Jaime Caruana: Basel II - the road ahead

Remarks by Mr Jaime Caruana, Governor of the Bank of Spain and Chairman of the Basel Committee on Banking Supervision, at the Institute of International Finance Annual Meeting, Dubai, 21 September 2003.

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Ladies and gentlemen,

It is an honour and a pleasure for me to address the members of the IIF. In the kind invitation to participate in this meeting, two topics were proposed to me, the first being the economic situation and Spain's experience in the euro area, and the second the new Basel II capital accord.

I thought that Basel II would be more appropriate, given the very crucial stage we have now reached. But these two topics, the economic situation and the new accord, have suggested to me two preliminary comments.

First, while policymakers have long understood the importance of price stability to the health of an economy, in recent years we have all learned much about the concurrent need to promote broader financial stability as well. A number of different episodes of economic crisis and financial disturbance have plainly illustrated the threats that weak financial systems and poorly managed banks can pose to the macroeconomy.

This is why I have always stressed that banking regulation should be analyzed not only from a micro viewpoint but also from the macro perspective. Creating the right incentives, consistent with good market practices and sound risk management, appears to be an important way of promoting the safety and soundness of the financial system and therefore a good way of sustaining both the stability and growth of the economy. This is not only relevant for prudential regulation; other areas such as accounting should also be consistent with this broad perspective.

This consideration underlines the importance of taking seriously certain concerns such as procyclicality. In my view Basel II goes in the right direction. I am convinced that when banking systems are adequately capitalised, well-managed and risks are correctly assessed within the appropriate time horizon and the financial system becomes more stable, less procyclical, better able to promote sustainable growth, and more resilient during periods of distress.

My second reflection is that one of the most significant conclusions of the analysis of the recent economic and financial evolution of the world economy has been the resilience of banking systems in most countries. In my view, this resilience has been the result not just of the presence of sufficient capital in the system, but also of improvements in banks' risk management systems.

I think we owe the industry a special vote of congratulations with respect to the latter, but we also owe it a commitment on the part of supervisors to continue to support such developments. This is exactly what we are all trying to do with the proposals for a new Capital Accord, which I would like to address now.

As you are aware, the comment period for the third consultative paper (CP3) closed at the end of July. If you have seen the "comments on CP3" page of the BIS website, you will not be surprised to hear that we have received over 200 responses. I must admit that this is more than we had expected, even if it is below the 250 responses we received on the second consultative document two years ago. Obviously, not all of the comments are mutually compatible, nor would it be feasible to incorporate them all. However, there are some substantive issues which have been raised, and I will mention some of these briefly in a moment. But just let me say first that the Committee is taking the comments very seriously and working extremely hard to resolve the issues that have been raised. What is most important to the Committee is the quality and consistency of the new Accord, and we are clear that this cannot be unnecessarily constrained by deadlines and timetables.

Michelangelo once said that, having seen an angel in a block of marble, he carved until he set it free. From most of the letters of comment received by the Committee this summer, it seems that the industry sees an angel in the proposals and wants to carve away at the text until it's been set free. Indeed, even among the most critical of respondents we had support for the Committee's three pillars and its intent to align capital more closely to risk; to introduce greater consistency in the supervisory review of capital adequacy; and to promote effective market discipline by enhancing transparency. It was, moreover, satisfying for us that most commentators acknowledged substantial improvements in the proposals since the release of the second consultative paper in early 2001.

Respondents have raised a large number of issues for consideration, including several that address some very fundamental concepts and many that have been debated throughout the entire process. In addition, some member jurisdictions will continue to receive responses through their national rule-making processes up until late autumn of this year, during which time we can expect to hear additional views on the proposals.

For those of you who have not yet managed to make it through all of the responses posted on the BIS website, I would like to mention some of the most common issues which have been raised. First of all, the complexity of the proposals. This has also been raised in the past, and is, I think, a valid concern. At the same time, we mustn't forget that many of the areas of the new Accord have expanded in size and complexity precisely as a response to calls from the industry for different types of business to be more finely reflected. Another key issue, mentioned in many comments, is the need to maintain a level playing field. The Committee is very conscious of this matter, and I will say something about our efforts in this respect a little later. Finally in relation to the general issues raised in the comments, I would mention fears of over-conservatism in the proposals when taken as a whole.

I would like also to pick out a few of the more technical comments on CP3. For example, one issue, a high-level issue, which has also received a lot of attention, is the calibration of capital requirements to expected and unexpected losses. We have also received many comments on the securitisation proposals, on the issue of "double default", on the incentive structure and on the recognition of insurance within the operational risk proposals.

After five years of work, the process has reached a critical stage. Leading market participants and supervisors alike have long understood that sophisticated banks have "outgrown" the 1988 Accord and are in need of a more refined regulatory capital regime, and we have all worked extremely hard to achieve this. So it is important to finalise the new Accord, and open the way to its effective implementation.

To that end, as I have already said, we appreciate the candour and thoughts that members of the IIF and other institutions have shared with the Committee and its working groups over the years. We are studying your latest letters and suggestions carefully.

As you will have gathered from my earlier summary, many comments have focused, as in the past, on the minimum requirements laid out in Pillar 1, but as we get closer to finalisation, comments about implementation are becoming more important. I would like to take a few minutes now to talk about these other aspects of the New Accord that deserve equal consideration.

Let me address four specific issues:

- Pillar 2 and consistency
- Home / host implementation issues on a world-wide basis
- Accounting Standards and Basel II
- The recognition of diversification

Pillar 2 and consistency

On the first of these subjects, as you well know, the innovation of the New Accord does not rest solely on the refinements to the quantitative measures of risk. Another innovation, and one of the most beneficial, is the incorporation of supervisory review into the international framework. This represents a real breakthrough for all of us, since supervisors in each jurisdiction have until now found their own ways to evaluate the adequacy of a bank's capital base. That is an unsatisfactory solution since it can lead to inconsistencies in the way that a global banking organisation's operations are supervised at a local level.

By incorporating into the New Basel Accord the requirement for supervisors to evaluate the internal processes behind a bank's view of its need for capital, the Committee expects that bankers and supervisors will engage in a more focused discussion of risk management. Pillar 2 recognises that national supervisors may have different ways of entering into such discussions and provides flexibility to accommodate those differences. At the same time, Pillar 2 will ensure that supervisors share insight into their approaches with others and will foster a better understanding among supervisors and bankers about the differences in national regulatory practices.

Over time, discussions among supervisors will undoubtedly improve our understanding of each other's processes and promote information sharing and cooperation among regulatory agencies. Consequently, Pillar 2 should help us to reduce the supervisory burden on globally active banking organisations and foster more consistent supervisory approaches and practices across national borders.

This corresponds directly to the mandate of the Committee's Accord Implementation Group, or "AIG". The AIG was set up at the end of 2001 under the Chairmanship of Nick Le Pan of the Canadian Office of the Superintendent of Financial Institutions, and Vice-Chair of the Committee. The group comprises high-level supervisors from member countries, who share planned approaches to implementation. The intention is that this exchange of information should enhance the consistent application of the New Accord and thereby promote a level playing field - which we all agree is an important objective. In this sense, the AIG has a practical focus, while policy issues remain the responsibility of the Committee itself.

Home / host implementation issues on a world-wide basis.

This brings me to the second topic on my list, which is home/host implementation issues. As part of the Committee's general efforts in recent years to enhance its relationships with supervisory agencies outside its member countries, the AIG has itself begun a dialogue with other supervisory agencies. In fact, based on the AIG's early discussions, the Committee published a paper in August on the "high level principles for the cross-border implementation of the New Accord".

In this document, we reiterate our view that home and host supervisors will retain their traditional responsibilities in regulating internationally active banks under the New Accord. Nonetheless, the revised capital framework will require an even higher level of cooperation among supervisors. Let me mention areas such as the initial approval and validation of "advanced" approaches to credit and operational risk under Pillar 1; the supervisory review process under Pillar 2; and ongoing assessments of compliance with the requirements for the use of "advanced" approaches.

Although supervisors must make practical arrangements to carry out these responsibilities, the Committee wishes to implement the New Accord in a manner that strengthens the quality of supervision across all countries. Moreover, we recognise the special role we can play in helping to ensure that all host supervisors, and especially those from emerging market countries, are able to supervise the local operations of foreign banks effectively. We will continue to work with emerging market supervisors and the World Bank and IMF, as well as with the Financial Stability Institute and others to exchange ideas on ways to strengthen the regulation of both domestic and internationally active banks.

A key question for many supervisors, and particularly for our colleagues in emerging market jurisdictions, is whether the New Accord represents the next step to take.

The Committee's view has always been that the fundamentals come first. It is only after a solid foundation for a sound banking and regulatory system is in place that anyone should contemplate the more sophisticated requirements of the New Accord. Over time, it is our hope that more and more countries will adopt the new framework, but not before they are ready. The better capitalised and the better managed that all banking systems are worldwide, the more resistant the global financial system will become to periods of distress.

For this reason, the Committee developed a "simplest standardised approach" during the consultations leading up to CP3. This approach has been developed with the assistance of some of our non-G10 colleagues. More recently, we have developed guidance to assist non-G10 supervisors in making decisions about adoption of Basel II and to help them achieve the transition in the way best suited to their national circumstances. Emerging market supervisors have welcomed both the simplest standardised approach and the transition guidance.

And we will do more in this regard. We are currently considering how we might best enhance and upgrade our structures for co-operation with non-G10 countries at the Committee level.

Accounting Standards and Basel II

I would like to turn now to the third topic on my list. One trend in the market environment that we must track concerns the increasing harmonisation in accounting rules and practices internationally. The IIF has quite correctly noted the need to align the supervisory framework more closely with the emerging framework for harmonised accounting guidelines. A greater "meeting of the minds" is warranted especially now that the New Basel Accord includes explicit disclosure requirements intended to promote greater insight into a bank's risk profile.

Yet as the Institute's comment letter reminds us, there are also other areas of the New Accord, such as its treatment of provisions and the valuation of financial instruments, where supervisors and accounting professionals should continue to work toward convergence.

We think that In order to contribute to financial stability, accounting standards should be consistent with sound risk management and control practices in banks and should facilitate market discipline. The Committee has, therefore, attached great importance to taking an active role in the international debates on accounting and to promoting the supervisory perspective on key accounting issues.

The Committee has consulted extensively with representatives of the accounting profession and this dialogue will continue. I should add that we are interested in pursuing new opportunities for discussion on issues of mutual concern with accounting-standard-setting bodies and private sector accounting professionals. In this respect, we very much welcome your initiative to enhance this important dialogue.

Recognition of diversification

An area of change that capital rules must mirror is the constantly evolving state of the art in risk management. The 1988 Accord became outdated to a large extent because it was a relatively simple and static document: its one-size-fits-all approach to capital regulation represented an important advance as a universally accepted standard, but it did not provide a means to recognise more advanced risk measurement techniques. It quickly fell behind as the pace of innovation in technology, financial products, and markets accelerated.

In response, the Committee designed the New Accord to be a more flexible document and one that would be more welcoming of improvements in risk management techniques. Its evolutionary approaches to credit risk and to operational risk, for example, give banks a range of options to choose from and create explicit incentives for banks to strive to adopt the most advanced approaches.

The New Accord still has its limits, however. Members of the IIF and others have cited as an example the failure to recognise use of full credit risk models, which would adjust a bank's capital requirements in accordance with the benefits of diversification in its balance sheet. As you know, the Committee evaluated proposals that would have allowed advanced banks to estimate the degree to which their assets might behave similarly or default together.

For the time being, we have decided instead to establish standard estimates of diversification that banks would apply. I know that many members of the IIF have accepted that choice as prudent for now, but you have also cautioned us that this decision is incompatible with the existing treatment of market risk and the emerging practices in operational risk management.

We know that some banks are making commendable progress in thinking about ways to estimate the value of diversification. Nonetheless, we remain concerned about the degree of confidence one might have in those estimates, given the relative lack of data available on which to base them. Furthermore, we are concerned that it would be difficult for third parties to validate any estimates at this time. Finally, we are not convinced about the consistency of application of these diversification effects. For example we are not certain that any leading bank today consistently adjusts the value of all of its assets based on each asset's contribution to diversification.

Portfolio theory suggests that an obvious next step to further enhance the risk-sensitivity of the capital framework would be to incorporate calculations of diversification benefits into the framework. In the coming years, and we can start very soon, we look forward to working with banks, with banking associations such as the IIF, and with academics and researchers to find ways to move Basel in the direction of full credit risk models, and to harness other improvements in risk measurement and management practices.

As we consider the long-term view, we should not lose sight of the fact that we are just at the beginning. The New Accord represents another important milestone in the adoption of more advanced risk measurement and management practices. But to remain robust and relevant to the demands of twenty-first century banking, our capital regulations must keep pace with changes in the market environment and with the state of the art in risk management.

On that note, I would like to emphasise the importance of research and debate in promoting the safety and soundness of the financial system. The Basel Committee owes a debt of gratitude to the studies and efforts undertaken by economists, risk management professionals, and researchers in both the public and private sectors as we have sought ways to refine the proposals. We know that your work has helped to inform ours. The future evolution of the Accord will be dependent on input and contribution from the industry, and I look forward to continuing our healthy and fruitful exchange of views.

In closing my remarks today, I would like to stress again the Committee's commitment to having a balanced Accord of the highest quality. Although we are encouraged by the general support for the proposals shown through the CP3 process, we recognise that there are some high-level issues still to be addressed and we are working hard to find the best ways to resolve them. I should also stress that no formal decisions have yet been taken in this respect. As you probably know, the Committee will meet next month for the first time since the comment period closed. I can assure you that we will continue to do our utmost to ensure that you - the industry - can take advantage of the benefits of the new Accord at the earliest possible opportunity.

Thank you for your attention.