Christian Noyer: Basel II – new challenges

Speech by Mr Christian Noyer, Governor of the Bank of France, before the Bank of Algeria and the Algerian financial community, Algiers, 16 December 2007.

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I am very pleased and honoured to be here and I wish to wholeheartedly thank my friend Mohamed Laksaci for inviting me to **speak on the subject of Basel II**. This subject is topical for two reasons: first, we have already entered into (or, in some countries, are about to enter into) the operational implementation of the new capital adequacy framework, which requires a greater-than-ever involvement of banks and supervisors; second, the current financial market turmoil raises questions as to the best way to implement this framework. In view of its topical nature, I will present a few thoughts on "Basel II: New challenges", while attempting to focus on the practical aspects of the implementation of the new capital requirements.

In this respect, and before moving on, I would like to thank the Bank of Algeria for its **participation in the Group of French-Speaking supervisors**, created at the meeting of Governors of central banks of French-speaking countries in June 2004 in Paris, which coincided with the Basel Committee on Banking Supervision's publication of the New Basel Capital Accord. I know that this Group is appreciated by many of its members as it enables them to exchange experiences and information and promotes best banking supervisory practices. It has already carried out useful work, in co-operation in particular with the Financial Stability Institute (FSI) of the BIS, on the theoretical aspects and practical application of Basel II.

Today, I will start by discussing the **practical challenges arising from the effective implementation of Basel II**. I will then stress the need to **pursue efforts** to implement the new Basel II framework in the context of the current financial market turmoil. Lastly, I will try to draw some initial lessons from this **turmoil** with a view to ensuring that implementation is optimal.

1. The effective implementation of Basel II is demanding and requires on the part of credit institutions and supervisors considerable efforts and significant resources.

The first challenge regarding Basel II is indeed of a practical nature, i.e. successfully moving from the planning stage of this capital adequacy reform to that of its implementation. This will be particularly challenging since Basel II is a much more ambitious supervisory framework than Basel I, based on three complementary pillars:

– minimum capital requirements (Pillar I), which can be calculated in accordance with various approaches, from standardised approaches to internal ratings-based approaches (IRB), specifically developed by each credit institution. The approach must be chosen by each institution under the control of the supervisor, in relation to size and level of sophistication;

– the supervisory review process (Pillar II), which gives supervisors a key role in assessing the risk profile and the quality of risk management of each institution as well as the corresponding minimum regulatory capital ratios;

– market discipline (Pillar III), which enhances public disclosure requirements.

These three pillars, whose technical aspects I shall not discuss today, constitute an **ensemble aiming mainly to**: i) improve banks' **risk management**, ii) align **regulatory capital** more closely with the actual risks incurred by banks, iii) enhance the **role of**

supervisors, as well as iv) that of market discipline and therefore, ultimately, v) strengthen **financial stability**.

The implementation of such a framework, embracing a broad spectrum of possible approaches for banks and covering a large array of risks, is no simple matter and accounts for the current variety of national situations, including within the G10: Japan for example implemented Basel II in 2007, EU Member States are set to do so in 2008 and the United States in 2009. The magnitude of this task is particularly vast since Basel II, in view of the very nature of its objectives that I have just recalled, will be applied in a very large number of countries. The latest study by the FSI on the application of Basel II, published in September 2006 and conducted among 115 countries, shows that 82 Non-Basel Committee Member Countries intend to implement the new framework, in most cases as of 2008 or 2009, and in some cases at a later date.

Fully aware of the practical aspects of implementing a more modern, complete and risk-sensitive prudential framework, the Basel Committee published, in July 2004, i.e. directly in the wake of the New Capital Accord, a document entitled "Implementation of Basel II: practical considerations". Recognising that the adoption and application of Basel II may not be a short-term priority for a certain number of supervisory authorities of non-G10 Countries, the Committee encouraged the latter to develop their own approaches and implementation timetables. Given that the necessary legislative and regulatory changes and human resource requirements have to be identified, the application of Basel II will necessarily be a gradual process throughout the world. This is especially the case since technical decisions often have to be taken on the exact choice regarding the scope of application of Basel II or the possibility of a staggered implementation of the three pillars.

In this respect, I welcome the choice made by Algeria to adopt and implement Basel II in the near future. **This choice should not be seen by banks as a regulatory constraint but rather as a great opportunity to converge towards best international practices.** Moreover, this choice should preserve and strengthen the stability of the Algerian banking system, which has been achieved in particular by strong economic and financial performance since 2001 and the enhanced supervision capacities. The strengthening of these capacities over the past years constitutes a major asset for the Bank of Algeria and should make it possible not only to successfully ensure that Algerian banking regulation and supervision complies with international standards (such as the Basel Committee's Core Principles for Effective Banking Supervision), but also to efficiently prepare the implementation of Basel II with a good take up of the Accord by Algerian banks.

As Governor of the Banque de France and Chairman of the *Commission bancaire*, I am aware of the extent to which the preparation of the implementation of Basel II requires efforts and resources on the part of both institutions and supervisors. Allow me to illustrate this by briefly presenting **initiatives carried out by the *Commission bancaire* and its General Secretariat for effectively implementing Basel II in France**. By 31 December 2007, over 30 on-site inspections will have been conducted in 20 institutions, involving at times up to 100 inspectors at a time. These on-site inspections examined IRB systems for credit risk and advanced operational risk measurement approaches.

This choice to carry out on-site inspections of internal risk measurement systems and approaches and the importance attached by the *Commission bancaire* to such checks is mainly due to the fact that, in 2008, 17 institutions (accounting for almost 95% of the total assets in the French banking system) are set to use an IRB approach to measure their credit risk and 5 institutions (accounting for almost 60% of the total assets in the French banking system) are expected to adopt an advanced operational risk measurement approach. As institutions have the possibility under Basel II of using their IRB approaches to calculate regulatory capital requirements, supervisors must ensure that these approaches are reliable.

Following these on-site inspections and the examination by the *Commission bancaire* of the corresponding inspection reports, 26 **Memoranda of Understanding (MoU) were signed**

with the institutions concerned. Improvements were requested mainly in the following areas i) the different classes of risk held by the institutions, sometimes also ii) the definition of default used by them, iii) the estimate of certain parameters such as Loss Given Default (*LGD)*, iv) the operational integration of the approaches implemented in the daily management of risks and v) the governance principles applicable to these approaches.

Until the end of 2007, the *Commission bancaire* will monitor the implementation of the corrective measures requested of the institutions. Following this process, the *Commission bancaire* will take a formal decision as to whether or not to authorise the institutions in question to adopt the advanced approaches of Basel II on 1 January 2008. For institutions with foreign entities, this authorisation is granted, where appropriate, following an exchange of information with the host supervisors, i.e. where the institutions' subsidiaries are established.

While many counties, such as France, have entered into the effective implementation phase of Basel II, the recent financial turmoil has once again drawn attention to this framework, leading some observers to call into question its overall rationale. **This turmoil has new characteristics as it is a credit crisis in a market environment with particular implications concerning contagion channels.** Risk transfer operations, in particular securitisation, and the **interaction between funding liquidity and market liquidity risks** have played new or at any rate greater roles than before. I am nevertheless convinced that the reform of the capital adequacy ratio rightly remains a crucial element in the regulatory response to the problems facing us today. I would now like to explain why I am convinced of this.

2. The current financial turmoil confirms the need to concretely implement Basel II.

This turmoil may very legitimately raise questions about several of the major provisions of Basel II, such as the use of rating agencies or the internal approaches developed by banks to assess credit risk. The risk associated with a regulatory capital ratio that is more sensitive to risk, and therefore potentially pro-cyclical, has also been advanced in some quarters. **I shall, however, give five main reasons showing that these questions do not cast doubt on the benefits provided by the implementation of Basel II.**

Firstly, unlike the present solvency ratio, the Pillar 1 of Basel II stipulates down a specific calculation of regulatory capital to set against credit risk transfer transactions (such as securitisations and credit derivatives). This is essential in the framework of the "originate and distribute" model currently used by many financial institutions and that consists in transferring as quickly as possible the risks associated with the loans extended and not retaining them as in the past. The treatment set out in Basel II thus aims to ensure that securitisation transactions now have their own economic reality, rather than seeking regulatory arbitrage as was sometimes the case under Basel I. Based on two fundamental principles – first, the actual nature of risk transfer and second, the significant nature of these transfers – the treatment of securitisation in Basel II applies not only to banks acting as originators and investors but also as sponsors. This treatment also takes account of the many specific mechanisms in this type of transaction, such as early amortisation clauses and credit enhancement. Lastly, it introduces a requirement for regulatory capital to be tailored for certain off-balance sheet exposures, particularly liquidity facilities associated with these transactions, which under Basel I were generally exempted of any capital charge.

Second, by reinforcing the link between the capital base and the risks actually incurred, Basel II encourages banks to improve their systems for managing these risks as well as their due diligence procedures. Beyond reminding banks of the basic caution required when extending credit, this encouragement is all the more useful in that banks now often play a role in securitisation transactions for which the underlying assets, for example housing loans, may be initiated by unregulated entities, that are not always accountable for their risk analysis and pricing. In other words, the weaker the discipline surrounding the granting of a loan the stronger banks' diligence procedures needs to be.

Thirdly, Basel II gives banks and supervisors a vital tool, Pillar 2, with which to assess the risk profile of institutions and in particular to take account of certain risks that are sometimes difficult to quantify but whose impact can be great. By way of example, I shall merely mention refinancing risk and reputational risk. Pillar 2 thus enables banks, through the determination of the level of economic capital and supervisors, via for example an increase in capital requirements, to ensure that all of the risks incurred are appropriately covered.

Fourth, Basel II sets out to promote stress tests as one of the tools for managing and assessing risks. This is very important in dealing with the turmoil like that we are currently experiencing. Basel II stipulates that the stress tests conducted by banks must incorporate the effects of a large increase in credit and market risks as well as those of a rise in liquidity risk. The aim is to ensure that banks hold sufficient capital to absorb severe shocks.

Fifth and last, Basel II aims to substantially reinforce transparency and market discipline. Pillar 3 of the framework lays down numerous requirements regarding the disclosure of qualitative and quantitative information about capital and risk, including in respect of risk transfer transactions. The importance of this information was thrown into sharp relief by the financial turmoil this summer, during which greater transparency, particularly regarding the nature and quality of assets recorded by credit institutions in securitisation vehicles, proved necessary.

To sum up, and before trying to draw any preliminary conclusions from this turmoil aimed at optimal implementation of Basel II, I should like to emphasise that the new framework encourages banks to **better assess and manage risks linked to securitisation transactions and to improve their financial reporting**, two crucial areas in which the current problems have highlighted that significant progress needs to be made.

3. The financial turmoil has shown that optimal implementation of Basel II requires further progress in several areas.

While it is too early to draw definitive conclusions from the current episode, it is nevertheless apparent that progress needs to be made by credit institutions, for example in the management of credit risk, market risk, liquidity risk, the risks associated with certain activities such as asset management and risks linked to the valuation methods used for some financial instruments.

Regarding credit risk:

– **It is important to check that banks' internal rating systems, along with the estimation of the different risk parameters they use, are updated in order to reflect the increase in default risk and losses in the wake of the current turmoil. It is indeed vital that these systems do not lead to risk being underestimated.** This update appears all the more necessary at the present time given that in the case of real estate loan portfolios, estimates of risk parameters have perhaps not been sufficiently rigorously tailored by all banks to the specific features of some risky forms of credit such as US subprime mortgages. The same thing may have happened in other countries. In a more general way, it seems useful that supervisors should continue their analysis of the ways in which banks take account of the specific features of certain financial assets whose risk profile may be higher than that of the regulatory asset classes defined in Basel II;

– **We need also to deal better with the issue – crucial for some assets such as housing loans and specialised financing – of the correlation between probabilities of default (PD) and loss given default (LGD).** This may be quite variable depending on the characteristics of housing loans in different countries. More generally, we need to analyse in greater depth the ways in which banks take into account the guarantees and collateral used and especially the correlation between the risk associated with the hedged instrument and that related to the collateral. This is all the more important given that Basel II increases very substantially the range of collateral eligible for prudential recognition.

– **Lastly, it is important to improve the quality of stress tests relating to credit risk – including concentration risk – by including in them possible chain reactions and spillovers on different markets. The way in which the results of these stress tests are factored into risk management and assessment systems as well as, where appropriate, into the level of economic or regulatory capital required must also be closely examined, both by banks and the supervisory authorities.** This should also be one of the aspects of Pillar 2, which I have mentioned several times and which I will come back to a bit later, given its importance.

Regarding market risk, it is important:

– **to ensure that banks only book their transactions in the trading book if they are carried out on sufficiently liquid markets;**

– **and to better capture all of the risks within the trading book, especially default risk** the weight of which has increased over the past few years, notably due to growing trade in structured credit products and products including stakes in hedge funds. The publication by the Basel Committee on 12 October of guidelines for computing the capital charge for incremental default risk in the trading book constitutes an important step forward in this regard.

Regarding liquidity risk, the recent financial turmoil has highlighted the need

– **for banks, to reassess the way in which refinancing risk can materialise and analyse its impact on other risks** such as credit risk and concentration risk, in the event of liquidity facilities extended to securitisation vehicles being drawn on;

– **for supervisors, to ensure that banks have set in place, within the framework of their business continuity and "back-to-normal" plans, robust mechanisms and procedures for liquidity management, taking account both of their own refinancing risk, the risk of markets drying up and the potential interaction between these two risks.** This is all the more important in the context of the "originate and distribute" model given that the effectiveness of the risk transfer instruments on the basis of which the latter has developed requires sufficient liquidity both on the part of agents and markets.

It is, incidentally, worth noting that the Committee of European Banking Supervisors (CEBS) and the Basel Committee are working on a revision of the current regulations regarding liquidity.

Moreover, concerning risks incurred by some activities such as asset management, it appears necessary to gain a better insight into the transmission channels of these risks between activities carried out for banks' own account and for third parties as well as the liquidity requirements generated by the latter. More generally, the methods used to assess and capture some risks such as reputational risk and strategic risk, notably in the context of Pillar 2, need to be developed.

I would like to stress the very important role that Pillar 2 must play in improving banks' management practices i) regarding new risks not covered by Pillar 1 and ii) in areas that supervisors deem, specifically, liable to become new sources of vulnerability. In practice, for some activities, there are still no universally accepted standards for risk management. This does not mean, however, that banks' risk management processes in these activities are always sufficiently stringent, but rather that there is a wide range of instruments available for this purpose, each with its advantages and disadvantages. This also means that supervisors should not carry out a mechanical assessment of these risks and their management by banks such as would result for example from the simple observation of a statistical confidence interval. The assessment must be more refined. In addition, Pillar 2 should ultimately serve to improve risk management in the areas that supervisors, at a given moment, deem to be crucial for financial stability, using a forward-looking approach.

Lastly, the recent financial turmoil has highlighted the difficulties and risks associated with the valuation methods used for certain financial instruments, particularly complex structured products but also some products regarded as more straightforward. Indeed, a sometimes very great disparity has been observed between the theoretical valuations derived from models and market values. However, the issue of the accurate estimation of the price of complex transactions has taken on particular importance with the gradual adoption across the board of fair value assessments since the entry into force of the new accounting standards (IFRS).

In this respect, it seems necessary to include in risk assessments assumptions of an erosion of liquidity and a rise in volatility as well as, more generally, to ensure that processes for monitoring valuations within banks are strengthened. In particular, it is vital to reinforce critical, independent and regular analysis of valuations obtained for certain complex positions, which appear to have relied too often on external data supplied by external rating agencies or service providers, without real analysis of the characteristics of the underlying and collateral. **It is also important to increase the banks' transparency** with regard to information on fair value valuation methods and how they are used to produce income statements.

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As you can see, the challenges related to the implementation of Basel II are numerous. Whether these are long-recognised or recent, such as those that have appeared since the financial turmoil this summer, they must be addressed. To use what is I believe Governor Laksaci's expression, the "**challenge is a feasible one**" and over the coming period, banking supervisors will have to continue to work towards the robust and sound implementation of the new framework. This implementation will bring about significant improvements with regard to risk assessment and management, as has been confirmed by the initial feedback by authorities that have already switched to Basel II.

I will conclude my contribution by citing a formulation used by the General Secretariat of the Basel Committee, which, it seems to me, sums up perfectly the spirit in which the reform should be introduced in each country: "**Basel II is not a destination but a journey**".

Thank you for your attention.