Jwala Rambarran: Consolidated supervision, risk-based supervision and market discipline

Opening remarks by Mr Jwala Rambarran, Governor of the Central Bank of Trinidad and Tobago, at the Basel II Implementation Workshop, organised by the Caribbean Regional Technical Assistance Centre (CARTAC), Port of Spain, 17–20 September 2013.

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Good morning

First, I wish to thank CARTAC for arranging this ***Basel II Implementation Workshop*** and for inviting me to give some brief opening remarks this morning.

As we all know, safe and robust banks operating in a well regulated financial system play a key role in the economy and society. One of the main lessons of the recent global financial crisis is that banks must improve their ability to manage risk, so they do not inflict serious damage on the economy. This calls for a stronger risk management culture within banks. This calls for stronger regulation and supervision within central banks and other regulatory agencies.

In today's discourse, most commentators assume that "strengthening regulation" is simply a matter of implementing international standards, of which the most important is the Basel Capital Accord, designed by the Basel Committee on Banking Supervision. Other commentators, however, have examined alternative approaches to prudential regulation beyond standards. They argue that a strategy for prudential policy must address three main weaknesses: the impossibility of fine-tuning bank safety margins in the uncharted territory that is banking in the developing world; the need to provide insulation against the large shocks to which these economies are prone; and the lack of enforcement that results from the concentration of political power in many such countries.

This year marks the 25th anniversary of the 1998 Basel Capital Accord, which through its two incarnations has emerged as the international gold standard for banks" capital requirements. The first manifestation came in June 2004 when the Basel Committee wholly rewrote the original Basel Accord, which has a number of flaws. For instance, it is risk insensitive, it does not differentiate between credit risk and other risks a bank typically faces, and it can easily be circumvented by regulatory arbitrage.

The new Accord, generally known as Basel 2, represented a fundamental change of approach to regulation. The revised framework is highly complex and makes its understanding and implementation a great challenge, not only to regulators but also to the regulated community. Basel 2, for example, assumes that discipline by the markets and by supervisors is beneficial. Yet, as we have seen particularly, over the last five years, both markets and governments can, and do, fail.

The second incarnation of the original Basel Accord has seen most G-20 countries starting to implement the Basel 3 capital rules, which has delivered what many consider to be the world's first global liquidity standard for banks. The jury is still out on Basel 3.

As many of you know (or at least I hope you know), the Basel Committee does not have the right to impose the standards it produces on others, and has never, at least explicitly, sought to constrain national authorities to do so. Nevertheless, more than 100 countries are implementing the three versions of the Basel Accord in different forms at varying speeds.

Here in the Caribbean, most jurisdictions are still seeking to fully comply with Basel 1 before moving to Basel 2, while others are focusing on first satisfying Pillar 2 of the Basel 2 Framework. The region, as whole, decided to put the adoption of Basel 2 on hold following criticisms of the approach in the wake of the eruption of the international financial crisis in mid-2007. Five years later, one might even perhaps question why the region is not focusing on Basel 3 at this time.

So why has the Caribbean region been grappling with implementation of the Basel Accord. Perhaps the answer, in my respectful view, is that Basel framework was never really designed with developing countries in mind, and implementation of any version in developing countries is likely to be fraught with difficulties.

There are a number of factors which determine the speed of Basel Accord implementation plans in different countries of the world. These include the size, structure and degree of financial sector development, the level of economic development, and the capacity of the existing regulatory and supervisory authorities. Application of these factors to the Caribbean reveals the following:

First, the small island states in the Caribbean experience greater macroeconomic volatility, and greater volatility of external flows and greater vulnerability to external shocks than the industrial countries. Secondly, the newer versions of the Basel framework rely on strong institutions. In the Caribbean, institutions limiting rent-seeking are weak: banker and bureaucrat have more opportunity and incentive to reap private benefits at public cost. Basel 3, for example, presumes that sophisticated and integrated risk management systems are in place, and for the Caribbean this is generally not the case. And thirdly, skills are scarce in the Caribbean. Supervision and market discipline require skilled supervisors and market participants.

I, therefore, believe it is timely for the regional Working Committee on Basel 2 implementation to start thinking about developing a regional prudential road map that is more appropriately tailored to our circumstances. Such a road map should take at least three concerns into account. These are as follows:

1. ***Pay more attention to the stability of the financial system, not only risk of the constituent parts.*** Remember, two banks with the same failure probability but different size present the same risk to their depositors but different risks to the system. Macro-prudential data is most likely to give better warning to policymakers of a build-up of financial imbalances.

2. ***Take away the punch bowl just when the party gets going.*** We have learned the hard way that when the music is playing, bankers want to dance. One way to restrain the excesses of booms is to impose countercyclical prudential requirements to lessen the procyclical nature of the Basel 2 framework for credit risk. These countercyclical prudential requirements include minimum capital ratios, collateral haircuts, liquidity and currency mismatch limits.

3. ***Rely, as much as possible, on simple rules that are easy to write, communicate, enforce and verify.*** Agreement and implementation of the global regulatory agenda has been gradual. The reform momentum is waning due to lack of agreement on specific issues especially when national political pressures trump a global consensus. These delays are adding to regulatory uncertainty and weigh heavily on the financial sector.

In closing, I want to emphasize that no amount of regulation or intensive supervision will be able to catch poor financial conduct, malfeasance or unlawful activity, all the time. As Mark Carney, current Governor at the Bank of England, once remarked "virtue cannot be regulated."

I wish you all a productive Workshop.