Jaime Caruana: Coordinating regulation and supervision of banks - Basel II and beyond

Remarks by Mr Jaime Caruana, Governor of the Bank of Spain and Chairman of the Basel Committee on Banking Supervision, at the Global Operational Risk Forum of the Risk Management Association, Paris, 24 October 2003.

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I would like to thank the organizers for inviting me to this forum on operational risk. As the new Chairman of the Basel Committee on Banking Supervision, it is a pleasure for me to join you, the members of the Risk Management Association, in a discussion about the latest trends in capital and risk management.

Overview

Many of you have travelled great distances to join us here. Perhaps part of the attraction was the chance to enjoy the charms of autumn in Paris. But the main reason is that you believe risk management matters. Indeed, from their first meetings in Philadelphia almost 90 years ago, the members of the Risk Management Association have long helped to promote sound risk management, offering training, educational resources, and forums such as today's event to financial professionals. Moreover, for more than 80 years the RMA has emphasised the analysis of quantitative data in helping to evaluate risk through its collection and annual publication of financial data and benchmarks. Through your efforts, and the efforts of associations similar to the RMA, you are helping to advance the state of the art in the management of credit, market, and operational risk and to encourage responsible banking practices.

On this front, a risk manager and a bank supervisor share similar interests. A risk manager seeks the best risk measures and management techniques to protect a bank against losses, to hone its competitiveness, and to enhance its profitability and long-term growth. Supervisors, for their part, advocate the use of sound risk management practices to ensure the adequate capitalisation and prudent management of all banks. This, in turn, strengthens the ability of financial sector to withstand periods of distress, to serve as an intermediary of credit through good times and bad, and to contribute to more sustainable growth in the economy.

The Basel Committee's landmark revision of the international bank capital standard represents one of the most important global efforts to encourage the responsible pursuit of risk and rewards and, hence, to promote greater financial stability. This represents the outgrowth of trends in many countries to build incentives into the regulatory framework that encourage banks to identify and understand the risks they face today, to consider what risks may arise tomorrow, and to respond actively and appropriately to both. You've been discussing this topic here in Paris for two days now, but all of us have been thinking long and hard about the New Basel Accord for many years.

That should come as no surprise, as capital requirements are the foundation of the regulatory framework. Even more importantly, capital is a key ingredient to the health of the banking sector. But risk managers know that having adequate levels of capital does not ensure success - or even long-term survival. In calm seas, everyone is a pilot. Only rough waters prove the skill of a ship's crew. Supervisors and risk managers know that a bank's management and controls make up its first line of defence. The New Basel Accord seeks to capture the relationship between capital adequacy and risk management, a relationship that is quite apparent in its approach to operational risk.

I'd like to take this opportunity to discuss the latest news on the New Accord and some of my thoughts on the framework for operational risk. I'll begin with the Committee's announcement from two weeks ago about plans for finishing the New Accord. I'll then share some thoughts on the treatment of operational risk and the Committee's motivation for adopting an explicit charge for it. Given the interest that this proposal attracted, I'll address three important themes raised in public comments that the Committee is currently considering. During that discussion, I'll offer some thoughts on what lies ahead, not just for bankers, but also for supervisors in conducting and coordinating supervision under the New Basel Accord.

Recent developments: the October press release

First, to the most current news. By now you've no doubt read that the Basel Committee agreed two weeks ago on a plan to address the final issues raised in public consultations over the summer and to complete the new rules. This was no easy task, as the Committee received over 200 comment letters from the industry and the broader public on the Third Consultative Paper, or "CP3". While we might have been somewhat surprised by the number of responses that we received, we were not surprised by the hard work that was evident in the letters.

The quality of the responses shows that many banks and industry associations understand the deep significance of the proposals. On this note, I would like to offer the Committee's appreciation to the RMA-related working groups and others who devoted considerable time and resources during the consultations. You shared important views through comment letters, gathered data for impact studies, and engaged in discussions like the ones that have taken place here. If you've been following our work since the first consultative paper was released in 1999, you know that the proposals have evolved and improved considerably thanks to the industry's honest responses, candour, and letters such as those submitted by the RMA.

At the Committee's meeting, all members acknowledged our responsibility to consider carefully your concerns and those of the broader industry. At the same time, we recognised the need to resolve the open issues and release the New Accord as soon as humanly possible so that banks can continue to prepare for the new rules. In a statement to the press after our meeting, the members of the Committee noted that we expect to take account of the remaining issues and complete the text of the New Accord in the coming months and not later than mid-year 2004. This period of time will also allow us to take better note of domestic consultations underway in some jurisdictions.

The comment letters we received covered a wide range of issues. Most of the comments focused on credit risk. While this is not a major focus of today's conference, I would like to call your attention to the proposals that the Committee has developed to revise the treatment of credit losses. As you know, CP3 calibrated regulatory capital on the basis of both unexpected and a portion of expected credit losses. This was intended as a practical compromise to account for differences in national accounting practices and supervisory authority regarding provisioning. Based on views expressed by the RMA and other respondents, and in light of our own continued research, the Committee now intends to align regulatory capital more closely to economic capital by calibrating it on the basis of unexpected credit losses alone. A supplementary mechanism will help to encourage banks to provide sufficiently for expected credit losses. This proposal can be found on the website of the Bank for International Settlements, and the Committee has invited public comment through the end of this year.

Motivation behind the Committee's proposals

Beyond the advanced methods proposed for the treatment of credit risk, the inclusion of a capital approach for operational risk represents one the New Accord's most notable innovations, to which I'll now turn. In recent years, banks and supervisors have begun to recognise the need to evaluate and seek ways to reduce losses arising from failures in processes, systems, people, or external events. Increasingly, supervisors, like many leading institutions, consider the management of operational risk to be a comprehensive practice comparable to that of credit or market risk. While operational risk is not as readily quantified as these other exposures, the Basel Committee has noted genuine progress among leading institutions in measuring and controlling it. "Unbundling" operational risk from other risks and then including an explicit capital charge for it was intended to support these private sector efforts and to reward firms that develop better measures.

With that motivation, the Committee sought approaches to operational risk that mirror the New Accord's three pillars of more risk-sensitive minimum requirements, coordinated supervisory review, and enhanced market discipline through greater transparency. Together, the three pillars support the development of sophisticated measures of operational risk and offer incentives for banks to enhance their relevant controls.

The Committee recognises that the art of operational risk management is still in its nascence and that risk managers are experimenting with a wide range of methodologies. To accommodate various stages of development in thinking and risk modelling, the New Accord offers three approaches for calculating a minimum operational risk capital charge. Two approaches - the Basic Indicator and Standardised Approaches - are, by design, simple and so inevitably are somewhat imprecise measures of operational risk. But when combined with the supervisory review process of Pillar Two and the transparency requirements laid out in Pillar 3, the Committee believes that they offer a reasonable point of departure and will spark additional efforts to refine banks' approaches.

For the most sophisticated institutions, the "advanced measurement approach" - or "AMA" - is the ultimate expression of the Committee's goal to incorporate banks' own sense of risk into the capital framework. Because the AMA is not subject to supervisory "floors," the Committee expects it to serve as a true catalyst for innovation. We were pleased that the RMA Working Group on the Regulation of Operational Risk and others in the industry welcomed the Committee's decision to allow banks to test a great variety of methodologies and measures under the AMA.

Results of consultations

From our review of public comments, and from our member agencies' recent discussions with banks, we have noted a growing consensus that the revisions to the proposals have been positive. The operational risk framework has become more flexible, forward-looking, and better able to accommodate today's best practices. Moreover, we are confident it is nimble enough to incorporate future advances. Of the public comments on CP3 that touched on the operational risk proposals, it was gratifying that most sought refinement and clarifications of the proposals, and many acknowledged the value of the underlying principles.

Respondents addressed a range of issues, but the AMA clearly captured the industry's imagination. Three themes have emerged that are especially important to the Committee's work on the AMA. One concerns the qualifying criteria banks will have to fulfil to adopt the AMA. Two others addressed the allocation of operational risk capital and consistency in the application of the AMA standards, across both banks and jurisdictions. I'd like to spend a few moments to give you a sense of the Committee's deliberations to date on each theme.

Qualifying criteria for AMA

The first, and perhaps most pressing, of the themes concerns the minimum operational requirements that banks will soon need to meet in order to receive supervisory approval to use an advanced measurement approach. Many respondents felt that the Committee's requirements spell out a tall order for the industry, especially in terms of the requirements to validate operational risk data and correlation assumptions.

The Committee acknowledges that meeting the qualifying criteria will be a significant challenge for some banks. At the same time, the AMA offers banks an unprecedented degree of freedom in modelling their risk and determining their minimum capital requirements. The Committee considers it appropriate to pair this privilege with appropriately demanding standards. We should also remember that the qualifying criteria for the AMA focus not just on the quantitative requirements for measuring operational risk, but also on qualitative standards that demonstrate banks have instituted a robust control structure.

Institution-wide capital allocations

A second theme from the consultations addressed the question of whether the AMA should allocate operational risk capital on a consolidated, institution-wide basis or rather on a legal entity basis. Most banks, and especially large and internationally active institutions, understandably would prefer to calculate the relevant capital requirements on a firm-wide basis.

Banks shared a variety of views on why a firm-wide allocation model would be preferable. Some respondents highlighted the technical and logistical constraints on developing an AMA, indicating that it is more difficult, from a modelling perspective, to estimate the potential for operational losses at even a medium-sized entity because of the need for a large body of data. Others, including the RMA working group, noted the practical challenges that would arise if they were required to develop a separate model for each legal entity and seek approval from supervisors in each jurisdiction in which they operate.

But an economic view of risk suggested a different and more fundamental concern. Many banks would like full recognition of the economic benefits they gain from operating across a diversified mix of business lines and entities. Since it appears unlikely that a large organisation would suffer high losses from operational failures in many businesses or entities at once, some banks argue that capital requirements for a large and diversified firm as a whole might be less than the sum of capital requirements calculated for each individual entity.

The Committee acknowledges the technical and practical challenges associated with developing and implementing AMAs for large, diversified firms. We are working to reduce unnecessary burdens on banks adopting them. While we have not made any decisions yet, this is an issue that we are still discussing actively with the industry.

But we face even tougher questions if we consider the allocation of capital across not just legal entities, but also across national borders, as some have requested. This is a very difficult question to address in the Basel context. The Committee must respect the legal responsibilities charged to national supervisors in regulating locally chartered banks, branches, or subsidiaries.

All bank supervisors must have access to sufficient, comprehensive and detailed information on a bank's operational risk control structure, including its AMA, to evaluate the quality of risk management at banks they supervise. That may include a need for banks and other supervised entities to demonstrate the adequacy of their capital resources on a stand-alone basis. We are giving significant thought to the international implications of this issue, but I should caution that we may not be able to find a completely satisfactory solution at the Committee's level.

Consistency in application of AMA standards

The challenges of implementing the New Accord across borders raise concerns as well about consistency in the application of AMA standards. These concerns also address more broadly competition between AMA banks, which is the final theme I'd like to mention today. While many banks welcome the flexibility to use their own methodologies under the AMA, some are concerned that too much flexibility might allow competitors at home or abroad to employ methods that are subject to less rigorous supervision.

Ensuring the consistent application of the New Accord in its entirety is a critical concern for the Committee. The minimum standards were developed to help ensure that global competition in banking markets will be driven by each bank's strengths, rather than by differences in each country's rules. Moreover, Pillars Two and Three were created to a great degree to promote a more level playing field for banks.

For example, incorporating supervisory review - or Pillar Two - 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. 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.

To assist supervisors in developing and applying more consistent standards, the Committee created the Accord Implementation Group, or "AIG", precisely to share experiences and encourage shared approaches. This group, which is chaired by Nick Le Pan, the Canadian Superintendent of Financial Institutions, has already been long at work and provides a forum for supervisors to compare notes on practical matters. As a result, 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.

At the same time, Pillar 3 - market discipline - draws on the power of markets to help ensure that banks do not hold unrealistically low amounts of capital for operational risk. More generally, by emphasising principles in the rules - that an AMA must be credible, that it must adequately capture the risk of extreme events, that it must be used by banks in the daily management of their operational risk and not just for regulatory capital purposes - enhanced disclosure and transparency may actually result in more consistency in the application of advanced approaches than detailed quantitative criteria.

Conclusion

The Committee will need to spend the next few months discussing these three themes internally and with the industry to refine the qualifying criteria for the AMA, to determine how best to allocate operational risk capital, and to ensure a level playing field in the application of the operational risk framework.

As we conclude today's conference, I think all of us have a better sense of the work that is ahead for both bankers and supervisors. At the same time, it's clear from the issues and themes that you've been discussing at this conference that we've moved beyond a discussion of the principles behind the rules and to a focus on preparing for their implementation. This seems appropriate, since we expect that, given the very good progress that we have noted in banks preparing to adopt the New Accord, supervisors and the industry will be ready to implement the new rules by the end of 2006. Indeed, banks that wish to be among the first to adopt the AMA must being collecting the required three years of data by the end of this year - but for practical reasons, this process should have begun already.

Adopting a more risk-sensitive treatment of operational risk will require significant work on all our parts. What we learn about the factors driving operational failures, and how we can better measure and reduce our exposure to losses, means much more to all of us than simply a more favourable capital requirement. Instead, our efforts on operational risk, combined with advances on the credit and market risk fronts, will advance our understanding of the many risks banks face and improve our ability to navigate them successfully. For all of us, that offers the reward of a more stable banking system that is less susceptible to systemic risks and better able to ensure the circulation of credit to businesses and consumers alike.