BANK FOR INTERNATIONAL SETTLEMENTS

Fifth Biennial Conference on Risk Management and Supervision

Opening address by Jaime Caruana

Basel, 3 November 2010

Re-establishing the resilience of the financial sector: aspects of risk management and supervision

1. It is a great pleasure for me to open this conference and welcome you all here to Basel. I extend an especially warm welcome to those of you who have travelled a great distance, in some cases halfway round the world. At this conference you will have the opportunity to discuss issues that are very much at the forefront of current global market developments and the supervisory policy debate.

2. Today, I would like to touch on recent market developments and aspects of risk management and supervision that are important for strengthening the resilience of the financial system. **First**, I would like to talk briefly about the lessons learned from the crisis related to risk management issues and, **second**, about the regulatory reform undertaken through the so-called "Basel process", especially that of the Basel Committee on Banking Supervision. **Third,** I will highlight the crucial role of effective implementation of global standards in ensuring sound risk management in banks and adequate supervision.

Risk management lessons from the crisis

3. Let me start by identifying some of the risk management issues raised by the crisis. The report by the Senior Supervisory Group entitled "Lessons on risk management from the global financial crisis" (March 2008) identified weaknesses in the effectiveness of firm-wide risk identification and analysis, the consistent application of independent and rigorous valuation practices across the firm, and the effective management of funding liquidity, capital and balance sheet. Later, in a second report released in October 2009, the Senior

Supervisory Group identified further weaknesses in corporate governance and control procedures at the largest financial institutions, as well as in liquidity and capital management.

In my view, this combination of methodological and governance weaknesses points to a more fundamental problem: in good times, perhaps at all times, but particularly in good times when complacency reigns, there is a tendency, supported in many cases by misaligned incentives, to listen more to the business side than to risk managers. It is precisely during these periods that board members and managers should be most mindful of their duty to challenge the conventional wisdom and overly simplistic extrapolation of the present into the future. This is the time to ask difficult questions, the time to consider scenarios in which "other things do not remain equal" and systemic risk is internalised. Supervisors should reinforce this vigilance and questioning attitude in their dialogue with financial institutions.

4. The banking industry has also analysed the weaknesses in risk management practices observed during the crisis. The Institute of International Finance's report on "Reform in the financial services industry: strengthening practices for a more stable system" (December 2009) states that the large international banks had identified a substantial number of gaps in risk management and were working to address them. Whereas some governance issues could be addressed quickly by changing roles, responsibilities and reporting lines, other reforms could take several years to implement because these might involve major cultural change and IT upgrades. Key areas on the agenda for change are governance and risk appetite, culture and compensation, liquidity risk, valuation, stress testing and risk transparency. Ultimately, however, there is no substitute for senior management and the boards asking the right question.

The agenda for regulatory reform

5. The standard setters have put in place a comprehensive framework for regulatory reform. In June 2010 the Toronto G20 summit outlined a reform package that rests on various building blocks. Let me go quickly through these: the first block is a strong regulatory framework that integrates a system-wide or macroprudential approach. The second block is effective supervision. The third block is a resolution framework, particularly for dealing with systemic institutions. The fourth block is transparent international assessment and peer review. Please allow me to focus on the first two topics: the regulatory framework and supervision, and recent developments in these areas.

6. First, the regulatory framework: this year, at their July and September meetings, the Group of Governors and Heads of Supervision, the oversight body of the Basel Committee on Banking Supervision, decided to substantially strengthen existing capital requirements and to introduce a global liquidity standard. The new framework will increase the minimum common equity requirement from 2% to 4.5%. Additionally, banks will be required to hold a capital conservation buffer of 2.5% to withstand future periods of stress. Thus the total common equity requirement – the highest form of loss-absorbing capital – goes up to 7% from the current 2% (or even 1%, given the more rigorous definition of capital). Higher capital requirements for trading, derivative and securitisation activities will also reinforce the quality and quantity of regulatory capital. Moreover, the countercyclical capital buffer – a macroprudential overlay – will add a new, additional layer of defence for banks and the banking system when rapid credit growth is judged to be storing up risks. In addition, an internationally harmonised leverage ratio will serve as a backstop to the risk-based capital measure, thus protecting against weak asset quality assessment and helping to contain the build-up of excessive leverage in the system.

And finally, in response to the rapid drying up of liquidity during the crisis, the Basel Committee is introducing a global minimum liquidity standard consisting of a short-term liquidity coverage ratio. This ratio is complemented by a net stable funding ratio, which is a longer-term structural ratio addressing funding mismatches. We do not have much experience with such internationally harmonised liquidity ratios, so they will be phased in over time, and we will need to pay attention to any unintended effects during the upcoming quarters.

7. Second, effective supervision: I should begin here by emphasising that new, stronger rules should be complemented with more effective oversight and supervision. The Financial Stability Board is developing recommendations to strengthen oversight and supervision of complex and systemic institutions, banks and non-banks, to make supervision more effective. These recommendations are expected to relate to the mandate, capacity and resources of supervisors and their specific powers. The Basel Committee will soon initiate a review of the Core Principles for Effective Banking Supervision that will include, inter alia, the Financial Stability Board recommendations, with the aim of putting the final touches to the review by the end of 2011.

Based on observations made during the crisis, improvements are needed not only in the supervision of key risks but also in the timely follow-up and proper enforcement of rules. However the effectiveness of supervision is very much dependent on the soundness of corporate governance practices at banks and the effectiveness of boards in overseeing the risks being taken by firms. As we all know, the right “tone at the top” is essential to ensure effective governance.

8. Effective supervision also involves a better understanding of the quantitative models being used by firms. The assumptions on which models are built need to be understood if we are to appreciate the limitations of such models. During the crisis, several players stated that

models are to be blamed because they failed. However, it is more likely that the failure lay in the use of model output; that is, merely looking at the numbers without fully understanding or questioning the assumptions on which the models were built and their validity in times of stress.

9. Furthermore, better data collection, processing and monitoring will help in on-site and off-site review work. This is important for the analysis of historic data and the early identification of potential risks. It will better inform supervisors in discussions with individual banks and will help in identifying the build-up of system-wide risks.

10. Another key issue relates to the skill sets of supervisors. It is essential that supervisors keep updating their skills in order to understand products and markets as well as firm-wide and systemic risk. The Financial Stability Institute has been contributing to the dissemination of supervisory standards and has worked to ensure that its programmes address the issues highlighted during the crisis. A key way to maintain skills is to share information among supervisors; therefore information sharing must be improved both within individual supervisory agencies and across supervisory agencies in different countries. Looking over the fence and learning from each other is often the right way to find out what works best for one’s country.

The challenge of effective implementation

11. Now comes the difficult part: the challenge of effective implementation of new risk management and supervisory standards in large and complex organisations. One has to accept that this requires considerable time, resources and expertise. It may also need a new mindset that promotes a more proactive, even intrusive, approach, and, most importantly, one that incorporates a system-wide analysis of risks.

Furthermore, the range of practices is vast and there are many good reasons for national differences and implementation tailored to individual needs. This is particularly true in some

of the new elements of Basel III such as the countercyclical buffer, because cycles are in many cases national or regional. However, I believe that the effort is well spent, as the benefits from implementing principles and sound standards will contribute to sounder financial firms and therefore a more stable financial system. How you go about this is up to you. It is commonly said that “All roads lead to Rome”. Today, though, I prefer to say “Many roads lead to Basel”.

We can all agree that (i) there are things to improve NOW and that individual authorities are aware of their supervisory priorities, and that (ii) there is a lot we can learn from each others' mistakes and individual supervisors can learn from these even if they were not directly affected by the crisis.

Therefore, based on a recent review, the Basel Committee has agreed to undertake thematic peer reviews of the implementation of selected Basel Committee standards. It has also agreed to monitor follow-up action plans to help promote the implementation of standards. A pilot review will be undertaken in 2011 and I think the members of the Standards Implementation Group, many of whom are here today, are keen to get on with this important work.

Three issues and challenges

I would now like to focus on three issues that I feel are important to all of us: ***first, the importance of supervisors developing a system-wide understanding of markets, products and their interconnectedness in stressed times and taking a more proactive approach when necessary.***

Before the crisis, improvements in trading technology, together with the pressure of increasingly competitive and innovative markets, led to a narrowing of margins on financial products. Ample funding liquidity contributed to this trend. During the crisis, some margins widened very rapidly. This extreme jump in volatility complicated the analysis of risk.

Emotions – the fear and insecurity of market participants – combined with high-volume trading, swung market prices during the crisis, and probably not for the last time. To avoid surprise, I believe supervisors and central banks need to be even closer to the markets to better understand interlinkages and reactions in times of stress and to be brave enough to take action even on the basis of uncertain judgements.

Depending on national arrangements, supervisors will have to establish efficient relations with "systemic councils" so that systemic risks are properly monitored and managed from early in their build-up phases.

12. ***This leads me to my second point: uncomplicate things!***

When I look at the volume of complex financial products being traded across time zones, from regulated to unregulated sectors, from transparent to non-transparent markets, from banks to insurers, to private investors, to firms and vice versa, I realise that it is very difficult to pinpoint where the risks reside, particularly when we try to internalise interlinkages and procyclicality. Also, the traditional categorisations of "bank", "securities firm", "insurance company" and "reinsurer" are losing their meaning because they no longer accurately describe – in the eyes of investors and consumers – the risk exposures being taken by some of these financial institutions.

I believe that, if products and firms are too complex to understand, they may be too difficult to manage. There may be a need to simplify things. Supervisors need to distinguish complexity that is intrinsic to a productive innovation – a better hedge, a better way to share risk –from complexity that aims to finesse regulation and to arbitrage away the capital needed to protect the stability of the system. It takes work and courage to insist on this distinction, but supervisors should welcome the first type of complexity and restrain the second.

13. ***Thirdly, the issue of building trust through effective communication***

In my view, the importance of effective communication between banks and supervisors and among different supervisory agencies should not be underestimated. Let me mention the important role that supervisory colleges can play in the supervision of large international banks. Core colleges help to coordinate supervisory activities and decisions, as well as to enhance the exchange of information among relevant authorities. Experienced senior supervisors tell me that during the crisis some of the colleges worked extremely well. The time and resources used to build these colleges was and will be well rewarded. I would very much encourage you to keep following this road of information sharing – even though it can sometimes be burdensome and resource-intensive. This is an investment supervisors need to make in the interests of financial stability.

An important case study will be how supervisors manage and communicate the new countercyclical buffer for global banks. For such a bank, the required buffer will reflect its portfolio distribution across markets and the local supervisors' setting of the required buffer in response to their different cyclical situations across those markets.

14. Supervisory meetings and conferences are also a part of effective communication. Some of you participate in the groups and subgroups of the Basel Committee, FSB, IAIS and IADI. As with the supervisory core colleges, I see the work of these groups as critical because they play an important role in the harmonisation of standards and their implementation across the globe.

Conclusion

15. Let me conclude by summarising the issues I have talked about today. First, I talked briefly about the lessons learned from the crisis regarding risk management. Getting the balance right between the business units and risk management is key. Management and board members must ask the right questions. Second, I discussed how the standard setters are working on the reform package with the aim of re-establishing the financial system's resilience. I pointed out that proactive implementation is crucial for effective supervision and risk management.

We in Basel draw up the standards but you implement them. Effective implementation of the current standards will help to ensure that firms do not take on excessive risk and employ high leverage in the future. A proper implementation of standards and, more importantly, your vigilance and courage to act proactively as experienced supervisors will prepare us for the future.

A final observation is that excessively light supervision does not ultimately create an advantage for any financial system. On the contrary, the banks that apparently laboured under the stricter supervisory regimes were the ones that emerged from the crisis as the fittest competitors and the ones best positioned to support the growth of their home economies.