Jaime Caruana: What next for Basel?

Remarks by Mr Jaime Caruana, Governor of the Bank of Spain and Chairman of the Basel Committee on Banking Supervision, at the Seventh Annual Supervision Conference of the British Bankers Association, London, 9 October 2003.

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Introduction

Mr. Mullen, distinguished guests, and members of the British Bankers Association, it is an honour for me to address you this morning as the new chairman of the Basel Committee on Banking Supervision. This conference, the seventh to date, encourages a healthy exchange of ideas between bankers and supervisors on ways to promote safety and soundness in the banking sector. Today's agenda offers a timely focus on the development of regulatory policy on several levels – on a national level through the mission of the Financial Services Authority, on a European level through the directives of the European Union, and, of course, on a global level through the standards adopted by the Basel Committee.

It seems appropriate to think about banking and supervision on national, regional and global levels. Enhancements in telecommunications, continued expansion in trading relationships, and the increasing interdependence of markets make it difficult to view banking on a purely local or even domestic level. Bankers are no strangers to the global economy, having underwritten letters of credit to exporters and merchants almost since the first trading vessels plied the rivers and seas. However, it seems fair to say that the pace of globalisation and innovation has accelerated dramatically in recent years. As banks enter new markets, create ever more complex products, and pursue customers near and far, the challenge for all of us is, first, to understand how our risk profiles are changing and, next, to find responsible ways to manage them.

Whether they compete on a national, regional, or global level, banks have developed countless new tools and processes that promote their competitiveness, strengthen their returns, and control their exposures to credit, market, operational, and other risks. In turn, supervisors must review periodically the tools and processes at our disposal to ensure that our regulations and practices accommodate changes in market trends, the introduction of innovative products and services, and advances in the art of risk management.

The current efforts to reform the international guidelines on capital adequacy represent a critical review of the cornerstone of bank supervision. The members of the Basel Committee have devoted substantial resources to this reform because we believe that, when banks are adequately capitalised and well managed, they become more stable and better able to withstand periods of financial distress. But more importantly, when all banks have the proper incentives to manage their risks appropriately and hold adequate levels of capital, we believe that the entire financial sector becomes more resilient, less sensitive to the ups and downs of the business cycles, and better able to serve as a source for the sustainable growth of the broader economy.

That is our motivation for proposing the adoption of a New Basel Accord, which I will discuss this morning. I'll begin with a few words on the conclusion of the third consultation period and a short summary of the major themes we gleaned from the comments we received. Since we have discussed the new capital requirements themselves extensively over the past several months, I would next like to address some of the other equally important issues that the BBA and others raised in their comment letters.

The conclusion of the third consultation period

Allow me to begin with a report on the very busy summer we had in Basel. It's fair to say that we received more responses on the third consultative paper than we expected. Over 200 comments were submitted by the conclusion of the comment period in July though that was less than the 250 comments we received on the second consultative document two years ago.

What was not surprising was the depth of interest in the proposals and the considerable degree of thought and care that respondents demonstrated in their letters. In this regard, the Committee owes a debt of gratitude to the many members of the industry and the public who have supported our work over the past several years. The considerable time and attention that especially the BBA and its members have devoted to the development of the New Accord are evident in the high quality of your comments and suggestions. You have offered constructive thoughts and creative solutions. You have shared data on technical issues, and you helped to make our quantitative impact studies possible. Your efforts have helped to inform ours and have assisted us in strengthening the quality of our proposals.

We will take the time needed to consider the comments with care to ensure that we meet the high standards you expect from us, which is to develop an intellectually sound and also pragmatic and cost-efficient proposal. The members of the Committee and I understand that our efforts must not be unnecessarily constrained by deadlines and timetables, although we all believe strongly that it is important to move forward with the New Accord and bring it to finalisation as soon as possible.

Overall, the comments we received through the consultation were constructive and in many senses positive. Indeed, even among the most critical of respondents, one finds support for most of the New Accord. There is support for its three pillars and its intentions 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.

Not unexpectedly, respondents have raised a large number of points worth closer consideration. Some letters addressed fundamental concepts as well as several issues 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 anticipate hearing additional thoughts.

What are some of the themes emerging from the public's reactions? Certainly the complexity of the proposals continues to draw your attention. This is a matter we have discussed in the past and is a valid concern. It is important to remember that much of the complexity in the proposals stems from the concerns raised by banks earlier in the process. Throughout the process, various banks have requested that the Committee offer flexibility and a range of approaches to evaluate the particular risks and profiles of various businesses and specialisations. Indeed, one needs only to read a handful of the letters on our website to discover that some recommendations from the industry would tend to increase further the degree of complexity of the Accord. Nonetheless, the Committee is aware that it is easier to enforce a simpler rule than a complicated one. We have long sought ways to simplify those rules thought most complicated. Those efforts will continue.

Another theme noted in the comments concerns the need to maintain a level playing field – or, at least, to avoid "unleveling" the playing field further. The Committee is very conscious of this matter, and I will say something about our efforts in this respect a little later.

A last important theme addressed the sense that the Committee may have adopted an overly conservative approach to some aspects of the framework, resulting in much higher capital charges than banks feel are necessary. These concerns are important, as a key goal for the

New Accord is to align capital more closely to risk. This means that where the original Accord treats exposures too harshly relative to the degree of risk that they entail, we expect to reduce the capital requirements. But where the risk is greater, and where the existing rules fail to assign adequate capital, it should not be surprising that supervisors will raise capital requirements.

Respondents attribute what they view as excessive levels of conservatism to different sections of the New Accord, including, for example, the calibration of capital requirements to both expected and unexpected losses. The treatment of credit losses is an issue which has attracted a lot of comments and which is, indeed, very important. As you will probably be aware, the present proposals to calibrate on the basis of expected and unexpected losses represented a compromise in the face of cross-country differences in accounting practices and supervisory authority regarding provisioning. But the Committee will look into this important issue again, and I am optimistic that we can find a way to improve the present proposal.

We have received similar concerns about conservatism in the securitisation proposals and in the treatment of "double default" risk, which is the risk that both a borrower and a guarantor would default on the same obligation. Other questions have been raised on the incentive structure and on the recognition of insurance within the operational risk proposals.

It is perhaps natural that the majority of comments address the minimum capital requirements, or pillar 1. This section of the New Accord defines the capital charges in monetary terms for banks' exposures and activities. But one should not forget that the New Accord is premised on three pillars, not just one. So I would like now to turn to the other two pillars, beginning with the importance – and benefits – of the proposals for the supervisory review of capital and home/host issues. Afterwards, I would like to spend a moment on another topic which has been raised in the comments, namely the New Accord and harmonisation of accounting standards. Finally, I will conclude my presentation with some remarks about the current status of our discussions and our future work.

Supervisory review & home/host issues

As you know, under the New Accord the Basel Committee will recognise formally the role that supervisors play in ensuring that banks manage their risks and their capital needs appropriately. In the past, supervisors in each jurisdiction found their own ways to evaluate capital. This has sometimes resulted in an inconsistent application of the minimum requirements and the adoption of different expectations across countries and an increase in regulatory burden on banks.

Incorporating supervisory review into the international guidelines represents a genuine breakthrough for all of us. By developing guidelines for the supervisor's evaluation of a bank's internal capital allocation process, the Committee believes that supervisors and banks will engage in more focused, more consistent, and less burdensome discussions of the risks that banks face and the responses they adopt. The Committee recognises that national laws and regulations provide different avenues through which supervisors may conduct such reviews, and consequently Pillar 2 affords each jurisdiction the flexibility to accommodate those differences.

The topic of supervisory review must also be considered in the context of the level playing field, one of the themes I mentioned earlier that came out clearly in the comment letters. As the members of the BBA and the London Investment Banking Association expressed in their joint comment letter, for example, the way in which the New Accord is applied and supervisory review is conducted across countries matters critically to the daily operations of internationally active banking organisations. Your letter noted the importance of consistency in standards and consistency in the interpretation of the new framework, as well as the challenges that even limited areas of national discretion can create.

These concerns go the very heart of the Committee's mission. Some thirty years ago, the founders of the Committee recognised the growing need for cooperation and consistency in the supervision of internationally active banks. As we prepare to adopt a new capital framework, we know that we supervisors will need to cooperate even more in the future to supervise an internationally active bank's adoption of the more advanced approaches to credit or operational risk.

The Accord Implementation Group was created under the leadership of Nick Le Pan, the Canadian Superintendent of Financial Institutions, precisely to share experiences and approaches to applying the new rules. By sharing information on practical matters, we expect that supervisors will apply the New Accord more consistently at home, thereby promoting a more level playing field across countries as well.

Based on the AIG's work to date, the Committee published a paper this past August on the "high level principles for the cross-border implementation of the New Accord." In this paper, we reiterate our view that the traditional allocation of responsibilities to home and host supervisors will continue. Cooperation will be critical to the effective supervision of institutions under the New Accord, especially considering the challenges an internationally active bank will face in receiving the initial approval to adopt, and then validate, advanced approaches to credit and operational risk at home and in host jurisdictions. Similarly, supervisors will need to find practical ways to cooperate in the evaluations of capital adequacy under pillar 2 and ongoing reviews of compliance with the minimum operational requirements of the New Accord.

By promoting a more consistent approach to supervisory review, we intend to strengthen the quality of supervision across countries. We recognise as well the special function the Committee can offer in strengthening the ability of host supervisors – particularly those in emerging market economies – to regulate the local operations of foreign banks.

Harmonisation of accounting standards and the New Basel Accord

Supervisory review helps to create very direct incentives for banks to evaluate and manage their risks carefully. Transparency can supplement that incentive by leveraging the power of financial markets to encourage prudent risk-taking, and I would like now to address the third pillar of the New Accord, namely market discipline.

Even just over the past few months, the popular press has reported on several examples of corporations that failed to disclose adequately the kinds of activities in which they were involved and the degree to which they bore risk. Both inside and outside the banking industry, the renewed focus on sound corporate governance practices has highlighted the importance of appropriate disclosure to the market – and the dangers that ensue when companies fail to disclose their risks adequately.

These failures in disclosure have added fuel to the drive to harmonise accounting and disclosure practices worldwide. With reference to the New Accord, many respondents quite correctly noted the need to align the supervisory framework more closely with the converging accounting practices worldwide. 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. Likewise, the Basel Committee's treatment of provisions and the valuation of financial instruments must keep pace with changes in the relevant accounting standards. These and other topics constitute areas where supervisors and the accounting profession must continue to work toward convergence.

The members of the Committee believe that market discipline, and hence financial stability, is strengthened when accounting and disclosure requirements reflect sound risk management principles and are consistent with the control practices that banks adopt. Consequently, we recognise our responsibility to participate actively in the development of national and international accounting standards. I must confess that, in Spain, part of this responsibility is perhaps a bit easier for me than for some of my fellow members of the Committee, since the Bank of Spain is not just a bank regulator, but also the national accounting authority for banks. Where the development of international standards is concerned, the Committee and its member organisations devote considerable resources and our staff's time to share our perspectives as supervisors with those who make the rules.

But the discussions between supervisors and accountants cannot be a one-way street. In turn, as supervisors on the Basel Committee have been developing standards for the disclosure of components of capital, for loan accounting, and for other topics of mutual concern, we have sought out the views of representatives of the accounting profession. This dialogue will continue. I should add that we are currently seeking new opportunities for discussion on issues of mutual concern with accounting standards-setting bodies and private sector accounting professionals.

Current status & future work for the Basel Committee

I know that you are eager to know where the Committee stands at the moment. As I suggested, the Committee and its member organisations are closely reviewing all of the comment letters received so far. Working groups have been discussing potential refinements to the proposals to address the concerns raised during the consultation. The Committee itself will meet tomorrow. Our agenda is straightforward: we will evaluate the industry's views and consider the solutions proposed by the Committee's working groups. No conclusions are foregone at this stage. The members of the Committee are in agreement that our primary responsibility is to develop an agreement that is sensitive to risk, forward-looking, and fit for the service of twenty-first century banking. But we are also conscious of the need to avoid unnecessary burden and to provide the industry with as much certainty as possible.

As we near completion of the New Accord, I am frequently asked the same question that you proposed as the title of my presentation: "what next for Basel?" Rest assured that we will not rest once we've introduced the New Accord. Indeed, some hints of topics that the Committee may wish to tackle next emerge even in the comment letters sent by the industry.

One good example might be to consider the incorporation of full credit risk models in the calculation of minimal capital requirements. In theory, a bank's capital requirements would then reflect to a greater degree the economic benefits of diversification in its balance sheet. Some respondents have long asked the Committee to climb this mountain now in the New Accord. As you may know, the Committee early in the process evaluated proposals that would have allowed advanced banks to estimate the degree to which their assets might behave similarly or default together.

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.

Consequently, 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 industry have accepted that choice as prudent for now, but you have also stressed the need to move forward with an approach that is more consistent with the existing treatment of market risk and the emerging practices in operational risk management. We are ready to start this work as soon as it is possible.

Still, 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 BBA, and with academics and researchers to find ways to move Basel in the direction of full credit risk models. Likewise, the Committee must continue to monitor developments in the industry to be prepared to harness other improvements in risk measurement and management practices.

It is at once exciting and perhaps a bit daunting to think about the work ahead for all of us, whether on a national, regional, or global level. Indeed, you need only to consider the energy and time that supervisors and the industry have already expended to prepare for the New Basel Accord to recall that great benefits can be reaped only from great efforts. While many challenges lie ahead, even more lie behind us that we have already overcome.

Thank you for inviting me to your conference today.