Nout Wellink: Global banking supervision in a changing financial environment

Formal opening address by Dr Nout Wellink, President of the Netherlands Bank and Chairman of the Basel Committee on Banking Supervision, at the 14th International Conference of Banking Supervisors, Mérida, Mexico, 4 October 2006.

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Introduction

Good morning. It is an honour and a privilege for me to officially open the proceedings of the 14th International Conference of Banking Supervisors. This is my first formal address as Chairman of the Basel Committee on Banking Supervision, and I can't imagine a more appropriate venue for my first speech than here with my colleagues from the international banking supervisory community.

In addition, this year's ICBS is the first to be held in Latin America, and I'm very pleased that we have at long last gathered in this rapidly growing and dynamic region. Since we gather at the ICBS to bring together our varied views and experiences, it is appropriate that we are here in the beautiful city of Mérida, which reflects the diverse influences of Europe, the Caribbean and the local Mayan culture.

I would especially like to extend my sincerest thanks to Jonathan Davis and his staff at the Mexican National Banking and Securities Commission for their warm and generous hospitality. Not only have they put together what I expect will be a very thought-provoking programme of speakers and working groups, but they have also arranged a fascinating programme of events to better acquaint us with the colourful history and culture of Mexico and its Yucatán region.

Before I begin, let me acknowledge one of our colleagues who was supposed to be joining us here. As you are no doubt aware, Andrei Kozlov, first deputy chairman of the Central Bank of Russia, was recently and tragically slain. We will remember Mr Kozlov for his tireless efforts to promote the safety, soundness and integrity of the banking system. His death is a great loss to the international supervisory community.

In my remarks this morning, I would like to touch on several key themes. First, I will briefly review the work that has taken place since we last gathered two years ago in Madrid. I would then like to share some thoughts on developments in financial markets and the banking sector, and on how these developments influence the types of issues that both supervisors and the industry face. Finally, I will end with thoughts on the future agenda of the Basel Committee. In particular, I will emphasise our commitment to Basel II implementation, the need to monitor and assess the broad impact of the new capital standard, and the importance in all our work of minimising any unwarranted burden on the industry.

Octavio Paz, the Nobel Prize winning Mexican poet and author, once said that "wisdom lies neither in fixity nor in change, but in the dialectic between the two". As I will discuss shortly, we are in a time of rapid change, and we must continue to adapt. But at the same time, we must not lose sight of the fundamental elements of banking supervision. I believe that, as supervisors, we need to evolve to keep pace with changing developments, while also making sure that we retain the basic lessons that have served us well over the years. My hope going forward is that we all benefit from the wisdom of striking the correct balance between change and stability.

Recent supervisory developments

As I think ahead, I am greatly encouraged that the Committee's recent work – under the steady guidance of my predecessor, Jaime Caruana – demonstrates an awareness of the need to strike this balance. Supervisors face an ever growing challenge of devising appropriate prudential structures for a financial industry that is in a constant state of change. In recent years, for example, we have witnessed an ongoing revolution in banks' risk management practices. More and more, banks are taking a firm-wide approach to risk management that considers a broader array of risks, across a wider range of product lines and regions. Risk managers have become increasingly more disciplined in their approaches, harnessing both technology and advanced quantitative techniques in the process.

Such changes require that supervisors design flexible standards and regulations that ensure a safe and sound banking system while still allowing for continued innovation in bank practices. The Basel II framework is designed to achieve this balance. It represents a fundamental paradigm shift in how we think about capital regulation. The advanced approaches to credit and operational risk rely on banks' own assessments of risk as inputs to capital calculations, a recognition that banks are best positioned to understand and measure the risks that they face.

In addition, because the quantitative and qualitative parameters for using the advanced approaches are intended as a baseline of sound practices, they can accommodate continued innovation by firms. And since the advanced approaches are driven by rigorous internal processes for risk measurement and management, they are clearly well suited for today's sophisticated global banks. Indeed, the results of our fifth Quantitative Impact Study reveal that virtually every global bank intends to implement one of the advanced approaches.

In combination with the role assigned to supervisory review and market discipline, these features of the new framework represent a more forward-looking approach to capital regulation, with the flexibility to evolve over time. A similar approach is evident in the new capital rules for certain exposures in the trading book, published in July 2005. Among other things, these rules update the trading book capital framework to better reflect the growth in traded credit products. The rules directly recognise the realities and complexities of today's markets, and demonstrate that, even in the face of such complexity, greater harmonisation of regulations across sectors is possible.

The Basel Committee has also strengthened its collaboration with banking supervisors throughout the world. This cooperation is particularly important for the success of Basel II, which raises many challenging questions regarding the roles and responsibilities of home and host supervisors. As one example, the Basel Committee's recent paper on *Home-host information sharing for effective Basel II implementation* was developed jointly with a group of supervisors from a range of other countries. Likewise, 19 countries from outside the Committee submitted data to the fifth Quantitative Impact Study, allowing for a fuller understanding of the likely impact of the new framework on overall capital levels. Our commitment to working closely with non-member countries on Basel II implementation is also evident in their representation in the technical subgroups of the Accord Implementation Group.

The Basel Committee also worked closely with supervisors from around the world on the updates to the *Core Principles for Effective Banking Supervision*. In what was truly a global effort, we have all succeeded in designing a practical yet flexible framework. It recognises not only the changes in financial markets and supervisory practices since the Core Principles were first published in 1997, but also that these changes have not occurred evenly across jurisdictions. The outcome of our effort, I believe, will allow for the application of the Principles to less sophisticated financial systems, without sacrificing their relevance for assessments of more complex systems.

International accounting and auditing standards have also evolved rapidly in recent years. As supervisors, we are keenly interested in ensuring that banks' accounting practices promote sound risk management practices, reinforce the safety and soundness of the banking system, and support market discipline through transparency. Where objectives of accounting standard setters diverge from those of bank supervisors, supervisors may have to put in place additional safeguards. Likewise, when audit reliability is called into question, supervisors may need to take steps to encourage greater reliability. Given these interests, the Basel Committee has taken an active role in the debate on changes to the framework for international accounting standards and promoting stronger global auditing oversight.

As we look back on our accomplishments since we last assembled, I believe we have much to be proud of. In our completion of the Basel II rules, our attention to Basel II implementation issues, and our updates to the Core Principles, we have pursued approaches that have the flexibility to accommodate the continued evolution of bank and supervisory practices. We have also recognised the critical contributions that the broader supervisory community, the industry and other standard-setting bodies can and must make. All these efforts amount to significant contributions to ensuring the robustness of the financial system in the face of any future shocks.

Evolving financial markets and emerging risks

At the same time, however, the pace of innovation in financial markets shows no sign of slowing. Thus, even as we look back, we must look forward to ensure that our work remains appropriately focused on the most relevant risks. In this process, an important first step is considering market developments that affect how we view risk in the banking sector. This is the second topic of my remarks this morning.

The role of banks is changing. As we know, banks have historically been the primary source of financial intermediation in most economies, with the loans they originated serving as their primary assets. Now, however, banks increasingly originate loans and other types of credit instruments with the intent of securitising them and selling them to other market participants. While it may be the case that banks in the end hold fewer credits on their balance sheets, I believe that it would be wrong to say that banks now play a less important role in credit markets. Banks, as well as securities firms, are at the centre of a new risk intermediation landscape that is increasingly based on traded products. In this new landscape, banks and securities firms are actively involved in origination, securitisation and active management of credit exposures. This shift to capital markets-based distribution of risk has been accompanied by increased velocity in intermediation, aided by new technologies that allow for greater automation and standardisation. And the greater role of capital markets in intermediation also implies that many of the risks once held by banks are now held by other types of market participants.

The greater reliance on capital markets in credit origination and distribution has also served to unlock the creative potential of market participants. We see this, for example, in products that not only bundle loans with similar characteristics prior to sale, but also then structure the resulting securities into tranches with different risk profiles. We have also witnessed explosive growth in over-the-counter derivative products that give exposure to, and provide hedging vehicles for, a growing array of new and increasingly complex risks. To give some sense of the volume of this activity, the International Swaps and Derivatives Association recently estimated that the gross notional amount of outstanding credit derivatives was $26 trillion, a growth of over 50% in just six months.

While I believe that these changes have made the banking system more resilient, these developments also pose a range of risks that both supervisors and the industry need to monitor closely. In a very broad sense, many of the challenges that we face stem from the mismatch between rapid market innovation and risk management infrastructure. The rapid growth in the markets for new financial products, and the entry of a diversity of participants into these markets, frequently strain the capacity of banks to manage the associated risks. If not addressed promptly and appropriately, these circumstances can have significant consequences for financial market stability. It is therefore imperative that we explore the extent to which the management of risks such as counterparty credit risk, market risk, liquidity risk and operational risk evolve in the face of market innovation.

Globalisation is another important trend in the banking industry. A combination of liberalisation of financial markets over the past two decades and business opportunities in rapidly growing economies has led to an increasing proportion of global bank activities in foreign countries. This is particularly the case in capital markets, but also in areas such as retail where the presence of global banks in local markets continues to grow.

As a result of cross-border mergers and acquisitions, an increasing number of banking markets now have a significant foreign bank presence. In general, I would argue that the scale of foreign banks operating in emerging markets allows them to bring expertise and financial resources that might not otherwise be available. They can also introduce more sophisticated risk management tools that may have been developed for the larger financial group. While these benefits are significant, the scale of foreign banks' presence can have implications for host countries. For example, a local financial system could be disproportionately dependent on the safety and soundness of a small handful of foreign banks. This has potentially significant implications for how banks in these markets are supervised.

It is one of the great challenges of our work that as many banks' operations and risk management frameworks become more global, the supervisory structure remains national. Thus, as we work to address the issues I have highlighted, supervisors must also solve problems of cross-border information sharing and coordination, and clearly define those areas where supervisory responsibilities overlap and those where they diverge. Our recent updates to the Basel Core Principles show that we have been up to these challenges. The process of updating the Principles was a truly global supervisory effort and demonstrated our capacity to cooperate and seek a common understanding on many important issues. And the result – a global standard whose local application can be scaled in proportion to local risks and financial market realities – demonstrates our ability to work effectively within the constraints imposed by using national structures to supervise global institutions.

Future work of the Basel Committee

Given the developments that I've just cited, where do we go from here? How do we strike the appropriate balance between change and stability? My third topic this morning is to share some ideas on where I see the importance of work in the supervisory community over the next several years. I will focus my remarks on three key areas: our commitment to Basel II implementation; the importance of assessing and monitoring the impact of Basel II; and the need for proportionality in supervisory efforts relative to underlying risks in order to minimise the regulatory burden on the industry whenever possible.

Basel II implementation

Let me begin with Basel II implementation, which remains the key item on the Committee's agenda. As I mentioned at the outset, Basel II represents a fundamental paradigm shift in the supervisory approach to capital regulation. This new approach is entirely necessary if capital standards are to keep pace with rapid innovation in financial products as well as in risk measurement and management techniques, and the ever increasing complexity of firms' risk profiles. As such, the new framework is absolutely critical to the health and stability of the banking system.

Given the importance of Basel II, I am pleased to report that implementation is fully under way. For example, implementing legislation or regulation is either in place or in process in markets such as the European Union and Japan. Likewise, supervisory agencies in the United States recently issued their notice of proposed rulemaking. Meanwhile, banks are continuing their discussions with supervisors on their specific Basel II plans, in many cases with a goal of implementation next year.

Let me not, though, gloss over the difficulties involved in successful implementation. For example, it is clear that home-host issues remain among the most challenging for both supervisors and the industry. In addressing these issues, we should strive to achieve as much cross-border consistency as possible on key elements of the framework. At the same time, we should also recognise that both home and host supervisors have legitimate interests that need to be met and national implementation will vary in relation to local needs. Indeed, the tension inherent in applying a global standard within national supervisory regimes will never fully dissipate.

Issues must often be resolved on a case by case basis, seeking pragmatic solutions that recognise the limits of what can be accomplished. Going forward, we must extract lessons and principles from specific cases and apply them back to our overall Basel II work. This is an iterative process, and one that will help to maximise consistency in implementation across banks and jurisdictions. In this regard, the Committee's Accord Implementation Group, or AIG, is working to share information and thereby promote greater consistency in implementation across countries.

As we address the challenges of Basel II implementation, we must remember that Basel II is more than a one-off exercise in getting the details and the numbers right. More than anything, it is a flexible framework that supports innovation over time, and provides appropriate incentives for improvements to risk management, supervision and disclosure. Basel II is as much about this long-term process, and the beneficial dialogue it has spurred between banks and supervisors, as it is about the more micro-level details of implementation. It provides the medium for interaction with the industry on a number of complex issues, and for thinking about how risk management and supervisory practices are likely to evolve over time. I encourage all of us not to lose sight of this important aspect of Basel II.

The impact of Basel II

I would also like to address the importance of understanding the impact of Basel II on banks and markets. Many banks, and market participants more broadly, have voiced concerns that the new framework could have unintended consequences on banks' risk-taking and capital allocation in both the short and the long term. These consequences could occur across different dimensions, for example firm size, risk profile and jurisdiction. There could also be consequences for banks' activities relative to those of securities firms.

The Committee has been sensitive to the potential impacts of Basel II throughout its development, and this will not change as we move into implementation. I believe that shorter-term consequences, such as those related to so-called "gap year" issues arising from different implementation dates, will ultimately resolve themselves as these gaps disappear over time. This will be easier if there is constructive dialogue during this transitional period with the industry and among supervisors from jurisdictions with varying implementation dates about how best to address these short-term challenges.

Some of the longer-term consequences, however, may be more difficult to predict but in many instances are likely to be the natural result of a more risk-sensitive framework. So as a first step in any discussion of longer-term consequences of Basel II, supervisors and banks should distinguish between those that reflect the closer alignment of regulatory and economic capital, and those that are indeed unintended and undesirable. Indeed, where regulatory and economic capital are more closely aligned, I expect that this will have a levelling effect on the playing field by eliminating any competitive distortions caused by Basel I. In addition, as is currently the case, I expect that banks' decisions will be driven more strongly by assessments of risk and return than by regulatory capital considerations.

Nevertheless, we must closely monitor and assess the impact of Basel II to mitigate the possibility of any competitive distortions. Failure to do so would undermine much of what is innovative and beneficial in the new framework. While I do not currently expect that it will be necessary, the Committee remains prepared to revisit aspects of the rules where there is clear evidence during the coming transition years of unintended consequences for risk-taking and capital allocation.

We must also be attuned to the risk that these consequences can result from inconsistent application across banks or sectors, particularly for rules related to risk assessment and quantification. This is an area where the AIG and its subgroups will continue to actively exchange information on observed industry and national supervisory practices.

I would like to highlight what I believe is a major accomplishment in this regard. Earlier in my remarks I mentioned the new trading book rules, which were developed jointly with our colleagues from the International Organization of Securities Commissions. Through this cooperative effort, we have developed a common framework for the convergence of capital requirements for banks and securities firms, which is a significant step towards providing a more level playing field.

Proportionality of supervisory efforts

As an important guiding principle for future supervisory areas of focus, we need to ensure that the scope and scale of any work we undertake is commensurate with the risks we seek to address. The realities of today's banking industry and financial markets argue for more measured and flexible approaches. In an environment of continuous innovation and growing competition within and across sectors, it is important that regulators assess the appropriate balance between formal regulatory responses, enhancements to supervisory tools, industry solutions and market discipline. In the years to come, it is inevitable that the Committee will choose to develop guidance aimed at strengthening supervisory practices or highlighting necessary improvements to banks' risk management.

However, I anticipate that there will be many more instances where we decide to limit our work to stocktaking exercises and information exchange, or defer work altogether so that industry and national supervisory initiatives have the time and flexibility to run their course. As we consider the trade-offs of these types of approaches, we will continue to seek industry input on the intersection of market developments, the robustness of risk management practices, and the adequacy of supervision and regulations. In doing so, we will be able to build on the excellent dialogue that has existed around Basel II.

Guided by this principle of proportionality, I would like to explore some broad aspects of the Committee's agenda. These include cross-border information sharing, banks' risk management practices, supervisory techniques and cross-sector coordination. My goal is not to provide specific details on potential projects, but to give you some sense of how the Committee perceives its role in the international supervisory community.

Cross-border information sharing

Looking first at information sharing, one of the main challenges I see going forward relates to the tension, if you will, between regulatory structures and market realities. A trend that we see is that banks increasingly manage risk on a global basis. This poses a challenge to us as supervisors since we generally operate within national regulatory structures (for very sound reasons, I might add). Supervisors will need to depend ever more on information provided by their colleagues in other jurisdictions, and will need to set up the appropriate mechanisms for doing so in ways that do not impose a burden on one another, or on the industry. In particular, we need to consider how supervisory information sharing and coordination can be deepened and broadened.

Risk management practices

We will also need to stay abreast of the latest developments in risk management and be attentive to the possibility that these developments may, as they have on occasions in the past, lag innovations in financial products and markets. Where such lags between financial innovations and risk management practices arise, the Committee will consider the merits of issuing guidance that conveys to banks and supervisors the sound practices that institutions should be following. Moreover, there is significant value in supervisors providing the industry with transparency about the range of practices they see in areas where financial innovation and risk management practices are evolving rapidly. For example, I think the Committee might usefully explore industry practices in areas such as counterparty credit risk, liquidity risk management and techniques for assessing economic capital. We will also continue our important work in the accounting sphere, to ensure that accounting and sound risk management practices are properly aligned. Moreover, ongoing changes in the accounting framework can have important implications for valuations, capital, and disclosure practices, and the Committee will continue to monitor developments in this area closely.

Supervisory techniques

The sharing of information on emerging supervisory practices will remain a fundamental role of the Basel Committee. It is not uncommon for national supervisors to pursue different approaches when adapting to changes in industry practices and market structures. Given the dynamic nature of the financial industry, diversity in supervisory practices is to be expected, and even encouraged in instances where our methods and processes continue to evolve. As best supervisory practices emerge, however, we have a strong interest in ensuring that these practices are clearly articulated and widely disseminated. Doing so will help to raise the level of global supervision, reduce any competitive distortions resulting from differing practices, and ultimately contribute to the resilience of the financial system.

Cross-sector coordination

In these and other efforts, it is equally important that we work closely with our fellow supervisors in the securities and insurance sectors, as firms in the three sectors increasingly compete across a range of products and markets. I have already mentioned our joint work with IOSCO on the trading book, and I am encouraged that securities regulators remain involved in our continued exploration of trading book issues, an area of growing importance as credit products become increasingly and actively traded. We will also continue to work closely with securities regulators and insurance supervisors under the auspices of the Joint Forum, which focuses on issues common to the three sectors, including the supervision of financial conglomerates and areas such as risk concentrations and management of complex retail products.

Enhancing dialogue

In all of our work, one of my key goals as Basel Committee Chairman is to maintain and enhance the dialogue with the wider supervisory community. For example, I earlier discussed the growth of cross-border banking and the challenges this poses for both home and host supervisors. This makes it essential that the Committee have a keen understanding of these challenges from both a home and a host supervisor perspective. In recent years, the Committee has strengthened its outreach through, for example, more frequent meetings with chairs of regional groups of banking supervisors and with the Committee's Core Principles Liaison Group, which includes representatives from 16 non-G10 countries. This dialogue has been absolutely essential and must continue and be strengthened.

Concluding thoughts

In closing, as I mentioned earlier in my remarks, over the past several years we have tried to design flexible, principles-based standards that foster greater resilience in the banking sector while allowing for continued innovation on the part of banks. Looking at the pace of innovation in financial markets, the changing role of banks and the more globally interlinked banking industry, we must continue to respond in kind. Going forward, I expect the Committee will continue moving full speed ahead with Basel II implementation, assessing the impact of Basel II, and maintaining a sense of proportionality so as not to overly burden the industry and ourselves. Moreover, while we will probably continue to issue supervisory guidance as necessary in the future, we will also focus on some of the "basics" such as cross-border information sharing, understanding bank risk management practices and supervisory techniques, cross-sector coordination, and dialogue with the industry and among bank supervisors.

In adapting to a changing world, we must not lose sight of the basic supervisory tools that have served us so well over the years. We should continue to encourage the development of sophisticated tools for better risk management, but we should also continue to emphasise simple but vitally important concepts such as sound corporate governance. We should strive to understand the increasingly complex quantitative models that banks increasingly rely upon, but not lose sight of the importance of sound judgment on the part of bankers as well as supervisors.

I hope that you find the next several days in Mérida enlightening, challenging, energising and even, dare I say, fun. Thank you very much, and I look forward to exchanging views not just during this ICBS, but over the coming years as well.