Jaime Caruana: The Basel II initiative

Remarks by Mr Jaime Caruana, Governor of the Bank of Spain and Chairman of the Basel Committee on Banking Supervision, at the IIF Spring Membership Meeting, Madrid, 31 March - 1 April 2005.

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I would like to begin first by thanking for his kind introduction. It is an honour for me to participate once again in an event sponsored by the Institute for International Finance. It is doubly a pleasure for me to do so here in the city of Madrid.

Although the title of this session is “regulation and consolidation in the financial industry”, I will not speak about consolidation in my intervention, because I believe that the role of the banking supervisor in such issues is minor compared to the role of the market.

Structural changes in the financial sector, such as consolidation, should, in my opinion, be market-driven phenomena that respond to market needs - such as economies of scale, IT synergies, the benefits of diversification, gaining access to a larger client base, etc.

This is particularly relevant in the EU context, where we are aiming for a truly single market. In this respect, I support all the steps the Commission is taking to remove remaining internal barriers and restrictions in pursuit of this goal.

The banking supervisor’s role in issues related to consolidation is tightly defined by both the letter and spirit of EU banking legislation. Our task is confined to ensuring that structural changes do not undermine the soundness and “supervisability” of banking institutions, and that bank shareholders are suitable.

So, with this in mind, let me turn to the main topic that I would like to discuss, which is the Basel II initiative.

When the IIF met in Madrid last July, the Basel Committee had just released the text of the revised capital framework. The publication of Basel II marked a critical milestone in our efforts to improve the risk-sensitivity of bank capital requirements while providing incentives to strengthen the quality of risk management.

I think that on this occasion the meeting of the IIF has been preceded by another milestone in our work in relation to the new capital framework. A successful meeting of the Basel Committee concluded yesterday. Among other things, we dealt with the double default and trading book issues, on the basis of the work undertaken in close collaboration with the International Organization of Securities Commissions. I think this teamwork between IOSCO and BCBS can also be perceived as a landmark in the area of cooperation among supervisors.

Let me therefore start by talking about this work strand. Then I will try to clarify some aspects of the calibration exercise and, finally, I will address implementation issues of Basel II.

When we were in Madrid last summer, I mentioned that supervisors were very interested in finding practical and prudent solutions to the treatment of certain exposures under Basel II. These include exposures subject to double default effects, or the likelihood that both a borrower and a guarantor will default at the same time. Likewise, supervisors and bankers have long understood that we needed to address a small number of issues closely related to trading activities to avoid inconsistencies.

The Basel Committee wanted to ensure that our approaches to double default and selected trading-related exposures were sound and balanced. As a result, we have been very pleased to work closely with the International Organization of Securities Commissions to engage both banks and securities firms in our review of these special matters.

The Basel Committee and IOSCO are very close to reaching agreement on a paper that will outline the structure of these proposals. We intend to publish the paper in a few days, for a fast-track consultation with the industry. The paper will address five topics in particular, namely,

- First, the treatment of counterparty credit risk for over-the-counter derivatives, repo-style and securities financing transactions;
- Second, the treatment of double-default effects for hedged transactions, in relation to trading book, but also banking book, exposures;

- Third, the short-term maturity adjustment, under the internal ratings-based approach, for some trading book-related items;
- Fourth, a limited number of improvements to the current trading book regime, especially with respect to the treatment of specific risk; and
- Fifth, the design of a specific capital treatment for unsettled and failed transactions.

We did not intend to overhaul the capital rules for trading book exposures, but rather to seek to address narrowly a handful of concerns that relate either to potential inconsistencies that could arise with the new treatment for banking book assets or to a limited number of issues that have arisen since the adoption of the Market Risk Amendment.

I cannot comment on the proposals, given that they have not yet been formally approved by both organisations. As far as the Basel Committee is concerned, this approval was given yesterday, obviously pending the approval of IOSCO, which will study it in a few days' time. I can tell you that, in my personal opinion, the proposals appear to be prudent, balanced and appropriately sensitive to risk. Moreover, I believe that they support our goal to encourage continued improvement in the measurement and management of these exposures.

The rapid progress that we achieved here largely reflects the contributions that the IIF, its members, and many others in the industry provided in the discussions with the various working groups. For that, I would like to express my thanks to the IIF and its members.

I look forward to continuing our discussions on the solutions proposed in the coming weeks. I am confident that we will then be able to finalise the rules by early July so that national rule-making processes and banks' own preparations can incorporate them in time for Basel II's implementation.

I'd like to mention one other area of preparations that will affect banks directly: **the recalibration exercise.**

In order to establish a common data set on which to base this review, the Committee has decided to begin the recalibration exercise in autumn this year.

We recognise that the recalibration exercise will demand resources from both banks and supervisors. The IIF expressed clearly to us this concern. In this regard I would like to make two comments.

First, we discussed this issue yesterday in our meeting and decided to publish a newsletter clarifying some elements of the proposed work that I hope will address these concerns. In this newsletter, available on the BIS website, we underline several ideas.

The Committee thinks that this early recalibration, in the spring of 2006, will give banks and supervisors more time to reflect and will facilitate implementation.

In order to ensure that the envisaged review is based on recent and high-quality data, the Committee will undertake a so-called fifth impact study between October and December 2005, three months earlier than previously envisaged.

The calibration of the revised Framework will be discussed in spring 2006 on the basis of QIS 5 data. As we are conscious of the workload of this exercise, the Committee does not intend to set data requirements or timeframes for the parallel calculation that will be conducted in 2006. So there is no duplication of work.

In addition to that, in countries in which a QIS 4 has been conducted, the QIS 5 might be either a partial update of the QIS 4 or a new exercise.

Finally in terms of the schedule, to enable banks to make early preparations for the impact study, the Committee intends to provide banks with workbooks for the QIS 5 in July.

This is in relation to the calibration. The second point I wanted to make is related to this but is of a more general nature. I agree that much is changing today in a short span of time. The wide range of standards that are evolving in parallel represents a drain on the limited resources that banks have to keep pace with these changes.

In this respect, and especially in relation to our work on Basel, I see some merit in concentrating, at least for a while, on completing our current regulatory work, and on ensuring the quality and consistency of its implementation. This will allow us all a period to digest the framework we have designed.

Let me conclude with a few words on the third topic: implementation of Basel II. I have just two remarks.

On validation, we have recently published six principles that will guide our future work. We have also published a working paper entitled: “Studies on the Validation of Internal Rating Systems”

Although validation is foremost the responsibility of banks, supervisors must have a thorough understanding of validation in order to ensure the overall integrity of banks’ activities in this area. I think these principles set out clearly what supervisory expectations are, and should provide a useful guide to the industry.

Our work on validation will accelerate over the coming months, although our focus will be more on sharing and cataloguing information and approaches, and not on trying to develop a prescriptive method. Close dialogue with the industry in our work will be of great importance.

Let me finish by saying that we, the supervisory community, continue to devote significant resources and efforts to improving the consistency of cross-border implementation.

Consequently, the excellent dialogue between supervisors, organisations such as the IIF, and the industry more broadly, must continue in the coming months and years ahead. I welcome the discussions that we have been having, both inside and outside this conference, and look forward to hearing more of your thoughts and perspectives.