Nout Wellink: Goals and strategies of the Basel Committee

Remarks by Dr Nout Wellink, President of the Netherlands Bank and Chairman of the Basel Committee on Banking Supervision, at the High Level Meeting on the Implementation of Basel II in Asia and Other Regional Supervisory Priorities, Hong Kong, 11 December 2006.

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I. Introduction

Thank you very much for the opportunity to address this important meeting on the implementation of Basel II in Asia and other regional supervisory priorities. I would like to thank the Hong Kong Monetary Authority for hosting this event, and congratulate the FSI and EMEAP on putting together such an impressive conference program. Hong Kong is a dynamic city in this rapidly growing region, so I can think of no better place to discuss the changes that are taking place in banking and supervision.

What I would like to do this morning is talk briefly about the goals of the Basel Committee, outline the strategy and work program the Committee has in place to achieve those goals, and then provide some concluding thoughts.

II. Goals of the Committee

As the new Chairman of the Basel Committee, I think it is appropriate at this time for me to step back and consider the broad goals and strategies of the Committee. I would like to start by sharing with you today the Committee's objectives as I see them. In my view, the Committee has three broad objectives. One, to provide a forum for dialogue and information exchange among supervisors. Two, to promote improvements in bank risk management practices and the framework for banking supervision. And three, to promote mechanisms for pragmatic implementation of the principles developed by the Committee.

Turning to the first objective, a core goal of the Committee has always been to provide a forum for dialogue and information exchange. This helps to promote supervisory co-operation, greater consistency, and a level playing field for an increasingly global banking industry. Information sharing and dialogue also has a much broader aim, however. That is to provide the Committee with the context and perspective needed to develop policies and practices that most effectively promote a robust banking and financial system.

The second objective of the Committee is perhaps most visible to the broader community. With the insight gained from information sharing about developments in risk management, supervision and financial markets, the Committee promotes improvements in these areas. In this regard, the Committee seeks to develop and promote proportionate responses to the issues identified using a range of tools. This may include undertaking further fundamental research, preparing range-of-practice papers, or where necessary developing new policies or guidance.

Third, as you know, the policy guidance developed and promoted by the Basel Committee is based on consensus rather than on formal international legal agreements. An important objective of the Committee therefore is to promote credible, practical and flexible mechanisms to achieve effective policy implementation in a wide range of countries. The successful implementation of international policies requires processes and mechanisms that engage non-Committee supervisors, other sectors and the industry throughout the lifecycle of any initiative.

With those objectives in mind, I would now like to discuss how the Committee's strategy is working towards achieving those goals.

III. The Committee's strategy and work program

The Committee's strategy has four interrelated and reinforcing elements. The first element of the strategy is to maintain a strong capital foundation. That strong foundation is enhanced by the Basel II Framework, which many countries are now in the process of implementing. Secondly, the Committee reinforces the strong capital foundation by promoting other infrastructure needed for sound supervision. Thirdly, the Committee develops policy responses that are proportionate and flexible.

Fourthly, the Committee is deepening and expanding its outreach to non-Committee supervisors, to other sectors, and to the industry.

Strong capital foundation

It should not come as a big surprise to you that implementation of the Basel II Framework is one of the highest priorities on our current work program. Integrating an effective approach to supervision, incentives for banks to improve their risk management and measurement, and risk-based capital requirements are fundamental objectives of Basel II. By definition, we don't know where the next economic or financial shock will come from. Our focus, therefore, is on the important role of capital as a key shock-absorber for individual banks, and for the banking system more generally, no matter what the next shock entails.

The implementation of Basel II reflects the reality that simple risk measures, such as those embodied in Basel I are, for the largest and most complex banking organisations, no longer very meaningful. A strong capital foundation requires a risk-sensitive capital framework that is flexible to adapt to innovation. Moreover, it should promote improvements in bank risk management and supervisory practices, and enhance transparency and market discipline. The three pillars of Basel II have been developed with those goals in mind.

I would also like to emphasise that the choices that individual countries make with respect to the timing of implementation of Basel II, and the menu of options available in Basel II, should consider the development of their banking and supervisory systems, and financial markets. This leads me to my next point – the importance of other supporting infrastructure.

Other supporting infrastructure

For risk management and supervision to be effective and efficient, it is not sufficient to just have a sound capital framework. The second element of the Committee's strategy is to get the basic supporting infrastructure in place. The development of the Core Principles for Effective Banking Supervision, the Committee's liaison with international accounting bodies, and the Committee's work on cross-sectoral bodies such as the Joint Forum are examples of our efforts to promote the fundamental infrastructure needed for a sound banking system and for effective supervision.

Building the foundations for effective supervision and promoting the prudence and integrity of financial accounts are an integral part of the Committee's current work. A sound system of accounting and provisioning underpins the integrity of risk measures, capital adequacy and meaningful market discipline.

Moreover, as many of you here would know too well, it is not enough to just focus our attention on the implications of our policies for banks as the traditional lines between the various financial sectors become less clear. It is therefore important to understand the implications of market developments and supervisory changes on non-bank financial institutions and financial markets more generally.

Supervision is not all about sophisticated modelling approaches. Rather it is about understanding the risks that a bank faces and promoting better management of those risks. Used appropriately, advanced modelling approaches can help a bank to refine and sharpen its ability to measure, monitor and control risk. Used inappropriately however, and without an understanding of the limitations and assumptions built into such models, the costs may be greater than the benefits. In this respect, I view the infrastructure supporting the capital foundation as vitally important.

An initiative that the Committee will begin work on is the so-called "definition of capital". Over the past decade we have witnessed significant advances in the way banks manage their economic capital, as well as the development of new and innovative capital instruments. The definition of capital topic highlights the importance of the supporting legal and accounting infrastructure, and the need to understand market dynamics within and across jurisdictions. At this stage, the Committee's work in this area will focus on a stocktaking of the issues.

Proportionate policy and flexible frameworks

The third element of the Committee's strategy is to promote proportionate policy responses, and to develop flexible policy frameworks. The Committee promotes a range of supervisory methods and advocates proportionality in supervisory approaches. The supervisory tools may include better regulation, supervisory guidance, or range-of-practice papers. In addition, in some cases, industry-led solutions may be the best approach.

To respond to the accelerating pace of financial innovation and globalisation we need flexible frameworks. Both the Core Principles and Basel II are examples of global standards that were developed for local application. Both initiatives are flexible and responsive to innovation. For example, Basel II provides a menu of options to suit institutions with a range of complexity. Moreover, the more advanced approaches are based on the modelling approaches developed by advanced banks – allowing regulatory and banking models to develop together.

Over the past ten years, we have observed significant changes in international capital flows, greater reliance on market funding in many jurisdictions, and banks becoming more active buyers and sellers of complex financial instruments. In light of the central role that banks play in providing liquidity, I believe that liquidity risk management is an area where it would be appropriate for the Committee to do some exploratory work. I believe there is much that can be gained from sharing information on supervisory approaches to assessing liquidity, and bank tools for managing liquidity, particularly during stress scenarios.

In this and all cases, I expect that the Committee's response will be proportionate to the risks identified, and that the policy tools that the Committee employs will be designed to achieve the maximum benefit for the least cost. I also expect the Committee will consult widely in the process of developing its views on the issues and then deliberating on possible responses.

Proactive outreach

This brings me to the fourth element of the Committee's strategy, which is to engage in proactive outreach. This encompasses outreach to non-Committee countries, to the industry and to other sectors.

The Committee's dialogue with non-Committee member countries is an extremely important element of its strategy. This stems from the need to promote the development of sound supervisory practices in developing markets and to accommodate the growing importance and sophistication of non-Committee member banks, supervisors and markets. In addition, it is critical that we address home-host coordination issues that arise with the growth of cross-border banking. These trends, and the resulting need for dialogue, are quite clear when we look at the growing and changing financial landscape and the increasing trend towards market liberalisation in the Asian region.

As an indication of the importance the Committee places on its outreach strategy, at its October meeting in Merida the Committee agreed to the establishment of the International Liaison Group (ILG). This group will replace the Core Principles Liaison Group, which with the completion of the revised Core Principles had completed its mandate. The new ILG will report directly to the Committee, and allow for broad supervisory dialogue on a range of issues. The ILG will provide a platform for non-member countries to contribute to new Committee initiatives early in the process, and to develop new proposals. The ILG will also initiate its own work streams on issues that are of interest to the broad supervisory community.

I should also highlight the important relationship the Committee has with the FSI, which provides an outstanding program of training events and tools for supervisors around the globe. Members of the Committee and its Secretariat have been actively involved in FSI events since its founding, and we see this as a key element of outreach and dialogue to the wider supervisory community.

By engaging in dialogue at a range of levels - within the supervisory community, with the industry, with representatives from other sectors, and also with other interested parties - the Committee aims to identify and address the most important risk issues. This process of filtering issues may lead the Committee to consider new initiatives from time to time. However, in most cases the exchange of information and ideas on a given topic, and making more transparent to industry the range of practices we see in a rapidly developing area, may be the most important outcomes.

IV. Concluding thoughts

I would like to conclude by summarising the main themes of my talk. The committee's goals are, in my view, to provide a forum for information sharing, to promote improvements in risk management and banking supervision, and to promote mechanisms that facilitate consistent local implementation of global policies and principles.

The Committee has a multi-faceted strategy to achieve its goals, which is developed within the context of developments in international banking and financial markets. The strategy and work program that the Committee has in place are built around the cornerstone of a strong capital framework. This is supported by other fundamental infrastructure, which includes strong accounting; the Core Principles for Effective Banking Supervision and cross sector collaboration. Proportionality and flexibility are overarching themes that permeate our policy work. Finally, the Committee's strategy of proactive outreach and dialogue is critical to the long-run success of the work undertaken today.

Thank you.