Nout Wellink: Basel II – market developments and financial institution resiliency

Opening address by Dr Nout Wellink, President of the Netherlands Bank and Chairman of the Basel Committee on Banking Supervision, at the Risk Minds Asia Conference – Basel II Implementation Summit, Singapore, 4 March 2008.

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Introduction

I am pleased to speak with you this morning about the Basel II capital framework in the context of recent market developments. As you know, most global banks are only beginning to implement the Basel II framework as of the beginning of this year. The financial turmoil therefore has been playing out under the Basel I capital regime.

In my remarks today, I would like to discuss how the implementation of the Basel II framework provides an opportunity for banks and supervisors to strengthen the resilience of the banking system to financial and economic shocks.

I will first discuss some key objectives of capital regulation. I will then discuss how the Basel II capital framework is better able to achieve these objectives in the face of rapid financial innovation. Next, I will discuss some lessons from the recent turmoil and their potential implications for Basel II going forward. Finally I will talk about the work of the Committee to supplement strong capital with improvements to global liquidity risk management and supervision.

Objectives of capital regulation

In assessing the implications of the recent turmoil, a key area of discussion has been the role of regulatory capital. It is clear that the capital regime plays a key role in shaping the incentives and constraints that banks face when managing their portfolio of risk exposures.

In developing Basel II, the Basel Committee had a number of objectives in mind. One objective was to develop a more meaningful link between banks' on- and off-balance sheet risk exposures, and the capital supporting them. Another was to strengthen the links between sound regulatory capital and risk-based supervision as a way to create incentives for strong risk management practices at banks. A third objective was to enhance market discipline through better information about banks' risk profiles, risk measurement techniques and capital. And finally, the Committee sought to develop a framework that was adaptive to rapid financial innovation.

The Basel I framework played an important role in raising capital levels across the banking system over the late 1980s and 90s. However, as recent events are demonstrating, it has increasingly failed to deliver on the four objectives I have listed. For example, the failure to capture off-balance sheet exposures to ABCP conduits and SIVs demonstrates the growing gap between banks' rapidly evolving risk profiles and the regulatory capital framework.

Changes introduced by Basel II

How will Basel II do a better job delivering on the four capital objectives I have described to you? It does so by moving capital regulation to a better point on a spectrum of two extremes. On one end of the spectrum, we have Basel I-like regimes, which rely on rigid, externally imposed regulatory ratios which collapse under their own weight as rapid financial innovation and capital arbitrage proceed. The result is a breakdown in the link between risk and capital (as we have seen in the example of structured credit exposures). On the other end of the

spectrum, we have full reliance on banks' internal credit models. Here we run the risk of regulatory capital not putting appropriate constraints on banks' risk taking, and as we all know, the role of regulatory capital is to impose limits on banks that do not manage themselves in a prudent way.

Basel II falls in the middle of this spectrum by leveraging off and reinforcing the basic building blocks of sound credit risk management, but filtering these elements through a rigorous regulatory framework. In particular, I am talking about requiring banks to have sound internal ratings classification systems that decompose any exposure into its probability of default, loss given default and exposure at default, subject to stringent supervisory standards and internal controls. Moreover, these inputs are filtered through a regulatory framework where supervisors conservatively specify correlations within asset classes.

Let me elaborate a bit more on how Basel II does a better job of capturing the types of risk that banks increasingly face. Some of the most important areas relevant to the current crisis are the following:

- First, Basel II delivers greater risk differentiation. Banks that move from prime into subprime mortgage lending or that move from traditional corporate lending into leveraged lending will see an increase in their capital commensurate with the changing business strategy and risk profile. Under Basel I, all such exposures receive the same charge.
- Second, off-balance sheet contractual exposures to SIVs and conduits will be brought into the fold and subject to regulatory capital, whatever the accounting treatment.
- Third, there will be a much more risk sensitive treatment for securitisation exposures. This will create more neutral incentives between retaining an exposure on the balance sheet or distributing it in the market through securitisation.
- Fourth, banks will have to develop more rigorous approaches to measure and manage their operational risk exposures and hold commensurate capital.
- Fifth, banks will have to develop more rigorous methodologies for capturing counterparty credit exposures, including so-called wrong way risk. This is the risk that the exposure increases as the counterparty's credit quality deteriorates, as we saw in the monoline sector.

In addition, Basel II has in place a variety of safeguards, which also have the benefit of reinforcing supervisors' objectives to strengthen risk management and market discipline. Let me say a few words about some of Basel II's safeguards.

- For example, banks will have to continuously improve the quality of their internal loss data. Basel II requires that banks have at least five years of data, including a downturn. Our quantitative impact study work showed that this will raise the bar from current practice at many banking institutions.
- Another safety measure is the requirement for banks to estimate their recovery rates assuming a downturn in the credit cycle. This will reflect up front in capital that losses on liquidated collateral will be greater during stressful periods.
- In order to use Basel II's advanced approaches, banks will have to demonstrate robust data management and firm-wide aggregation capabilities.
- The requirement for banks to perform stress tests of their on- and off-balance sheet exposures is an additional safeguard. Based in part on these stress tests, banks will need to demonstrate to supervisors that they have adequate capital cushions to manage through a down cycle.

- Finally, banks will have to provide much better transparency to the market about the range of exposures they hold, including to securitisations and conduits.

Taken together, these measures will introduce a more rigorous, forward looking perspective on the types of risks that banks could face in a downturn. They will require banks to factor these risks into minimum regulatory capital, internal capital planning and disclosures to the market. Supervisors will reinforce these disciplines by assessing banks' risk management, measurement and capital before capital ratios fall below the minimum requirements. This will help change incentives to anticipate risks and potential losses and to hold commensurate capital ex ante.

In sum, all these efforts recognise the fact that banks' business models and associated risks have gotten increasingly complex, and that there is no longer one simple measure that can capture them and stand the test of financial innovation. Indeed, the framework, through its three pillars and various safeguards, provides multiple perspectives on a banks' risk taking, ensuring that there is no over reliance on any one measure.

Lessons from the recent turmoil and possible implications for Basel II

My remarks so far should indicate to you that a number of the lessons for banks and supervisors will be addressed through the improved capital framework. Moreover, the framework puts regulators in a better position to reflect future lessons and change. So the first priority is for Basel Committee members and other jurisdictions to press ahead with this fundamentally important enhancement to capital regulation.

The current Basel II framework, however, is not perfect. There are opportunities to reflect some of the new lessons within this more adaptive capital regime. Let me share with you some of the issues we have been discussing within the Basel Committee, as well as some of our current priorities. While we have a rigorous and ambitious work plan with clear timelines to make progress and deliver on these issues, I nevertheless want to caution you that this is still work in progress. I will say a few words about each of Basel II's three pillars.

In the first pillar, we are taking a look at the treatment of highly rated securitisation exposures, especially so-called CDOs of ABS. These securities have recently been the source of the greatest losses across the banking sector and they have an unusual feature: most of the time they perform very well, but when they start experiencing losses, these can build very rapidly, producing a real cliff effect. This explains the unprecedented downgrades we have seen on triple-A super senior tranches, which exceed anything we have seen in traditional corporate bonds. These structured securities are highly correlated with systematic risk. The Basel Committee will look at whether the capital charges for these types of exposures are calibrated appropriately in relation to their risks and complexity.

The Committee also is pressing ahead with our work to introduce a credit default risk charge for the trading book. As you know, there has been a rapid growth of less liquid, credit sensitive products in banks' trading books. These products include structured credit assets and leveraged lending. The VAR-based approach is insufficient for these types of exposures and needs to be supplemented with a default risk charge. In addition, it is critical that banks conduct rigorous Pillar 2 stress testing of their trading book exposures. They must factor in liquidity horizons and reflect these results in their risk limits, economic capital and concentration management strategies. Many structured credit products are tailored for individual investors and have a limited or no secondary market. The Basel II framework has guidelines for what should and should not go into the trading book and these need to be reviewed by banks.

In the second pillar of the Basel framework, supervisors will be reinforcing the importance of banks' stress testing practices. As I mentioned, Basel II already requires that banks conduct stress tests of their credit portfolios to validate the adequacy of their capital cushions at all points of the credit cycle. However we need to think more about the importance of banks'

conducting scenario analyses and stress tests of their contingent credit exposures, both contractual and non-contractual. These contingencies have implications for balance sheet growth and capital. As we have seen, many banks have taken significant exposures back on the balance sheet for reputation reasons. Being better prepared for such scenarios going forward can help make banks more resilient to stressful conditions.

In Pillar 3, there are opportunities to further leverage off the types of disclosure required under Basel II. In particular, supervisors need to monitor the type of information that banks make available for structured credit products. The Committee will determine whether improvements are needed, particularly related to securitisations, conduits and the sponsorship of off-balance sheet vehicles.

Strengthening liquidity risk management and supervision

So far I have told you about the Basel Committee's objectives in developing the Basel II framework and the lessons we have thus far learned from the recent turmoil, which – taken together – will forge a strong capital framework. But a strong capital base is one part of the puzzle – another is strong liquidity risk management and supervision. Banks with a weak capital base are vulnerable to liquidity problems during periods of financial market stress. However even banks with strong capital can experience liquidity problems if they do not manage this area well.

Before the market turmoil began last summer, the Committee had already launched a work stream to assess the current state of liquidity risk management and supervision. However, as a result of the turmoil, we have accelerated this work. Last month we released our assessment of the weaknesses identified by the crisis and what we think needs to be done about it.

We are now well along to completing a fundamental review of the global standards for liquidity risk management and supervision, which were issued by the Basel Committee in 2000. We plan to issue the new standards for public comment this coming July. Some of the key areas we will address include the need to enhance overall governance for liquidity risk management, integrating it more closely with other risk management disciplines. We will address the need to strengthen liquidity stress testing practices, including the capture of off-balance sheet contingent exposures. And we will focus on the importance of firms having in place rigorous contingency funding plans that reflect the possibility of major funding sources drying up for long periods of time. Finally, we will have guidance for strengthened supervision, banks' reporting to supervisors and market disclosure. I am convinced this initiative will take liquidity risk management and supervision to a new level. However, I would also note the critical importance of rigorous follow up by supervisors on a continuous basis to ensure that these standards are implemented in practice.

Conclusion

The banking sector needs to have strong capital and liquidity buffers to absorb financial shocks and the uncertainties around how such shocks could play out in the future as the process of financial innovation continues. Basel II is an important next step to enhance bank resiliency. Moreover, it provides supervisors with a better framework within which to make enhancements in the future, as financial markets evolve. There are no simple measures that will capture the complex risks that global banks now face. We need multiple perspectives on risk, as provided under the three pillars of Basel II. Moreover, there is no substitute for strong risk management, liquidity management and supervision. Risk managers need to continuously translate the basics of sound risk governance and management to rapidly changing environments. And importantly, regulators need to make sure that the infrastructure of supervision, regulation and transparency keeps pace with innovation and promotes appropriate incentives for sound risk management. If we take these lessons forward, I

believe that we will have a banking sector that is ever more resilient to the next set of shocks, whatever their source. Thank you.