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Opening Remarks

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Thank you for that kind introduction. I would like to thank as well Daniel Bouton, Charles Dallara, and the Institute of International Finance for inviting me to participate in this very timely seminar on Basel II.

As you know, less than two weeks ago the Basel Committee published the text of Basel II, a document that we have officially named the "International Convergence of Capital Measurement and Capital Standards: a Revised Framework." This marked the culmination of an intensive, nearly six-year process of discussion, debate, and consultation to specify the structure and rules for Basel II.

I. Preview

First of all, Basel II represents the recognition of the good work done by banks in recent times to develop and improve their risk management and measurement systems. It is also an encouragement to continue this work. Therefore, Basel II offers an unparalleled opportunity for banks to improve their capital strategies and risk management systems. Likewise, it offers supervisors with an opportunity to align supervision more closely to sound industry practices and to enhance the dialogue with the industry and among banking supervisors. In our discussions today, we will consider the challenges and opportunities ahead under Basel II from the perspective of banking organisations, supervisory authorities, and the financial industry more broadly.

I would like to address these topics from my perspective as Chairman of the Basel Committee. First, I would like to share my views on the significance of Basel II's recent publication. As I will explain, the conclusion of the work to develop the framework does not mark the end of our work on Basel II. Indeed, in the second part of my remarks this morning, I will identify four transitional matters that we must address during the period leading up to implementation of the new framework. Finally, I will conclude my remarks by sharing with you the Committee's plans for future work on regulatory capital.

II. The conclusion of the work to specify Basel II

Allow me to begin my remarks by sharing some thoughts on the recent conclusion of the work to specify the Basel II framework. The release of the Basel II text marks the end of a challenging but very worthwhile process. Bankers and supervisors alike devoted considerable efforts to this project because we agreed that a new framework was necessary to maintain the relevance of capital supervision to the needs of banking in the twenty-first century. We also recognise that the capital framework serves as a cornerstone to the safe and sound operation of the banking system.

Given the importance of the issues at stake, the Committee sought to conduct its discussions in a highly transparent process. We discussed the new framework with many interested parties on the domestic and international levels. I would like to express my appreciation to two groups of external organisations and individuals in particular who supported our efforts.

First, I should mention the numerous representatives of banking organisations, industry associations, and other private sector bodies who devoted considerable time and energy to sharing their views. Organisations such as the IIF and its member banks engaged us in a very active dialogue, something that was enormously helpful to improving the quality of the framework. Above all, banks and other private sector bodies helped us to ensure that supervision would be more closely aligned to sound industry practices.

A second group I would like to acknowledge consists of those supervisory authorities, central banks, multilateral financial institutions, and other public authorities around the world who shared with us the perspectives and needs of banking systems that are based in many different markets, economies, and legal systems. Thanks to discussions with these colleagues in regional consultations and meetings, the Committee was better able to ensure that the new framework would be relevant to many different kinds of banks and economies that are in various stages of growth and development.

Basel II represents a success story in promoting international cooperation and in enhancing the quality of dialogue between banks and their supervisors. And it is a success story for all of us. We have concluded an important phase in our efforts to ensure that the supervision of capital will remain robust and relevant in the future.

But we cannot stop to rest yet. As the poet and former banker T.S. Eliot once wrote, "What we call a beginning is often the end, and to make an end is to make a beginning. The end is where we start from." Similarly, banks and supervisors know that our work on Basel II has not ended. Indeed, our most important work is in many ways only just beginning, as we must now prepare for the implementation of the new framework.

III. The transition to the new framework

This leads to my second topic today, namely the work that we will do to move toward the implementation of Basel II.

During the upcoming period of transition, banks and supervisors will prepare to embrace a new approach to banking supervision. Basel II represents a new philosophy for supervision, as supervisors have in recent years been turning their focus away from point-in-time assessments of a bank's financial condition. Under Basel II, we will look more deeply into the processes and control structures that banks put in place to safeguard their financial "health" into the future.

At the same time, Basel II introduces a new set of incentives for internal controls. The increased use of internal measures of risk as inputs to capital requirements will encourage banking organisations to review, update, and renew their approaches to risk measurement and management constantly.

In the short to medium run, these new approaches will require national authorities and banks to invest time, talent, and treasure to adapt their practices and processes to Basel II. In the long run, however, I am confident that these investments will yield stronger controls over risks, a more stable flow of rewards, and a strengthening in our resilience.

To implement the new framework successfully, and to realise these longer term benefits, I believe that there are four important transitional matters that we must address in the years leading up to implementation. They are,

- first, to transform the framework into enforceable rules;
- second, to ensure that the schedule for implementation reflects the overall readiness for new approaches to risk management;
- third, to commit our best resources to the parallel calculations or field tests that we will conduct; and,
- fourth, to confirm that the new framework will meet its quantitative objectives to maintain broadly the level of overall capital in the system.

I would like to take a few moments to address each of these four transitional matters.

- *Transforming the Basel II framework into national rules*

Certainly one of the most important legal matters ahead for our transitional period is to transform Basel II into national rules. The text that describes Basel II serves in some ways like a lighthouse, acting as a beacon to guide banks and supervisors in their journey toward the new framework.

If Basel II is a lighthouse, then the national rules that actually implement Basel II serve a bit like nautical charts. Just as ships rely on charts for precise information on safe passages and dangers to avoid as they approach the shoreline, national rules provide specific guidance on how the international standards will be applied and enforced with respect to domestic circumstances.

Consequently, from the perspective of supervisors, the text that was published in June will now serve as the basis for national rule-making and approval processes to continue. That work is of critical importance to the successful application of the new framework. Each jurisdiction has its own process to follow to articulate those rules. The Committee recognises the need to respect these national processes.

Similarly, in publishing the text, the Committee sought to clear the fog that might otherwise have obscured the expectations that supervisors have for banks' preparations. Banking organisations now have a stable framework on which to assess their own readiness. They will need to discuss their plans with national supervisors and, equally important, work to understand the national rules that will apply Basel II domestically.

- *Implementation timing*

In addition to transforming the framework into national rules, a second matter that we must address during the transition period is to permit banks to apply the new approaches to risk only when they are fully ready to do so.

All of us have a keen interest in making sure that the seas we cross from the existing rules to Basel II are not rougher than what we can manage. One way to do so is to launch the journey only when banks' systems can master the potential storms they may encounter. The Committee has confirmed that the simpler approaches to credit and operational risks will be available for implementation as of year-end 2006. This is important because many banks have already made considerable investments to prepare for Basel II, and we expect that many will be ready by that point.

For banks choosing the advanced IRB approach to credit risk or the advanced measurement approach to operational risk, there is more work to complete. We think that an extra year of preparation and analysis will permit a more successful implementation. It has been said that haste makes waste: in the case of Basel II's advanced approaches, none of us will benefit from an overly hasty implementation if our systems are not sufficiently ready for actual use as risk management tools. Likewise, national authorities must be sufficiently comfortable with the expected results that the new approaches will offer.

Consequently, in order to allow banks and supervisors to benefit from an additional year of impact analysis or parallel capital calculations under the existing and new rules, the most advanced approaches to risk measurement will be available for implementation as of year-end 2007. The IIF has expressed important views about the need to manage a staggered implementation schedule carefully, something that the Committee is working hard to address. In this sense, it is important to notice that the availability of the standard and foundation IRB approaches as of year-end 2006 means that Basel II in fact allows banks to stay on Basel I for an additional year. Therefore, I would encourage all banks to be proactive and to consult carefully with their national supervisors. This would include discussing your plans for the transition period and any arrangements that may help to reduce the potential for a burdensome transition.

Bankers and supervisors have a mutual interest in a smooth crossing to the new framework for all banks, whether they are adopting advanced approaches or simpler ones. The Committee will take steps to reduce potential disruptions to competition during the very short period that implementation will be staggered. In this sense, the Committee has agreed to adopt a 95% capital floor for banks using the foundation IRB approach during 2007.

Likewise, we are working to encourage cooperation and coordination among home and host supervisors during the period of transition. Supervisors must carry out their legal responsibilities to promote the safety and soundness of their banking systems, while seeking to manage and minimise the degree of burden that may arise as we move toward Basel II. I will allude a bit later to some of the relevant work that is already well underway within the Committee's Accord Implementation Group. Nick LePan, the Canadian Superintendent of Financial Institutions and the Vice Chairman of the Committee, will provide a more detailed overview of the AIG's work toward the conclusion of this conference.

- *Parallel capital calculations and national field tests*

This second matter regarding the timing of implementation is related closely to a third transitional matter that we must all address, namely running parallel capital calculations or conducting national field tests in 2006 and 2007. These are some of the most important preparations that banks and supervisors will conduct prior to implementation. Parallel calculations and field tests will serve as our best source of information on the effects of Basel II on banks' capital requirements. Having access to accurate results will help to ensure the successful implementation of the advanced approaches under Basel II.

Parallel calculations will also be important for banks as they prepare for Basel II. Performing the calculations will allow them to ensure that their systems are performing as expected, that they are aware of the impact of the move to Basel II and that they make adjustments as necessary.

Parallel calculations and field tests deserve much more attention and commitment from industry leaders than the question of when particular approaches will be available does. Indeed, if advanced approaches have not been calibrated effectively, it does not matter at all when they are implemented. An improperly calibrated framework will never deliver the improved sensitivity to risk and the increased efficiency that we expect. Such a result is clearly not in the interest of the industry or of regulators.

- *Confirm that the new framework meets the objective of maintaining the overall level of capital*

This leads to a fourth transitional matter that we must address, namely to confirm that the new framework will meet its quantitative objective to maintain the overall level of capital in the system.

The Committee has long stated that its intent is to maintain broadly the aggregate level of capital that is required for the banking system, while still providing incentives for banks to adopt more risk-sensitive approaches to risk measurement and management. Parallel capital calculations and national field tests will help the Committee to review its objectives for the calibration of the new framework prior to its implementation. Should we determine that our objective will not be achieved, we are prepared to address the situation.

In particular, if the new framework is found to fall short of maintaining broadly the aggregate level of required capital in the banking system, the Committee may decide that adjustments should be made to the framework. This could include applying a single scaling factor to the capital charges that arise from the internal ratings-based approach to credit risk. The Committee believes that it would be preferable to apply such a factor if the resulting capital requirements conflict with our objectives rather than to make last-minute changes to the IRB approach. Late changes to the fundamental construction of the capital requirement could be disruptive to banks' efforts to prepare for its implementation.

The IIF has shared its views with the Committee about the potential application of a scaling factor to IRB capital requirements. I want to emphasise that the use of a scaling factor is fully consistent with our long-held objective to avoid increasing or decreasing the overall level of capital required for the banking system. Moreover, it in no way undermines the potential for individual banks to achieve reductions in their capital requirements if they adopt advanced methods and can demonstrate that their exposures to risk are indeed lower. In fact, we recognise that Basel II will allow for capital requirements to be redistributed among individual banks

I should moreover emphasise that the scaling factor, if applied, might be less than or greater than one. While the introduction to the Basel II text cites a factor that might be slightly higher than 1.0, I want to emphasise that we provided this figure purely to give the industry insight into our best and most current sense of where the factor may lie. During the transition period, we may learn from banks' calculations that this figure was too conservative – or perhaps not conservative enough. This re-emphasises the importance of the parallel calculations and field tests and the reasons why we must all devote our best efforts to them.

IV. The Committee's future agenda for regulatory capital

Together, these four matters – namely, transforming Basel II into national rules, implementing the approaches at appropriate times, conducting parallel calculations and field tests, and verifying that Basel II's objectives will be met – constitute the issues that banks and supervisors must address immediately in the months ahead as we make the transition from the existing rules to the new framework. I would like to conclude my remarks today by giving you some insight into the Basel Committee's agenda for future work on regulatory capital relevant to Basel II.

The new framework is intended to be a more forward-looking approach to capital supervision, and certainly the Committee intends to keep Basel II up to date with changes underway in risk management in the industry. We must continue to monitor industry developments to make sure that Basel II reflects sound practices. We intend to do so in part by continuing to cultivate a dialogue with industry participants and with other supervisors in the coming months and years.

We expect that dialogue will be particularly important in the area of "double default" – that is, the likelihood that both a borrower and a guarantor default on the same obligation may be lower than the likelihood of the guarantor defaulting alone. The Committee believes that we must recognise double default in the new framework, though it is also essential that we consider all of the implications, especially those related to measurement, before we agree to a particular solution. We intend to continue to work on this issue with the goal of finding a prudentially sound solution as promptly as possible prior to the implementation of the new framework. Alongside this work, we have begun joint work with the International Organization of Securities Commissions (IOSCO) on various issues related to trading activities, such as the potential future exposure of derivative positions.

Similarly, as I suggested earlier, the Committee's Accord Implementation Group has developed a detailed agenda for its work through 2005. As you all know, implementation issues have become very important as we enter into this new phase of the work of the Committee. They are important both for supervisors and banks, as you have mentioned in many of your comments recently. These are difficult issues where it is essential that we give the right answers, and develop adequate and clear implementation solutions. As Nick LePan will discuss later today, the AIG is studying issues may arise in the cross-border application of the new Framework and how home and host supervisors may work through such issues. It is also studying Pillar 2 issues and considering principles and options for implementing Pillar 2 and will take up important technical work on how banks should best develop estimates of losses given default in "economic downturns", among other issues.

Over the longer term, the Committee intends to undertake work on the definition of capital. This is motivated in part by changes to the Basel II framework related to the treatment of expected versus unexpected losses, which, together with changes to the treatment of provisions, tend to reduce Tier 1 capital requirements relative to total capital requirements. Likewise, we have to consider the impact of International Accounting Standards that will begin to be applied in many countries from next year onwards.

A final area related to capital that the Committee intends to discuss with the industry over the longer term includes risk management practices that aim to quantify measures of risk and economic capital. Leading institutions have invested substantial resources in modelling credit risk, something that Basel II stops short of recognising for regulatory capital requirements. Nonetheless, we know that the IIF and many banks are deeply interested in moving toward greater recognition of these practices in the future.

We recognise the need to continue to discuss such practices with banks. We intend to use Basel II as a means of developing experience in the performance of such models. The Committee will continue this discussion with a view toward potentially allowing the greater use of credit risk modelling for regulatory capital purposes in the future and working towards the recognition of diversification effects. These discussions will focus on addressing concerns such as those regarding the reliability, comparability, validation, and competitive equity that might arise when greater recognition of full credit risk modelling is permitted.

V. Conclusion

The recent publication of the text of Basel II marks the end of an important phase in our work. But, let me repeat T.S. Eliot's words that to make an end is to make a beginning. It is now time for all of us to redouble our efforts to build the necessary infrastructure that will support the successful implementation of the new framework.

For supervisors and other authorities, this means converting Basel II into national rules and providing guidance to banks to help smooth the transition to the new framework. For banks, this means working to enhance internal systems and controls to improve the quality of their risk management.

Ultimately, our goal for Basel II is to encourage prudent risk-taking and the adequate capitalisation of banking organisations. We expect that, when banks have the right incentives to manage their risks appropriately and to hold sufficient levels of capital, the financial system as a whole will become more resilient, more stable, and better able to serve as a source for credit and growth.

Those characteristics matter greatly to the health of the overall economy, to the livelihood of consumers, and to the outlook for commerce and business. To harvest the benefits of Basel II, we must avoid the tendency to view this as merely an exercise in compliance. Banks should, of course, work to comply with the letter of Basel II's requirements, but I would encourage you to seek to achieve its spirit as well. We should view Basel II as an opportunity to do those things that make good economic sense to strengthen the quality of risk management and to enhance the stability of the financial system.

Thank you for your attention this morning.