# Jaime Caruana: Basel II - emerging market perspectives

Keynote remarks by Mr Jaime Caruana, Governor of the Bank of Spain and Chairman of the Basel Committee on Banking Supervision, for a panel discussion on "Basel II - Emerging Market Perspectives", Bankers' Conference 2004, New Delhi, 11 November 2004.

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Thank you, for your kind introduction and opening thoughts on the significance of the new capital framework in emerging market countries. I would like to thank as well the Indian Bankers Association and our host institution, Punjab National Bank, for inviting me to take part in your conference.

It is an honour to be asked to share some of my thoughts on Basel II and its implications for a country such as India. I must confess that it is a still greater privilege for me to hear your thoughts directly on this new standard and the role it may play in a large, rapidly growing dynamic economy. A discussion on India adds the perspective of a country whose banking sector has been undergoing an important period of transition. The scale of that transformation is evident in the global aspirations that Indian banking organisations are now pursuing, as the title of this conference suggests.

I would like to continue our discussion of Basel II first by discussing briefly why the Committee felt that the international capital standard needed to be revised and how Basel II addresses the Committee's goals for it. Then I would like to address some of the questions and issues about Basel II that banks and supervisors in emerging market countries have shared with me. After that, I look forward to hearing the thoughts of my fellow panelists and those of others on what Basel II might mean for the Indian banking sector.

## Why Basel II is necessary: an overview of the new capital framework

Before we discuss how Basel II may affect banks in India, allow me to begin by addressing why the Basel Committee drafted Basel II. The Committee published the text of the new capital framework this past June. This marked the culmination of nearly six years of difficult work for supervisors and for banks. Why did we take such pains to revise the existing capital rules? After all, the 1988 Basel Accord was a tremendous success in many ways.

I think that several factors led us to conclude that a new approach was necessary. As you know, the 1988 Accord established the first internationally accepted definition and measure of bank capital. It was adopted in over 100 countries. As a result, it became acknowledged as one of the benchmark measures of a bank's financial health.

While the simplicity of the 1988 Accord was an asset in promoting its acceptance, today its simplicity is quickly becoming a liability for some bankers and supervisors alike. Over the past 16 years, the methodologies for measuring and managing risk have evolved in ways that the architects of the 1988 Accord could not have anticipated.

For one, advances in technology, telecommunications, and markets have changed the way that banks collect, measure, and manage their risks. Having gained experience in quantifying exposures to market risk, leading banks today are quantifying and using increasingly reliable estimates of the credit risk associated with particular borrowers. Evolution in markets has furthermore provided banks with more tools for managing and transferring credit risk, such as through securitisation transactions and credit derivatives. Likewise, many banks seek to quantify in a more reliable manner their exposures to operational risk, or the risk of losses stemming from failures in internal processes or systems or from damage caused by an external disruption.

As risk management becomes more sophisticated, the simple and static rules of the 1988 Accord are becoming less relevant. Leading banks increasingly view the old rules as a burden, constraining their abilities to administer their businesses relative to the best information and practices available today. Supervisors, for our part, have less confidence in the 1988 Accord's measures of risk for banks that engage in the most sophisticated forms of risk taking and risk mitigation.

By the late 1990s, it became clear to banks and supervisors that we needed a new capital framework. But the Basel Committee sought more than just a reworking of the minimum requirements. We wanted instead to create incentives for the industry to enhance the state of the art in risk management. We believe that improving risk management helps to increase the stability of the global financial system - a goal that would benefit not just banks, but more broadly businesses and consumers.

To foster greater financial stability, the Basel Committee blended several policy approaches to replace the existing capital framework. Basel II consists of three mutually reinforcing pillars.

The first pillar aligns the minimum capital requirements more closely to banks' actual underlying risks. Many banks will rely on external measures of those risks to determine their capital requirements. These might include drawing on credit ratings issued by external rating agencies or on supervisors' assessments of the degree of operational risk inherent in various businesses. More sophisticated institutions, in comparison, may qualify to rely partly on their own measures of those risks when determining their capital requirements, an innovation that will help to create economic incentives for banks to improve those measures.

The second pillar - supervisory review - allows supervisors to evaluate each bank's assessments of its own risks and to determine whether those assessments seem reasonable. Ultimately each bank's own management is responsible for assessing and responding prudently to all of the risks that a bank faces, including those risks that might not be captured entirely in the first pillar. The second pillar will therefore foster a dialogue between banks and their supervisors on the nature of the risks that banks face and the measures they take to control them, including holding aside sufficient levels of capital. That dialogue creates great implicit incentives for management to undertake careful evaluations of the bank's capital needs.

Finally, the third pillar, market discipline, recognises the power of marketplace participants to motivate prudent risk management. By enhancing transparency in banks' financial reporting, the third pillar provides counterparties, investors, and other participants with greater insight into a bank's risk profile; that increases their ability to distinguish and reward banks that are well managed, while penalising those that are not.

One might say that Basel II seeks an "efficient frontier" of policy objectives through the three pillars. Each pillar provides something that the other two cannot. Each is essential to achieving our overall objective of financial stability - an objective that would benefit all countries in all stages of development.

Of course, some of the advanced approaches offered in Basel II are intended for large and/or sophisticated banking organisations; this has sometimes led bankers and supervisors in particular regions of the world to ask me whether Basel II is relevant to their situations. So I'd like to turn now to address some of the questions that I have heard frequently from bankers and supervisors especially in emerging market countries.

## Issues in emerging market countries

### *Is Basel II appropriate for emerging market countries generally?*

Let me address the question that I just mentioned, namely whether Basel II is relevant to the banking system of an emerging market country.

Let me begin by emphasising that I cannot answer the question of when or how any country should adopt Basel II. Only national authorities can decide when to adopt Basel II. Members of the Basel Committee believe that it is beneficial for all countries to move in the direction of Basel II, but the timing for its ultimate adoption should be determined by each country's own circumstances, and not necessarily the timetable for Basel Committee members.

At the same time, I should note that many bankers and supervisors from emerging market countries, including India, were very active in sharing their views and suggestions with the Committee to help make the Basel II framework relevant to banks in many different markets. Indeed, the Reserve Bank of India has played an important role in sharing the perspective of an emerging market country through its participation in the Basel Committee's Core Principles Liaison Group. In addition, representatives of Indian banks shared their views and even data on how they would be affected by the new framework. I would like to express my sincere appreciation to all of our colleagues in India who contributed to improving the quality and applicability of the new framework.

Unlike the 1988 Accord, which was relatively simple to adopt, Basel II is admittedly more complex and demands more of banks and supervisors. Therefore, the Committee does not expect Basel II to be adopted as widely and quickly as the 1988 Accord, at least at the outset. However, we expect and hope that the number of countries that adopt the new framework will grow over time. We also hope that they will do so only when they are ready. And when they are ready, we believe that they should adopt the options and approaches that are most appropriate for the state of their markets, their banking systems, and their supervisory structures.

### *Is Basel II appropriate for banks in emerging markets?*

A second question I hear frequently is whether Basel II is even appropriate for banking systems in emerging markets, which I would like to address now.

In my view, the principles and vision of supervision in Basel II are valuable for supervisors and banks in all markets. The great level of diversity in markets and in financial systems worldwide makes it difficult - and perhaps even counterproductive - to try to specify a single rule that could be applied to all banks in all countries. Fortunately, Basel II's menu approach provides supervisors and banks with options that make its basic standards more readily available to many kinds of organisations and economic circumstances. As I mentioned earlier as well, Basel II's three-pillar approach provides an "efficient frontier" of policy objectives that are relevant to banks in any country by emphasising the need for banks to assess their risks; the need for supervisors to evaluate those assessments; and the need for transparency to promote greater marketplace discipline.

One specific concern that some have expressed about Basel II's applicability in emerging markets is that banks with more basic risk management systems will rely on external credit ratings issued by rating agencies under Basel II's standardised approach to credit risk. In some emerging markets, there may still be few, if any, rated companies. The Committee has been mindful of this concern. If supervisors are uncomfortable with the use of external ratings in their countries, they may opt to weight all corporate claims at 100%, while sovereigns and banks can be risk weighted according to the risk scores of export credit agencies. This eliminates the dependence on ratings issued by external credit agencies.

Indeed, our discussions with colleagues and counterparts from countries outside the Committee, including India, as I mentioned, have been instrumental in addressing other concerns in the capital framework. Thanks to our consultations, we have endeavoured to address several other broad issues in the new framework, including the document's apparent complexity and the consistency of its application internationally, which I will set out now.

### *Complexity*

One inevitable by-product of designing a comprehensive three-pillar framework with a range of options for different circumstances is increased complexity. The members of the Basel Committee certainly recognise that it is far easier to enforce a simple rule than a complicated one. However, the balance that we seek is between simplicity and risk sensitivity: indeed, the banking industry has been quite clear in saying that we should not blindly pursue simple solutions if they would result in unnecessarily conservative estimates of capital requirements. Achieving a balance between simplicity and risk sensitivity is particularly difficult in an industry like banking, where a culture of constant innovation makes it a tall order for regulators to develop simple rules that fit all banking products and services in all their permutations. Paraphrasing Einstein, we might say that a good capital framework should be as simple as possible, but not simpler.

So while Basel II is admittedly a more complicated document than the 1988 Accord, I would suggest that much of its apparent complexity stems from the diversity existing in real world. The text provides multiple options in part because some banks and supervisors thought that a "blanket rule" would unfairly burden them. By providing a range of options, we are better able to fit the regulatory framework to each bank's risk profile, rather than the other way around.

Similarly, some of the complexity in Basel II stems from the details we provide to promote a more level playing field. Many bankers and supervisors asked the Committee to provide greater details where they thought a danger existed for differences in interpretation to arise across jurisdictions.

Nonetheless, we have worked hard over the past years to clarify the rules, to simplify those thought to be the most complex, and to provide options for those wishing to use a simpler approach. In fact, as the Basel Committee demonstrated in an annex to the third consultative paper, supervisors can select options that would result in a very simple set of rules that can be specified in just 12 pages of text. That is approximately half the length of the original 1988 Accord.

The “simplified standardised approach”, as we call it, is intended to be useful for those countries that do not wish to adopt all of the options available under the new framework. The trade-off, however, reflects the fact that the policy balance at stake is between simplicity and risk-sensitivity; if one chooses simpler rules, the cost is less sensitivity to risk and hence greater conservatism in capital requirements.

### *Competition and consistency of application*

Another broad concern that the Committee has worked to address is Basel II’s impact on global competition. In particular, some have asked whether banks that choose Basel II’s advanced approaches will enjoy benefits over those that choose simpler approaches. Others have wondered whether banks that remain on the 1988 Accord for some time will be disadvantaged.

To respond to these concerns, we should understand that adopting an advanced approach does not automatically reduce a bank’s capital requirements. Basel II is intended to align capital requirements more closely to risk. Furthermore, some national supervisors may set higher capital requirements than implied by Basel I, perhaps even higher than those implied by Basel II, depending on the risk environment.

For those banks that do experience reductions in capital as a result of Basel II, some observers have questioned whether the lower requirements might provide certain advantages and make it easier for those banks to acquire other banks that do not share in the same benefits. History suggests that this particular concern may be unfounded. In a paper published this past February by the Federal Reserve, researchers reported that they did not find convincing evidence that past changes in capital requirements have had a substantial impact on mergers between banks.

The issue of competition between banks has also come up in the context of competition between countries. Here, we should remember that Basel II is intended to help ensure that international competition in banking markets is driven by the strengths of each bank, rather than by differences in each country’s rules.

One way that the Committee has sought to promote a consistent application of the new framework is by providing banks and supervisors with detailed requirements where necessary. As I have already mentioned, these details may add to the appearance of length and complexity in Basel II, but that is a small price to pay for greater consistency and a more level playing field.

However, given the need to have a framework which can be adapted to a wide range of circumstances, cooperation among supervisors is clearly the most important tool in achieving an appropriate level of consistency. The Committee has established a working group of supervisors, called the Accord Implementation Group, or “AIG,” that shares information on implementation efforts among Basel Committee member countries. The AIG works with other supervisors as well, including through the Core Principles Liaison Group, a group of supervisors from many other countries that shares views and exchanges information. By promoting the sharing of information on practical issues, the AIG’s discussions will help to foster greater consistency in the implementation and application of the new framework across countries.

## Conclusion

I now look forward to hearing some additional perspectives from our panellists on Basel II and especially their thoughts on its implications for the Indian banking sector. As I have stressed in my remarks, Basel II is intended to reinforce our focus on risk and to encourage all of us to improve our skills in measuring and managing those risks. In one sense, then, Basel II might be considered an effort to re-invigorate the risk management culture in the banking sector. I believe that Basel II provides banks with the incentives necessary to encourage them to improve their risk management systems and processes. At the same time, the new capital framework will help to ensure that capital supervision continues to serve as a cornerstone to safety and soundness in the banking system. Both results will help to make banks more resilient, less sensitive to the ups and downs of the business cycle, and better able to serve as a source of credit and growth for businesses and consumers. Those benefits are worthy of our continued hard work.

Thank you for your attention.