The implementation of Basel II

Jaime Caruana

Introduction and overview

I am honoured to have the opportunity to share some brief remarks on the ongoing implementation of the Basel II capital framework.

I realise that not all of our institutions are responsible for banking supervision, but, as central bankers, we all share a common goal of promoting financial stability. In that regard, I'm sure we can all agree that a stable banking system is critical to the long-term growth of an economy. Businesses and consumers need to have access to credit on fair and reasonable terms through all stages of the business cycle so that they can build and grow. And this access to financial services must be widespread, including all income brackets of the population, because it is one of the key elements that can help to improve living standards. 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.

We also know that banking crises can threaten macroeconomic stability through their potential effects on confidence, savings, financial flows, monetary control and the budgetary impact of bank rescue packages.

In sum, achieving an inclusive, efficient, sound and stable financial system is an important and complex task, and it has many dimensions. To me, Basel II represents a tremendous effort of more than six years to analyse and promote some of the main elements of a sound banking system: those related to risk management and capital.

My talk will address two main issues. First, I will share some reflections on how I believe Basel II will contribute to the stability of the financial system. Secondly, I will offer some thoughts on steps countries can take in preparation for adopting Basel II.

Basel II and financial stability

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.

This is why the Basel Committee has devoted so much effort to developing the so-called Basel II capital framework, which was released in June 2004.

The new capital framework is built on three mutually reinforcing pillars. The first pillar aligns minimum capital requirements more closely with banks' actual underlying risks. The menu-based approach means that 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 "Basel I" 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.

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. Thereby, it is also about increasing the stability of the global financial system, to the benefit not only of banks, but also consumers and businesses. This is especially critical in markets where banks are the primary source of funding and therefore key drivers of sustainable development.

How will Basel II contribute to financial stability?

Allow me then to take a few minutes to elaborate on several areas where I believe Basel II will foster financial stability.

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 both incentive-based and risk-based. It therefore 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 formalised risk management will bring better assessment, better quantification and greater 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. Basel II is built on the expectation that a country's banks should be able to manage their risks today and respond to challenges tomorrow.

The second reason I believe Basel II will enhance financial stability is that it promotes more effective 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.

While much attention has been paid to some of the more complex quantitative aspects of Basel II, I believe the most important aspects 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. I should also add that the Basel Committee last month published a paper on sound corporate governance practices for banks, which I believe will be useful for all countries, whether they are ready or not to adopt Basel II.

The third reason I believe that Basel II will promote financial stability is that it reinforces the need to implement sound policies in both capital and provisioning. 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 and banking supervision is that banks need to create provisions to absorb expected losses and to have sufficient capital to absorb unexpected losses.

Let me add here 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. I believe that Basel II will contribute to a more resilient and stable banking system that is capable of promoting sustainable economic growth.

Adoption of Basel II: who and when?

Let me turn now to my second point, which is the timing of adoption of the new framework in different countries. Whenever I speak with colleagues from other countries, I stress that only national authorities can decide when to adopt Basel II. While the Committee believes that the framework is appropriate for all economies and banks, no country should adopt Basel II until it is ready. This view has been expressed consistently by not only the Basel Committee, but by the IMF and World Bank as well. We are all in agreement that if a country decides to adopt Basel II, the timing should be determined by its own circumstances, not the timetable for Basel Committee members.

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 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 contained within the framework 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.

This brings me to the second stage. 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.

In addition to the steps I have outlined for supervisors, there is also a wider set of preconditions that we as central bankers can help to promote, including appropriate macroeconomic policies which are consistent and sustainable over time.

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. I don't want to play down the challenge of achieving a coherent approach to financial stability that fosters financial innovation, promotes a level playing field and ensures that the banking system can remain resilient in the face of internal and external shocks. Nevertheless, I believe that the effective implementation of Basel II will contribute to the proper functioning of the economy under a wide range of circumstances.

Conclusion

To conclude, I think that Basel II recognises 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 into 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 cooperation and properly aligned incentives on the part of the industry, markets, central banks and supervisors.

Let me close by saying that 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.