

## **William J McDonough: The review of the Capital Accord**

Remarks by William J McDonough, President and Chief Executive Officer of the Federal Reserve Bank of New York, before the Eleventh International Conference of Banking Supervisors, held in Basel, 20-21 September 2000.

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I am greatly honored to be here as Chairman of the Basel Committee on Banking Supervision. I'd like to begin by thanking the Swiss National Bank, Kurt Hauri and the Swiss Federal Banking Commission, and Andrew Crockett and the BIS for organizing and hosting this important conference. They've done a wonderful job, for which I know we're all very grateful.

It is also a great pleasure to be with you under such dramatically different circumstances than when we last gathered together. Just two years ago, turbulence in the financial markets around the world had affected, in one way or another, the banking systems of virtually every nation, and bank supervisors were struggling to preserve confidence and stability. Today, of course, the global financial situation is much more stable and the outlook is very favorable.

In the United States, we continue to enjoy the longest economic expansion in our nation's history, and, following passage of financial modernization legislation, banks and other financial institutions now enjoy unprecedented strategic opportunities.

In Europe, following monetary union in January of 1999, the banking industry, along with other corporate sectors, is becoming more efficient and competitive as economic and political reforms have sharpened the focus on shareholder value.

In Asia, and in many emerging market economies, meaningful headway has been made toward recapitalizing banking systems, ridding banks' balance sheets of problem assets, and improving supervisory and regulatory frameworks. As a result, economies are growing again, equity markets have rebounded, and foreign capital has begun to return. What a difference two years of hard work can make.

When I last addressed this conference in October of 1998, I said that bank supervisors have a special role in maintaining financial stability, and that our special role has two components: facilitating the resolution of problems when they occur, and taking the necessary steps to lower the risk of problems occurring. Two years ago we were busy with the first component – crisis management and resolution. Today, as we stand on the threshold of a new century, we have the opportunity to focus on the second – prevention.

With that in mind, it is my view that the greatest challenge to the long-term goal of financial stability, both locally and globally, is the accelerating pace of change and financial innovation, driven by the steady march of technological advancement. To be sure, such rapid change has created unprecedented opportunities for both producers and consumers of financial products and services. But it must also be acknowledged that with such remarkable progress has come new, more complex and potentially far-reaching risks.

I'd like to begin by addressing the profound impact of today's technology on banking and the financial markets, then move on to the implications of that impact for effective supervision in the twenty-first century. On the subject of official supervision, I will discuss the Basel Committee's Core Principles for Effective Supervision, and then conclude with an update on the Committee's major initiative to revise and refine the 1988 Capital Accord.

## **Technology changing the world, banking and supervision**

It's been said that information is power. Whoever said that surely never had to deal with the flood of e-mail most of us receive each day. Indeed, with increasing frequency, the complaint nowadays is about "information overload." With wireless communications enabling us to conduct business anytime, anywhere, I sometimes feel, as I'm sure many of you do, that no matter where I am in the world, I'm expected to be awake and working.

For those who occasionally feel overwhelmed by technology's marvels, it's worth remembering that there was a time, and not so long ago, when reliable market information was decidedly scarce and concentrated in the hands of a privileged few. The Rothschilds built an international banking empire on the wings of carrier pigeons, whose messages enabled the brothers to buy and sell on information about investment opportunities or financial disasters in distant places long before their competitors heard the news.

Today, information of all kinds is transmitted easily, inexpensively and instantaneously around the world, providing finger-tip access to anyone with a laptop computer, cellular phone or palm pilot. As but one example, I'd mention that, as of last month, the most popular items on the Federal Reserve's public web site – including statistical reports on foreign exchange rates, selected interest rates, consumer credit and industrial production, along with press releases and Federal Open Market Committee announcements – are accessible by wireless remote.

If information is power, and it surely is, then a profound and irreversible transfer of power is underway in the global financial marketplace – from providers of products and services to consumers. For example, the Internet – something most of us had never heard of five years ago – is changing how consumers shop for financial products and services, the prices they pay, and with which providers they establish relationships.

In response, financial institutions, who once viewed technology mainly as a cost center, now see the Internet and other technological capacities as strategic tools for enhancing the value of customer relationship through cross-selling and improved customization. A recent survey of bank managers in the United States reported that, for the first time, investment in Internet technology was cited as the top budgetary priority, ahead of items such as investments in call-centers and brick-and-mortar branches.

The growing importance of the Internet as a distribution channel is also eroding traditional barriers between financial service providers and technology firms. Banks are increasingly providing technology services, such as account reconciliation software and "web-enabling" assistance, while technology firms are making inroads into services once the domain of banks and brokerage firms, such as financial planning and bill payment. Indeed, many banks are beginning to think of technology firms as competitors – or are contemplating ways to partner with them.

I'd guess that most of us, perhaps even all of us, consider the advancement of computing and information technologies, and their role in the development of ever-more sophisticated financial instruments and techniques, to be decidedly positive developments. Such technologies, and the innovation they enable, have reduced the costs of financial transactions, improved the allocation of financial resources, increased the competitiveness and efficiency of financial institutions and markets, and opened new avenues through which individuals and institutions can better diversify and hedge their risks.

But with this progress has also come new and difficult challenges. The rapid pace of technological advancement and financial innovation has introduced new, highly complex elements of risk, increased the speed and volatility of the markets, and blurred the barriers between previously distinct sectors of the financial marketplace.

Even as supervisors confront change, the fundamental questions remain the same. Where is the risk in banks' activities, and how effectively are they managing it? Where are banks extending credit and in what form? Who are banks' customers, and how are those customers changing? To what extent are credit risks being transformed into liquidity and operational risks?

The difference today is that the timeframe for answering these fundamental questions is dramatically shortened. As supervisors, we must be able to look at rapidly changing financial institutions and assess whether their strategies make sense and whether they are effectively evaluating the risks associated with executing those strategies.

Technology and innovation have also rendered geographic boundaries all but meaningless, and undermined the power and control of financial authorities. As you know, one of the principal means of supervising internationally active banks has been the process whereby the host supervisor approves the establishment of a brick-and-mortar presence in its country or jurisdiction. By way of a web-based platform, banks can now target customers far beyond the reach of a typical branch, and even cross borders into countries where they have no local offices and may never have conducted business before. We've already seen a few cases in which a bank is chartered in one country, handles its data processing in another, and targets customers in still others. Such situations will surely challenge traditional notions of "home" and "host" supervisor, and raise difficult issues regarding international coordination and cooperation, information sharing, law enforcement and privacy.

In a world of instantaneous communication, interconnected markets, and more complex instruments and risks, effective supervision is more important than ever to maintaining financial stability, both locally and globally. To remain effective and relevant, supervisors must understand how and to what extent the "wired" economy and other technologies are changing banking and finance. At the same time, we must take care that our efforts to ensure the safe and sound operation of the financial markets do not stifle the innovation and creative energy that is changing banking and finance – indeed, the world – for the better.

With these thoughts in mind, it is my firm conviction that to successfully meet the challenges of the twenty-first century, our very notion of supervision, broadly speaking, must evolve to include financial institutions themselves and the discipline applied by the marketplace.

### **Supervision in the twenty-first century**

And so what is the purpose of supervision in the twenty-first century? What are the objectives, and how can those objectives be best pursued?

Let me say first of all that there is no easy or single answer to these questions. The twenty-first century financial marketplace is too dynamic, too complex, and supervisors must work within the political realities of our respective nations. What I envision is a flexible, multi-faceted strategy that emphasizes prudence and problem prevention, compatibility with the market, and a close and cooperative working relationship between the private and public sector.

With these priorities in mind, I believe there are three essential elements of a modern supervision framework:

- effective bank-level management;
- market discipline; and,
- official supervision.

Let me discuss each of these in turn, noting that each should reinforce the others to effectively promote a safe and sound financial system.

#### ***Effective bank-level management***

Primary responsibility for the safe and sound operation of a banking institution lies with its board of directors and senior management. Boards of directors should oversee the development of the overall strategy of the organization and the decisions made by senior management in pursuit of those strategic objectives. In effectively executing these responsibilities, boards make a critical contribution to the long-term success of the institution. This is a fundamental principal of banking that has not changed with technological advancement. Indeed, if anything, the greater complexity and sophistication of the

modern financial services firm require more energy, effort and expertise from directors than ever before.

I see two areas of board operation as being particularly crucial. First, banks and other financial institutions must ensure that specific skills and competencies, consistent with the institution's strategic focus, are represented on their boards. Institutions that engage in complex credit or market activities, utilize sophisticated financial products, or expand their Internet or e-commerce capabilities, should include one or more board directors with pertinent expertise in such areas.

Second, boards should establish clear guidelines regarding the independence of their directors. Generally, it is desirable for at least some directors, and perhaps a majority, to be independent and from outside the ranks of the management of the institution. Further, the board should set parameters regarding at what point, or under what circumstances, a director's outside business interest becomes so significant as to raise questions of a possible conflict.

Serious measures to ensure relevant competencies and independence will greatly enhance boards' effectiveness and go a long way toward ensuring they perform their increasingly critical role in overseeing the decisions of senior management.

The role of senior management, in turn, is to set the business strategy, oversee day-to-day decisions made within the organization, and ensure their consistency with long-term objectives and policies as determined by the board.

There are several aspects to effective bank-level management. First, I would underscore the importance of good corporate governance, the basic elements of which include:

- Independent and competent outside directors, as I mentioned a moment ago;
- Capable and experienced management;
- A coherent corporate strategy and business plan; and,
- Clear lines of responsibility and accountability.

Together, these elements contribute to an overall operating process conducive to long-term health and prosperity. A tightly run ship with a disciplined crew led by an experienced and competent cadre of officers is far better able to survive a long journey that will inevitably confront sudden storms.

Closely related to good corporate governance and critical to any banking institution's well-being is a rigorous internal control apparatus. Of course, effective internal control systems have always been centrally important to sound banking. This point becomes clear if we consider for a moment their basic purposes:

- To provide reasonable assurance that the bank's and its customers' assets are safeguarded, that its information is timely and reliable, and that errors and irregularities are discovered and corrected promptly;
- To promote the bank's operational efficiency; and,
- To ensure compliance with managerial policies, laws, regulations and sound fiduciary principles.

With these purposes in mind, it is clear that the long-term success of any banking organization depends on the effectiveness of its internal control apparatus.

And never has this been more true than today. As the activities of commercial banks have become increasingly diverse and complex, internal controls have become critically important to the sound and successful execution of banks' strategic objectives.

I want to stress this point as strongly as I can. As a former commercial banker myself, I know there is a powerful temptation for management to focus its attention and resources on the front office – those areas and individuals that generate profits for the institution. But if something goes wrong in the back office, it can quickly become the most important aspect of a bank's operations. We've seen this time

and time again. It is essential that sufficient resources, staff and managerial attention are devoted to the back office and internal audit functions.

Firmly rooted on the foundation of good corporate governance and rigorous internal controls is the central importance of effective risk management. Banking by its very nature is a business of taking calculated risks. If they didn't take risks, banks could not perform their essential functions in a market economy. But sound banking also entails the prudent management of those unavoidable risks. Each banking institution must have in place the technical systems and management processes necessary to identify the risks associated with its activities – lending and otherwise – and to effectively measure, monitor and control those risks.

But even if an institution has an effective risk management and control structure in place, that structure must also be accompanied by an institutional management culture that ensures that written policies and procedures are actually translated into practice, with buy-in at all staff levels. Ultimately, an institution's culture is determined – once again – by the board of directors and the senior management it chooses to install. Management must take active steps to ensure that its commitment to an operating environment that includes effective risk management and rigorous controls filters down the line of the organization.

To summarize, these aspects of effective bank level management – good corporate governance, rigorous internal controls and effective risk management – represent the first and most important line of defense against potential problems. And this will increasingly be the case as the activities of banks and other financial institutions become more complex and more global.

### ***Market discipline***

After effective management at the bank level, the second line of defense against financial instability is market discipline, which is an increasingly important ally of the official supervisor. When armed with timely and meaningful information on banks' performance, market participants can, by way of their investment and credit decisions, encourage bank managers and boards of directors to manage their risk exposures soundly. Equally as important, market participants can penalize those institutions that do not.

But, of course, effective market discipline is not possible without meaningful public disclosure. While significant progress has been made in recent years, it unfortunately remains the case that disclosure practices have not kept pace with the rapid changes in banks' business activities and risk exposures, and with how these exposures are measured and managed.

For this situation to be fully remedied, notions of what is proprietary information and what should be in the public domain must change. Knowing a company's appetite for risk and its approach to, and methodologies for, managing risk is essential to understanding the risks of being a shareholder, a creditor or a counterparty. All financial market participants should approach the issue of disclosure as *users* of financial statements rather than as issuers.

There should be little question about the urgency of achieving dramatic progress in this area. Clearly, a full appreciation of risk cannot be achieved without sufficient information. All of us know that there is no greater enemy to financial stability than a loss of confidence – and nothing undermines confidence more than a lack of reliable information. Discipline imposed by markets might not be pleasant, but more, higher quality information – in a word, transparency – bolsters the confidence of depositors and other creditors and therefore makes doing business easier and more secure for everyone.

Of course, progress on the disclosure front will be limited until accounting standards are enhanced to ensure proper valuation and to reflect innovations over the past decade, both in terms of new products and modern risk management techniques. Accounting systems serve a variety of purposes, but none more important than helping creditors and investors make rigorous and clear-eyed decisions as to which enterprises meet market tests of efficiency, competitiveness and profitability that are necessary to fulfill their obligations. Sound accounting systems also enable investors to determine the value of enterprises, and, in so doing, assist in attracting capital, both foreign and domestic. With these

important purposes in mind, ongoing efforts to enhance accounting standards worldwide should continue and even intensify.

There is also a need for greater harmonization of accounting standards across countries. We simply must get to a point where supervisors and market participants alike can analyze and compare all internationally active financial institutions on a consistent basis. And it will not be possible to have uniform capital standards until we have achieved some consistency in accounting standards across countries. I applaud the significant progress being made by the International Accounting Standards Committee and look forward to the continued cooperation between the Basel Committee and the IASC toward achieving the goal of harmonization.

### ***Official supervision***

While effective bank level management and meaningful market discipline are crucial elements of an overall strategy for promoting and preserving financial stability, neither can substitute for the critical role played by official supervision. While banks perform functions that are indispensable to the success of any market economy, these same functions, by their very nature, introduce risks that are capable of undermining the prospects for such success.

This reality was acknowledged by Adam Smith over two centuries ago in his seminal tract *The Wealth of Nations*. And it is with this fundamental reality in mind that governments have long recognized that banking and other financial institutions must be subject to at least some form of regulation and official oversight.

The reasons for official supervisory intervention in the banking and financial system can be summed up as promoting financial stability and minimizing systemic risk. This is a broad mandate – to ensure that markets operate in a fair, transparent, and efficient manner, and that participants comply with the rules of the game. To successfully fulfill this critical responsibility, it is clear that the fundamental approach, scope and methodologies of official supervision must evolve in line with the way financial institutions manage their activities, which increasingly is along business lines rather than legal entities.

With this in mind, supervisors should continue efforts to develop a more dynamic, risk-focused and process-oriented framework, reflecting the reality that banks and other financial institutions are increasingly able to alter their risk profiles at will. By “risk-focused,” I mean that supervisory resources should be directed at the most material risks to which an institution and its capital are exposed, given its array of business activities. By “process-oriented,” I mean that examiners and auditors should determine whether management processes and methodologies are sufficiently rigorous and effective, given the institution’s identified risks. Institutions that demonstrate a sound control structure and effective management processes should be subject to less intrusive supervision than institutions that do not have this essential infrastructure in place.

### ***The Core Principles***

Specific supervisory arrangements, practices and techniques vary from country to country depending on differences in culture, financial system structure and internal political realities. The diversity of practices notwithstanding, a set of basic principles has been identified that should guide all supervisors in an increasingly interconnected, global financial marketplace.

In 1997 the Basel Committee on Bank Supervision issued a set of twenty-five Core Principles for Effective Bank Supervision to serve as a benchmark against which the effectiveness of different supervisory regimes can be assessed.

The Core Principles document brings together concisely all of the fundamental elements needed to carry out effective bank supervision – a remarkable achievement in its own right. Equally important, in my view, the document also balances the desire to set high standards for supervisory practices with the pragmatic recognition that not all countries are in the same stage of financial market development. As such, the Core Principles document is of particular importance for developing market economies,

as it establishes a clear set of standards against which any country's current approaches and progress can be measured.

It should be emphasized that, in attempting to craft a document that would have the legitimacy, quality and flexibility to meet the needs of bank supervisors around the world, the Committee made a conscious effort to consult broadly throughout the various stages of the project, and particularly with supervisors from emerging market nations. Only through an inclusive approach could we design comprehensive principles with broad applicability and support.

In October of last year, the Basel Committee, in cooperation with the IMF and the World Bank, produced a follow-up document called the Core Principles Methodology. This report was initiated in response to requests from a number of countries for additional guidance on how to interpret and implement the Core Principles. The Methodology document provides specific criteria for evaluating and implementing each Core Principle. One set of criteria focuses on issues deemed essential for the minimum implementation of the Core Principles; the other focuses on those issues deemed to represent "best practice." The IMF and the World Bank currently use the new methodology to assess the banking sectors in individual countries.

It should be stressed that the most important efforts to implement the Core Principles are occurring in individual countries and, with this in mind, I am pleased to say that approximately 120 countries have now endorsed the Core Principles. Without the support and backing of national authorities to follow through with the implementation of these principles, our broader efforts simply cannot be effective.

In this connection, the Basel Committee has long recognized the need for effective training of participants in the global supervision community, and over the years has sponsored numerous programs which have been beneficial in allowing supervisors from different countries to share experiences and exchange ideas for improved practices. In 1998, the Basel Committee, along with the Bank for International Settlements, jointly established the Financial Stability Institute, which conducts leadership seminars for supervisors in emerging market countries and facilitates technical assistance.

### **Effort to revise the Basel Accord**

Let me move on to the Basel Committee's initiative to revise the 1988 Capital Accord. As you well know, capital has been, and continues to be, an important supervisory tool.

Since 1988, capital regulation has evolved around a set of minimum ratios that were devised by the Basel Committee on Banking Supervision and set forth in a document known as the Basel Accord. The Accord was, without question, a milestone achievement – for the first time, supervisors were able to use a common yardstick for assessing banks' capital adequacy. The development of risk-based capital ratios has helped to strengthen capital standards in the more than 100 countries that adopted the Accord.

In recent years, however, the Accord has exhibited serious shortcoming. One significant weakness is that the Accord's broad brush structure may provide banks with an unintended incentive to take on higher risk exposures without requiring them to hold a commensurate amount of capital. It also has not kept pace with innovations in the way that banks measure, manage and mitigate risk.

With these concerns in mind, in June of 1999 the Basel Committee released a Consultative Paper for a new capital adequacy framework. While we knew this paper would not represent a perfect framework for all banks, our aim was to release a credible package that would serve as a basis for discussion. We actively sought feedback from the industry worldwide during the formal comment period that ended on 31 March of this year, and we are continuing this dialogue.

I should note that we are very pleased and encouraged by the more than 200 comments received from a variety of sources, including financial institutions, central banks and supervisors, non-G10 countries and other market participants. The respondents on the whole have sent us a strong endorsement of our overall goal of developing a capital framework comprised of three pillars – minimum capital standards, supervisory review and market discipline – that is more risk reflective and appropriate to banks of varying levels of sophistication.

At the same time, the respondents raised a number of important concerns and questions that the Committee is reviewing and considering carefully. The comments offered by emerging market and other “non-G10” countries have figured prominently into the Committee’s review of its initial proposal, and Claes Norgren, who is chairing the next session, will provide an update on the Committee’s thinking regarding these points.

I’d like to take a few minutes to update you on our efforts, focusing on a few topics of special interest. Given the progress we have already made, it is clear to me that the Committee is well positioned to continue its momentum and to release a revised Consultative Paper early next year.

### ***Internal ratings-based approach***

The centerpiece of the new Accord is likely to be the internal ratings-based approach to credit risk. We envision that the internal ratings method will be applicable to those institutions that have in place strong internal rating systems accompanied by robust internal controls. Naturally, our new standards will also encompass guidance on supervisory oversight and provide for ample disclosure.

The Committee is looking to establish standards that are rigorous and yet permit institutions willing to make the necessary investments to use the approach. I think that it is fair to say that the Committee now expects that many sophisticated institutions will seek to use the internal ratings-based approach.

How will an internal ratings-based approach work? Simply described, there are three components to the internal ratings-based approach being developed by the Committee. First, a bank would assign each of its loans or exposures to an internal grade, which reflects the risk associated to lending to each borrower. A bank would do so by using the expert judgment of senior lenders and its own well-defined internal rating scale and criteria. The bank would then assess the likelihood of default of borrowers in each internal grade, based on its own analysis. Many larger banks are doing this now. It is this assessment of the probability of default that is the core of the internal ratings-based approach.

The second step is for the bank to assess the severity of loss should a loan default – most often referred to as the Loss Given Default. The Committee currently envisions two internal ratings-based approaches, a foundation approach and an advanced approach with even higher minimum standards. A key distinction is that under the foundation approach, banks would use supervisory estimates of loss-given-default based on loan characteristics, while under the advanced approach, they could make use of their own analysis.

The third step is to derive the bank’s capital requirement. The Committee will set out the risk weights that correspond to different estimated probabilities of default and loss-given-default. These risk weights are being developed by the Committee as a measure of unexpected loss, reflecting the amount of potential credit loss for each loan.

A key aspect of the internal ratings-based approach is the development of rigorous supervisory standards for the assignment and quantification of internal ratings. An essential component of these standards is the so-called “use test” that requires a system of internal ratings to be an integral part of a bank’s risk management and own assessment of capital adequacy. The internal reliance on these risk ratings will not only help supervisors gain confidence in the accuracy of a bank’s ratings system, but will also provide a key link to the proposed second pillar of the Accord, supervisory review.

### ***Other work on minimum capital requirements***

While the focus of my remarks has been on the internal ratings-based approach, the Committee also is working on other key aspects of the new framework, including revising the standardized approach, developing an expanded treatment of credit risk mitigation techniques and assessing a capital charge for operational risk.



### ***Standardized approach***

The Basel Committee remains dedicated to revising the standardized approach as banks and supervisors in some countries may not yet have the necessary resources to implement an internal ratings-based method. To improve the risk sensitivity of the standardized approach, the Committee sought to establish capital requirements that recognized some differences in the probability of default between borrowers. At the same time, the Committee sought to be attentive to the views of many bankers and supervisors who wanted the standardized approach to remain simple so that banks of all sizes and levels of sophistication could implement it. It consequently proposed the use of external credit assessments, such as credit ratings, as a means for helping to assign risk weights, and hence capital charges, on claims.

We were pleased that on the whole respondents agreed with the goal of increasing the sensitivity of the standardized approach to credit risk. Nonetheless, given the difficulty of achieving the right balance between sensitivity and simplicity, the proposal to base the standardized approach on external credit rating agencies' ratings has raised real concerns. Some have noted that, especially in emerging market countries, very few borrowers have credit ratings, and the new framework might then not be able to differentiate credit risk substantially between borrowers. Some also raised questions about the performance record of some ratings agencies, particularly in the context of various regional financial crises around the world.

Unfortunately, few alternatives were suggested during the comment period. Still, we remain open to fresh ideas and are working hard to address the concerns noted. For example, we are exploring the use of other indicators of a borrower's credit quality to differentiate between risk exposures in a way that could be applied by any bank. Moreover, in response to suggestions made by commentators that the standardized approach could be expanded to allow for even greater risk differentiation, the Committee is actively evaluating whether it would be feasible to incorporate additional risk weights, particularly for corporate claims and the riskiest assets held by banks. Aligning the capital charges in the standardized approach more closely with economic risk while retaining relative simplicity is an important goal, as the Committee wishes to ensure that all banks worldwide that look to the Accord as the benchmark can subscribe to the new framework.

### ***Credit risk mitigation techniques***

The Committee is also looking to allow for greater recognition of credit risk mitigation techniques, such as collateral, guarantees and credit derivatives, while at the same time addressing potential risks that remain from their use. As we finalize our proposals, we are working to ensure that there is a high degree of consistency between the treatment of risk mitigation techniques under the standardized and internal ratings-based approaches, though the two are likely to differ in some respects.

### ***Operational risk***

The Committee recognizes that in refining the measurement of credit risk, it is also important to consider the coverage of other important risks, such as operational risk. The announcement of our intention to incorporate an explicit capital charge for operational risk in the new capital framework has had a catalytic effect on the industry, which is striving to improve its measurement capabilities in this area. The Committee wants to maintain this momentum. It is working closely with the industry to develop an "evolutionary" approach to operational risk that would reward banks that improve their risk management and measurement capabilities. We intend to include this approach in the next Consultative Paper.

### ***Pillar 2: Supervisory Review***

Let me also briefly touch upon the two other pillars of the revised capital adequacy framework – supervisory review and market discipline. These topics are certainly familiar and important ones to all of you.

As I mentioned in the context of the internal ratings-based approach, supervisory review of capital is a critical complement to minimum capital requirements. The task for supervisors in the revised framework is to evaluate how well banks are assessing their capital needs relative to their risks, including whether banks are appropriately addressing the relationship between different types of risk.

I want to stress that this proposed approach is in no way intended to replace the judgement and expertise of bank management, or to shift responsibility for capital adequacy to supervisors. On the contrary, it is well understood that bank managers have the most complete understanding of the risks their institutions face, and it is they who have primary responsibility for managing those risks. Most importantly, in proposing this second pillar, the Committee intends to foster a more active dialogue between banks and their supervisors, such that when deficiencies develop, prompt and decisive action can be taken to restore capital.

### ***Pillar 3: Market Discipline***

The third pillar of the new capital adequacy framework, market discipline, will serve to reinforce capital regulation and other supervisory efforts to promote the safety and soundness of banks and financial systems. To this end, the Committee has been working to formulate a set of disclosure requirements that will ensure the availability of sufficient information to assess the appropriateness of a bank's capital relative to risk, while taking into account the bank's proprietary needs. This is particularly important in relation to the internal ratings approach to credit risk.

In January of this year, the Committee issued a discussion paper detailing guidance for strengthening the third pillar of the new capital framework. This paper provides recommendations on disclosures of banks' capital structures, risk exposures and capital adequacy. The Committee is continuing to expand on these recommendations as its work on the first and second pillars of the new capital framework evolves.

As the Committee continues to fine-tune the new capital framework, we are focusing on issues of primary concern to the industry and supervisors world-wide, seeking to avoid getting bogged down in secondary issues that could slow the overall process. This most certainly is a broad-scoped effort that will not, indeed cannot, meet every priority and concern of everyone. But we are well aware that the perfect cannot be the enemy of the good. With this in mind, I fully expect that we will meet our goal of releasing a new capital adequacy framework by early next year, followed by a short international comment period and then implementation in each of the member countries.

### **Conclusion**

In conclusion, let me simply say that the dawn of the twenty-first century is a time of unprecedented opportunities and unique challenges for financial institutions and supervisors alike. In meeting the challenges posed by technological advancements and the rapid innovations they enable, and in pursuing the objective of a modern, flexible yet stable financial system, we must acknowledge that both the public and private sectors have a critical role to play.

While the perspectives of market participants and official supervisors may differ from time to time, our objective is the same – to maintain a strong and vibrant financial system. Indeed, it is evident to me, as a former commercial banker and now as a supervisor, that only if we work together, each meeting our responsibilities and reinforcing the other, will we be able to successfully manage a rapidly evolving, ever-more complex financial services industry.