

**Address by Jaime Caruana,
Governor of the Banco de España
and Chairman of the Basel Committee on Banking Supervision,**

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I. Introduction

I would like to thank the Institute of International Bankers for inviting me to join you here in the great city of Washington, D.C. As the only non-US regulator participating, it is an honour, if perhaps a daunting one, for me to try to present some reflections from the perspective of the Basel Committee on Banking Supervision at your conference. Yet in this increasingly global world, banking supervisors need more and more to co-ordinate and work with one another. The benefit of this is that I often find myself meeting friends and colleagues, both from within and outside the Basel Committee. I am pleased to see that several of them are here today. This includes Chairman Powell, plus of course my colleagues Bill McDonough, who served as chairman of the Basel Committee on Banking Supervision before me, and Mike Zamorski from the FDIC.

For nearly forty years, the IIB has served as an exchange for views on the issues that affect the U.S. activities of internationally active banking organisations. It has also been a forum for bankers to discuss these issues with regulators and policymakers. An active dialogue between banks, supervisors, and policymakers is essential for maintaining a regulatory framework that is relevant and robust.

Along those lines, I would like to thank those who are participating in one of the most important dialogues in bank supervision today, namely the Committee's

consultations on the New Basel Accord on bank capital requirements. Many industry participants have written comment letters, participated in discussions, and provided us with practical data. Your suggestions have helped us to clarify and simplify our proposals for the “three pillars” of minimum requirements, supervisory review, and market discipline. We have listened carefully and, thanks to the hard work of the industry and to the support from other supervisory agencies and central banks, the proposals for the New Accord have improved dramatically since the first draft was published in 1999.

The process to revise the Accord has sparked lively discussion among the industry, policymakers, and regulators, naturally, but also among the business community, the popular press, and other constituencies. One might ask why so many care so much about something as seemingly esoteric as bank capital requirements.

The answer, I think, lies in the unique public functions that banks provide. Banks settle payments among businesses and consumers. They channel savings and provide credit, which is vital to promote economic growth. And they safeguard public wealth. Yet banks cannot fulfil any of these tasks for long if they fail to remain adequately capitalised and to manage risk properly. Capital is, after all, a bank’s last line of defence. Even with appropriate risk management, there will be occasions when reserves are exhausted, leaving capital to absorb a bank’s losses. If capital is insufficient, troubled banks may disrupt the flow of credit and payments, with this leading to inefficiencies in markets.

So, many parties take a great interest in the safety and soundness of the banking system. In my remarks, I would like to share my thoughts on the New Accord and where we stand today. I’ll cover four areas of interest.

- I'll begin with a reminder of why a New Accord is so important and so different from its predecessor.
- That leads to our expectations for the New Accord, which is my second set of issues. Our overarching public policy objective is to promote a more stable financial system. To achieve that goal, the New Accord contains several transmission mechanisms I will elaborate upon, namely encouraging improvements in risk management and promoting greater cooperation between financial supervisors.
- Finding a way to accomplish such a wide range of objectives has not been an easy task. In my third batch of remarks, I'll address some of the challenging questions we face in drafting the New Accord.
- Finally, I'll conclude by offering some thoughts on the work ahead.

II. Why is the New Accord so important and so different from its predecessor?

Allow me to begin by focusing on the first area of interest and trying to answer why so many supervisors, central banks, and banking organisations themselves have invested so much hard work in revising the Basel Accord. Perhaps part of the explanation is that we know, as Benjamin Franklin did, that diligence is the mother of good luck. But our diligence is hard to explain if you consider that, in so many ways, the existing 1988 Accord was already a tremendous success story. The 1988 Accord was simple to apply. It represented the first internationally accepted definition and measure of bank capital. It has been adopted in over 100 countries and

has come to be acknowledged as one of the benchmark measures of a bank's financial health.

That begs a question. If the 1988 Accord was so successful, why has the Basel Committee published a huge number of pages on ways to improve it? Why have several hundred commercial organisations participated in hundreds of hours of meetings and written hundreds of comment letters to us?

The best explanation is that the existing rules have been overtaken by the pace of innovation in the banking system. The simplicity of the 1988 Accord was an asset in promoting its acceptance, but 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. Improvements in technology and telecommunications have changed the speed at which banks collect and analyse data on their exposures. The explosive growth in the markets for securitised assets and for credit derivatives has offered banks new ways to manage and transfer credit risk. And a new discipline in risk management is emerging – namely, operational risk management – through which banks are quantifying in an increasingly reliable manner the risk of losses stemming from failures in internal processes or systems or from damage caused by an external disruption.

As the art of risk management becomes more sophisticated, the static and very simple rules of the 1988 Accord are becoming less relevant to the most advanced banks. 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 and less confidence in the measures of risk that the 1988 Accord lays down for banks that engage in the most sophisticated forms of risk taking and risk mitigation.

II. The Goal of the New Accord: Financial Stability and Resilience

By the late 1990s, it became clear to leading banks and supervisors that we needed a New Accord. But one person in particular knew that we should do much more than merely revise the minimum requirements. Bill McDonough, the previous chairman of the Committee, convinced leaders in the industry, in central banks, and in supervisory agencies that we should recognise and provide incentives to advance the state of the art in risk management across the industry. He did not seek to reduce the amount of capital held by the banking system but rather sought to increase the stability of the global financial system – a goal that would benefit not just banks, but more broadly businesses and consumers.

This leads me to the second part of my remarks, namely what we expect from a New Accord. As a result of Bill's initiative, the Committee has set out as its overarching goal the promotion of greater financial stability. The members of the Basel Committee believe that, when individual banks are adequately capitalised and well managed, they become more stable and better able to withstand periods of financial distress. But more importantly, when all banks have the proper incentives to manage their risks appropriately and hold adequate levels of capital, we believe that the entire financial sector becomes more resilient, less sensitive to the business cycle, and better able to act as a source for the sustainable growth of the broader economy.

Increasingly, policymakers and central bankers recognise that financial stability is a public good much like price stability. All of us have long understood the

benefits of price stability and the need for sound monetary policy in the pursuit of smooth economic growth. In recent years, we have learned more about the concurrent need for a stable financial system as well. That includes the need for businesses and consumers to have access to credit on fair and reasonable terms through all stages of the business cycle so that they can build and grow. We need an efficient and resilient payments system to maintain the flow of funds through the economy at all times. We need financial markets that remain active, liquid, and trusted regardless of events in the economy.

Given the unique positions of banks at the crossroads of businesses and consumers in every economy – and their special role as intermediaries of credit to both – nothing threatens financial stability more than the presence of poorly managed and poorly capitalised banking institutions.

However, financial stability, like price stability, is not something that can be legislated into existence.

The New Basel Accord will seek greater financial stability through several mechanisms, all of which might be considered objectives in themselves. Some of these mechanisms were already present in the 1988 Accord, such as setting minimum quantitative capital requirements and a level playing field. But I want to focus on what I see as two innovations of the new Accord. The first is to encourage improvements in banks' internal risk management processes, which should, in turn, be anchored on good corporate governance. The second is to promote greater cooperation and coordination among supervisors across jurisdictions.

- ***Risk management and corporate governance***

The first objective is to encourage banks to improve their risk measurement and management techniques. The existing rules set out the quantitative requirements for capital – that is, how much capital in dollar terms a bank should hold relative to the kinds of risk exposures it has. The New Accord will improve those quantitative requirements by making them more risk sensitive and more closely tailored to banks' practices. But we will supplement them by setting incentives for banks to strengthen the structures and processes through which they assess and manage their risk exposures. To encourage enhancements in internal controls and risk management processes, the New Accord will offer explicit economic incentives for banks to adopt more accurate measures of risk and more sophisticated means for controlling their exposures to such risks.

Of course, risk management must be based on a strong foundation of corporate governance. Corporate scandals on both sides of the Atlantic – and elsewhere – have highlighted the significance of capable, responsible, and proactive management. The Committee has long recognised this, and this is why we have explicitly stressed the importance of good corporate governance in the New Accord. We have included provisions on the need for boards and senior management to understand the nature and level of the risks that their banks are exposed to, to set the bank's tolerance to these risks, to ensure that strong risk management and internal controls are adopted throughout the organisation, and to ensure that they themselves continue to be appropriately informed about the risks being taken on. The New Accord also stresses the importance of independent assessments and audits.

Let me now mention four different examples of provisions in the New Accord, which, through promoting good risk management and governance, should enhance financial resilience.

- *The adoption of a comprehensive, enterprise-wide view of risk*

First, as you may know, the New Basel Accord takes a big step forward in developing a clear, comprehensive, and consolidated view of the risks each bank faces. The 1988 Accord focused initially only on a bank's exposures to credit risk. In the years since 1988, the Basel Committee has sought to mirror the evolution of best practices in the private sector to identify other risks and establish appropriate controls for them.

In 1996, for example, the Committee adopted requirements for banks that are heavily exposed to market-related risks. The New Accord continues this trend by segregating and setting explicit capital requirements for exposures to operational risk. We believe that, when managers and boards of directors have a better sense of the different extent and kinds of risks they face, they will make more informed decisions at the enterprise-wide and business line levels.

- *The use of a comparable, quantitative measure for risk*

A second step that the New Accord will take is to provide banks with a means to compare their exposures to very different kinds of risks. It will require banks to express their exposures to various risks using a common "language," namely capital. By expressing exposures to market, credit, and operational risk in directly comparable terms, bank managers will be supplementing their more subjective expertise in each area with a more objective sense of the relative importance of each.

For risks not captured in the minimum requirements of the first pillar, the second pillar, supervisory review, is premised on the need for banks to review their exposures to all other risks and on the need for supervisors to evaluate those internal assessments. Taken together, expressing risk exposures in similar terms and considering exposures to risks not explicitly included in the New Accord should enable bank managers to make decisions more rigorously.

- *Demanding operational standards for collecting, analysing, and reporting risk data*

Of course, to quantify and compare the full range of risks, a bank must gather and report information on its various kinds of exposures using this common language. This brings me to a third step toward strengthened corporate governance, namely the New Accord's proposals to set demanding operational requirements for the collection, analysis, and reporting of risk data.

By raising the bar for gathering and interpreting data, we expect to improve the quality, effectiveness, and frequency of internal reporting. That should go a long way toward providing senior management and even individual members of the board with an accurate and timely understanding of the nature of their business. Senior managers and directors must see the right information at the right times. They must be positioned to ask tough questions and to make hard decisions confidently – before it's too late. This is something that we always expect of responsible business leaders. For the first time, the New Accord allows us to recognise these responsibilities of the board and senior management explicitly in the regulatory capital framework.

- *The promotion of transparency in financial reporting*

Beyond raising the bar for internal reporting, a fourth step that the New Accord will take to strengthen corporate governance is to promote greater transparency in a bank's external financial reporting under the third pillar of the New Accord. When marketplace participants have a better sense of a bank's financial condition, the risks it faces, and the controls it employs, they will be better able to make their own business and investing decisions vis-à-vis the bank. The Committee expects that rating agencies and others will be better positioned to evaluate a bank's condition and future prospects, while investors and counterparties will be better able to decide whether to invest in or to extend credit to the institution. The New Accord's improved transparency requirements leverage the power of market-based incentives for bank management to assess its risks carefully and to manage them responsibly.

Taken together, these four steps are intended to renew the emphasis on excellence in corporate governance – from the level of the front offices, to the back offices, and up to the board room.

- ***Promote cooperation, coordination, and consistency between supervisors***

So far, I have focused on improvements within banks that will help to make the financial sector more stable. The second objective I will mention today is to promote greater cooperation, coordination, and consistency in the ways that bank supervisors evaluate capital adequacy. When supervisors across jurisdictions share similar expectations for evaluating a bank's capital adequacy, we can foster competitive equality and lessen the regulatory burden on banks by allowing them to concentrate on managing their exposures and their businesses – rather than on managing and trying to balance differing or even conflicting requirements set by

individual supervisors. The IIB, for one, has expressed special concern about supervisory coordination and cooperation, which I will address in a moment.

IV. Responses to Current Concerns

Realising these inter-related objectives to attain greater financial stability will require a comprehensive framework for assessing the adequacy of a bank's capital. This is resulting in what, I must confess, is a more complicated-looking Accord than the less sophisticated, and much less comprehensive, existing Accord. We've offered formulas, annexes, and no shortage of footnotes. The astrophysicist Stephen Hawking was once told that every equation he included in his books would cut his sales by half: perhaps there is a lesson there. I'd like to turn now to the third area of my presentation and offer my thoughts on some of the questions that we have faced in drafting the Accord, starting with its potential complexity.

- *Is the New Accord too complex?*

One question I hear frequently is whether the New Basel Accord is too complex. To some degree, one might say that complexity lies in the eye of the beholder. Take just a brief glance at the hundreds of pages of legal documentation accompanying a simple debt security prospectus. You might quickly become convinced that such instruments are highly complex. Yet corporate bonds are sold every day to investors, including to individual investors.

Regardless of whether financial instruments are complex, one must ask whether the regulatory framework needs to be complex as well. The members of the Basel Committee know that it is far easier to enforce a simple rule than a complicated one. Still, banking is no longer a simple business. Leading banks offer a wide range

of highly evolved products and services. Likewise, they employ sophisticated analytical tools, advanced mathematical models, and even dense legal documents to help insulate themselves against losses. What's more, leading banks seek to differentiate themselves and their products continuously from those offered by competitors. 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.

In fact, some of the complexity of the New Accord stems from banks' own requests to address the rich variety of risks and practices in existence today. The New Accord offers banks and their supervisors numerous options for evaluating capital adequacy that are intended to reflect differences in each bank's level of sophistication. Many of these options were created precisely because some banking organisations thought that a "blanket rule" would unfairly burden them. Indeed, banks have asked the Committee not to sacrifice the New Accord's sensitivity to risk, even if this requires some complexity. By providing a range of options, we are better able to fit the regulatory framework to each bank's profile, rather than the other way around.

At the same time, the Committee has worked hard over the past five years to simplify the rules where possible. Just this past January, for example, the Committee proposed ways to simplify the treatment of securitisation exposures, which themselves arise from highly complex transactions. We will continue to seek ways to simplify the rules, but we must recognise that ensuring comparability and improving the rules' sensitivity to the actual risks banks face will entail a certain degree of complexity.

- *Will differences arise in how countries apply the New Accord?*

Another reason why parts of the New Accord are so detailed stems from our efforts to maintain a level playing field. This leads to the second question that I am frequently asked, namely whether the New Accord might be applied less stringently in some countries and thereby create unfair advantages to banks from more lenient jurisdictions.

Indeed, the IIB itself, in its comment letters to the Basel Committee on the New Accord and to U.S. supervisors on the domestic rules being discussed here, has highlighted some concerns about the cross-border implementation of the New Accord and the need to apply a shared set of expectations across jurisdictions to minimise regulatory burden.

The members of the Committee believe that competition in global banking markets should be driven by each bank's business strengths, rather than by differences in each country's rules. One way to promote a more consistent application of the New Accord is to provide banks and supervisors with detailed requirements where necessary. These details may add to the length and complexity of the New Accord, but that may be a small price to pay to promote consistency and a more level playing field.

The IIB, for its part, has asked the Basel Committee to provide clear standards for the cross-border implementation of the New Accord and, especially, on the roles that home and host supervisors will play in supervising capital under the new framework. The Committee has been working hard to do just that. Last August, for example, the Committee released a paper outlining six principles that re-emphasise the traditional responsibilities of home and host supervisors and that explain how those responsibilities will continue under the new framework on the basis

of enhanced cooperation. Cooperation among supervisors will be critical for effective supervision under the New Accord.

Just this past January, the Committee published another set of principles that would apply more specifically to the cross-border supervision of advanced measurement approaches for operational risk. The ongoing discussions of the Accord Implementation Group, led by the Canadian Superintendent of Financial Institutions, Nick LePan, are likewise intended to help supervisors exchange ideas and reach shared views on how best to implement the New Accord to domestic and international banking operations.

V. Where we stand today

Let me move now to my fourth point: where we stand today and the work ahead. I have five remarks.

First. I think the Committee has done tremendous work over the past few years, and in the last few months we have continued to make significant progress in a number of important areas: we decided to calibrate regulatory capital to unexpected losses only; we have made significant headway in securitisation, credit risk mitigation and operational risk; we have clarified Pillar 2, and we continue to make progress in the implementation of the Accord. Of course, the work is not yet complete, and we continue to evaluate questions and comments. However, we are well on track to resolving outstanding issues by the middle of this year, in line with the time schedule and work plan we set ourselves in October 2003, and to ensuring that the text will provide a solid basis for national implementation processes and the industry's preparations to continue. All this is compatible with the implementation date of end-2006 that was previously agreed.

Second. It is clear that the responsibility for implementing the New Accord is a domestic responsibility. As with the 1988 Accord, the members of the Committee know that the process for revising the New Accord will not be complete, and our work on the New Accord will not be done, until meaningful national processes are finalised and each member country is satisfied.. We have been sensitive to national rule-making processes, and we will continue to be sensitive.

Furthermore, and this is my third remark, the Committee has agreed that, prior to implementation, a further review of the calibration of the New Accord will be conducted on the basis of additional information, which may come from new national impact studies or field tests and the monitoring of bank's parallel calculations. The Committee welcomes these efforts and looks forward to considering those results.

Fourth. At the same time, the banking industry needs some certainty about the new rules, so that they can continue to improve their risk management systems in time for the implementation of the New Accord. Uncertainty about the particulars of the new rules will otherwise become a form of regulatory burden, as banks may become less willing or less committed to make investments in systems and processes if they lack confidence in whether certain rules will be implemented. Providing a greater sense of the rules will help to reduce that burden.

Finally, in this context, I would like to stress that the Basel 2 approach is intended to be evolutionary. In other words, it should continue to evolve in order to reflect continuing developments in industry practices. We do not intend to wait another ten years before reviewing the New Accord. In fact, we already have some items on our agenda which we will begin to consider immediately once we have completed the mid-year text, with the intention of finding a prudentially sound solution

as promptly as possible prior to implementation of the New Accord. So, we might think of the New Accord as “Basel 2.0”, to be followed by a further release – “Basel 2.1” - and so on.

This evolutionary approach is not inconsistent with the need for certainty. On the contrary, it requires a stable framework which ensures that the accord is not a moving target for the industry, as well as enough structured flexibility to be able to adapt to relevant changes in best practices.

VI. Conclusion

In concluding, I would like to note that the Committee and its working groups are addressing the remaining issues with the same level of commitment, energy, and enthusiasm that they brought to the table when we began to review the first Accord in the late 1990s. The openness of the process and the hard work behind us has strengthened the quality of our proposals. We expect the work ahead to be equally fruitful. The industry seems to agree, as you have not hesitated to continue to share your views and thoughts with us on the New Accord.

Adopting an Accord that will serve contemporary banking will require a substantial commitment from all of us. What banks and supervisors learn about the factors driving operational, credit, and market risk, and how we can better measure and reduce our exposure to losses, means much more to all of us than simply a more favourable capital requirement. We are advancing our comprehension of the many risks banks face and are sharpening our ability to navigate them successfully. For all of us, that offers the reward of a more stable banking system less susceptible to systemic risks and better able to circulate credit to businesses and consumers alike through good times and bad.