participating parties. Also, it should foster financial innovation, and ensure a level playing field. I believe that prudential supervisors should analyse the extent to which conditions are in place so that the banking system can remain resilient in the face of internal and external shocks. This should contribute to the proper functioning of the economy under a wide range of circumstances.

Basel II and financial stability

That leads me to my third topic, which is a discussion of the impact the new capital framework will have on financial stability. You are probably not surprised to hear that I believe the framework will enhance stability. But let me elaborate on several areas where I believe Basel II will foster stability.

Incentives for better risk management

First, I believe that Basel II is a major step forward in strengthening the incentives for the ongoing improvement of banks' risk measurement and management systems. The new capital framework is an incentives-based system and it is a risk-based framework. By creating a right set of market friendly incentives to improve risk management, Basel II offers us the opportunity to ensure that supervision and regulation takes a forward-looking view on risk, that it remains up-to-date with sound practices in the industry and that our supervisory framework motivates responsible risk-taking and prudent behaviour in our markets.

Improved and more formalized risk management will bring better assessment better quantification and more awareness of risks. To the extent that risk assessment and control methods **become more formalised and rigorous**, this will lessen the likelihood of making bad decisions and will improve risk-adjusted pricing policies. It will also contribute to the prompt detection of errors and deviations from targets, allowing banks to implement corrective measures at an early stage. Increased **awareness** of the risks and **early reaction** to problems is likely to lead to a smoother adjustment to new conditions or to the correction of mistakes, making decisions less abrupt

However, we should remember that despite the significant progress made in the banking industry in the use of models and new technologies, banks still depend largely on risk managers' expert judgement. Such judgement is valuable and will always be necessary, but should be reinforced with the best possible information in conjunction with up-to-date techniques and tools for processing that information. Banks should be encouraged to develop systems that allow managers to identify and understand the risks they are facing, consider the risks that may arise in the future, and respond promptly and actively to both. Basel II will not only help banks to measure and allocate the provisions and capital necessary to withstand expected and unexpected losses, but it will also help supervisors and market participants to ensure that banks have done so in a way that will maximise the likelihood that they can continue to operate, even in the most difficult of circumstances.

Sound corporate governance

The second reason I believe Basel II will promote financial stability is that it promotes more effective corporate governance. Risk management must be based on a strong foundation of corporate governance. A bank can have the most sophisticated measurement tools in the world, but if it is poorly governed, it will be vulnerable to financial and operational weaknesses.

The Basel Committee recognised this when it developed the qualifications that banks must meet in order to adopt the most advanced approaches under Basel II. While much attention has been paid to some of the more complex quantitative aspects of Basel II, I believe the most important qualifying criteria are those that address how the bank's risk management framework is governed. Banks that adopt Basel II will be expected to have a comprehensive and sound planning and governance system to oversee all aspects of their risk measurement and management process. The board of directors, senior management, and audit and other control functions will be expected to exercise their duties in a rigorous manner. I believe that better managed banks under Basel II will be safer, sounder, and more resilient.

Shock absorbers adequate and risk sensitive.

Third, I have already mentioned that no bank can maintain public trust for long if it lacks sufficient capital. One of the fundamental tenets of risk management is that banks need to create provisions to absorb expected losses and to have sufficient capital to absorb unexpected losses. Accordingly, capital and provisions are an essential part of any supervisory framework. I believe Basel II reinforces the need to implement sound policies in both areas.

I will just add in this point that given the unique positions of banks at the crossroads of businesses and consumers in every economy – and their special role as intermediaries of credit to both – nothing threatens financial stability more than the presence of poorly managed and poorly capitalised and provisioned banking institutions.

Appropriate time horizon and counter-cyclical elements. Stress testing

Fourth, the solid and stable functioning of banks requires an additional consideration, a macro perspective. Namely, risk management decisions, capital and provisioning policies should be set with an appropriate time horizon that allows at least a full business cycle to be considered and avoids excessive emphasis on the short term when assessing risks. The aim is not to promote the uniformity of time horizons, but to encourage managers to consider how risk determinants alter over the cycle and in conditions of stress.

The need for capital in a full range of economic scenarios has resulted in a requirement that banks consider stress scenarios when assessing capital adequacy. One of the fundamental tenets of risk management is that banks need to create provisions to absorb expected losses and to have sufficient capital to absorb unexpected losses. Accordingly, capital and provisions are an essential part of any supervisory framework. I believe Basel II reinforces the need to implement sound policies in both areas. In this respect, it is important to analyse provisions and capital over at least one complete economic cycle. Moreover, a range of potential future scenarios, with an emphasis on stress scenarios, should be considered, taking into account past experience and current conditions. Indeed, Basel II requires banks adopting the more advanced approaches to credit risk to apply a forward-looking approach to credit risk management by meaningfully stress testing their credit portfolios.

Gaining room for manoeuvre and shoring up finances during good times in the business cycle is not only prudent policy, but is also consistent with sound risk management. Many would say that risks increase during bad times, but I believe this is only partly true. In my view, the exposures of banks, and therefore their risks, actually increase during economic upturns. These risks may not materialise until times of difficulty, but the seeds are generally planted during good times. In sum, when designing their capital and provisioning strategies, managers should have the aim of strengthening banks during good times and should remember that the imbalances that foster financial instability usually build up during the best parts of the economic cycle.

Transparency

Fifth, a very important reason why I believe Basel II will contribute to financial stability involves greater transparency. The exercise of market discipline should be considered a vital element of successful prudential policies. In particular, in order to ensure responsible and prudent behaviour by bank managers, supervisory action is not sufficient. Majority and minority shareholders, depositors and debt-holders should also have the capacity to evaluate banks and reward or penalise them according to how prudently they are managed. As mentioned earlier, Basel II, via the third pillar of the framework, provides for greater transparency. This should serve to curb excessive risk-taking in advance, and should reduce surprises that arise from opacity that can result in a shock to the financial system.

Risk-based supervision

Sixth, the assessment of risk has begun to play a predominant role in supervisory procedures. Banking supervision traditionally sought to ensure the solvency of banks by emphasising an accounting review of their financial and capital position. There is certainly still a role for this type of review, particularly in assessing asset quality and ensuring proper provisioning and risk concentration policies. The traditional approach is no longer sufficient, however. Today it is necessary for supervisors to place a greater emphasis on anticipating problems. It is vital to complement the traditional accounting approach with a greater emphasis on the analysis of the risks that affect banks and the management and control systems that mitigate such risks.

Basel II places a firm emphasis on taking a risk-based approach to supervision. Banks are expected to conduct their own internal assessments of risk and capital adequacy. Supervisors, in turn, are expected to regularly review these assessments. The intent is not to have supervisors functioning as bank management. Rather, supervisors should evaluate the degree to which a bank has a sound internal process in place to assess capital adequacy.

This assessment should take into account not only credit and market risk, which are part of the current capital framework, but also other critical risks such as interest rate risk in the banking book and credit concentration risk. In addition, banks are expected to manage and hold minimum regulatory capital against their exposures to operational risk, which is the risk of losses stemming from failures in internal processes or systems or from external disruptions. Indeed, we have found that some of the largest bank losses in recent years have been the result of operational loss events.

Responsiveness to rapid changes in the financial sector

Seventh, Basel II is an evolutionary framework that is responsive to recent trends in the financial sector and capable of adapting to future changes. Technological advances and institutional developments have provided for more mature financial markets and more reliable and efficient payment systems. The banking business has grown more sophisticated, in large part as a result of technological progress. Technology allows banks to offer solutions which not only provide a more individualised approach to customers, but also allow banks to operate more efficiently. Competition has required banks to control their costs and operate with a higher level of efficiency in order to ensure their survival. This has occurred both within national borders and internationally as well.

The growing sophistication and internationalisation of financial institutions, combined with their greater sophistication, have contributed to the emergence of new risks and to the intensification and rapid transmission of previously existing risks. A number of bank managers have responded by improving their risk management systems and allocating more resources to risk identification, measurement and control. Banking supervisors face the challenge of responding meaningfully to these trends without curbing financial innovation, and I believe Basel II will help supervisors to meet this challenge.

Greater cross-border co-operation among supervisors

The final reason that I believe Basel II will contribute to financial stability is that the growing scope and complexity of banking groups and financial markets make it necessary to increase international co-operation between supervisors. While not new, this issue is increasingly important. Effectively combining the necessary supervision at the local level in the host country with effective supervision at the consolidated level in the home country requires greater co-operation, a more thorough exchange of information, and better knowledge of financial instruments and links within financial groups.

Basel II not only encourages such co-operation; its success will largely depend on the effectiveness of such co-operation. It will be necessary in the future to foster greater co-operation, co-ordination, and consistency in evaluating banks' capital adequacy. This will promote consistency in the implementation of standards, a level playing field, and the reduction of unnecessary regulatory burdens. It will also diminish banks' incentives to engage in regulatory arbitrage across different jurisdictions.

Work is underway on a variety of fronts to promote such co-operation. First and foremost, the Basel Committee's Accord Implementation Group, or AIG, is working to foster information-sharing among supervisors to promote consistency of Basel II implementation. The AIG is encouraging home and host supervisors, including those from non-G10 countries, to use actual banks' implementation plans as the basis for heightened co-ordination and communication.

The Committee welcomes the work being done in a number of non-member countries and believes that continued outreach is essential. Dialogue with countries outside the Basel Committee played a critical role in the development of the revised framework, and I am personally committed to continuing such dialogue in the future as the new capital framework moves into the implementation phase.

Adoption of Basel II: who and when?

I would like to share some thoughts on when and how the new framework should be adopted in different countries. I am not referring specifically to Turkey with these comments, as it is not for me to talk about your plans in this respect, but I would like to make some comments about how we see the process in general terms.

Let me begin by emphasising that I cannot answer the question of when or how any country should adopt Basel II. Whenever I speak with colleagues from other countries, I stress that only national authorities can decide when to adopt Basel II. Members of the Basel Committee believe that it is beneficial to move in the direction of Basel II, but no country should adopt Basel II if it feels that it is not yet ready. If a country does decide to adopt Basel II, the timing should be determined by its own circumstances, not the timetable for Basel Committee members.

I hope you will pardon my pronunciation, but I am told that there is a Turkish proverb that says "hamama giren terler," or "he who enters a Turkish bath sweats." If I understand correctly, the point of this proverb is that you should understand the consequences of your actions. If the result is to be very positive, some work and thus some sweat is required. I don't know whether adopting Basel II is similar to entering a Turkish bath, but I do know that it is important to understand that this is a high-quality and demanding standard.

Unlike the 1988 Accord, which was relatively simple to adopt, Basel II is more complex and demands more of banks and supervisors. Therefore, we don't expect Basel II to be adopted as widely and quickly as the 1988 Accord, at least at the outset. However, we do believe it is appropriate for all economies, and we expect and hope that the number of countries that adopt the new framework will grow over time. We believe that countries should adopt the options and approaches that are most appropriate for the state of their markets, their banking systems, and their supervisory structures. Basel II is not a "one size fits all" framework. Supervisors can adopt the framework on an evolutionary basis and use elements of national discretion to adapt it to their needs.

For any country that is considering adopting Basel II but may not yet be ready, I like to suggest a three-stage approach towards building a foundation for the new framework: (1) strengthening the supervisory infrastructure; (2) introducing or reinforcing the three pillars; and then (3) making the transition from the 1988 Accord to Basel II.

The first stage is strengthening the supervisory infrastructure. Basel II is not intended simply to ensure compliance with a new set of capital rules. Rather, it is intended to enhance the quality of risk management and supervision. One of the things that I strongly encourage for all countries is a review of implementation of the Basel Committee's *Core Principles for Effective Banking Supervision*. These principles are key to laying a successful supervisory foundation. Likewise, sound accounting and provisioning standards are critical to ensuring that the capital ratios, however calculated, meaningfully reflect the bank's ability to absorb losses.

The second stage, then, is to consider how the second and third pillars of the new framework can be implemented. Supervisors do not need to wait for the formal adoption of Basel II to start introducing or using the principles of the three pillars. On the contrary, incorporating these principles is excellent preparation for adopting Basel II in the future. For example, supervisors might choose to move towards a more risk-based approach to supervision, developing skills in assessing the quality of a bank's risk management and its ability to assess risk exposures. At the same time, banks could be reminded of their responsibility to develop their own processes for evaluating their capital needs and a strategy for maintaining their capital levels, consistent with the principles of Pillar 2. With regard to the principles of market discipline in Pillar 3, supervisors may wish to focus initially on ensuring a baseline level of disclosures across all banks. This might include discussing with banks, investors, and other users of financial information their information needs and the tools available so that supervisors can tailor requirements accordingly.

In my view, these two preliminary stages provide an excellent preparation for the "final" stage of moving to Basel II. With a strong foundation in place, supervisors can then select the alternatives within Basel II that are most appropriate for their own circumstances.

Conclusion

To conclude, let me insist on the general principle on which I think supervision should be built, which I mentioned before. Supervision needs to consider a broader analysis of the vulnerabilities internal and external to the banking sector, including the necessary macroeconomic and institutional elements, and those relative to the stability of financial markets on which banks operate. I think that Basel II recognizes the importance of a combination of micro and macro factors for achieving greater financial stability. Furthermore, I would say that Basel II incorporates some of the key basic principles that are also built in modern approaches to monetary policy: a flexible and forward-looking approach, anticipatory rather than reactive behaviour to risk, and the need to take into account market views.

Looking into the future, we must direct our resources to ensure that banking supervision in the 21st century is more dynamic, more preventive, more flexible, more inclusive, and more transparent. We should continue adapting and learning. I believe the ultimate objective of financial stability increasingly requires co-operation and properly aligned incentives on the part of the industry, markets, and supervisors.

Thank you.