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Remarks of Governor Jaime Caruana
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I'd like to thank the Institute of International Finance and the Bank of China for hosting this discussion on the outlook for banking and finance in Asia. For many reasons, it seems especially appropriate to discuss this topic here in Beijing. The tremendous growth of China's economy, its recent accession to the World Trade Organisation, and the wide scope of change that is occurring here has made China a reference for the world.

I am very pleased to have this opportunity to discuss with you some of the efforts of the Basel Committee on Banking Supervision to promote financial systems better able to sustain growth and more resilient during periods of distress. It is an honour to address this forum, but I must confess that I have come to listen and to learn.

The message I am consistently hearing is on the one hand one of strong support for the principles of the New Capital Accord and on the other a desire for the best standard for financial systems in each country. Too many examples have illustrated the economic costs and social unrest that weakly capitalised and poorly managed banks can inflict on an economy. It seems to me that we all recognize the importance of a sound banking system to our economic well-being.

In recent years, central bankers and supervisors around the world have been working hard on the new requirements for bank capital. I think you are familiar with the idea that, "he who asks is a fool for five minutes, but he who does not ask remains a fool forever." For the last five years, we in the Basel Committee have asked for comments and ideas from the industry, from academia, and from the community of supervisors on how to improve the international capital standards. The wealth of ideas and views that so many shared with us has made the process longer than we expected, but the benefit of this open and honest dialogue is that we are better able to achieve a sound and balanced accord. I think that we are very close to meeting our objective.

Today I would like to emphasise, perhaps even over-emphasize, three words that have guided our work on the New Accord, namely balance, consistency and cooperation. We seek a balanced approach so that the new capital guidelines can be applied around the world. A balanced approach that can be both meaningful to global organisations and yet flexible enough to be applied to smaller, more regionally focused banks. We have worked hard to strike a right balance between many other competing objectives, such as finding the balance between introducing incentives for banks to improve their risk management and implementing a system of prescriptive rules. We have sought a balance between complexity and risk sensitivity; between complexity and comparability; between soundness and conservatism; and between flexibility and consistency, and so on. Even the structure of the accord can be regarded as a balance among three different policy approaches: rules, discretion and market discipline.

In addition to seeking a balance in the New Accord, the Committee's work has also been guided by two other words, namely consistency and cooperation. I will have more to say about both later, but I would like to emphasize the word "consistency" now. We will achieve the full potential of a prudential standard such as the New Capital Accord only when we support it with other financial economic policies and regulations that share a consistent set of goals. Policy makers have long understood the value of monetary stability, and in recent years we have learned much about the importance of financial stability and how it interacts with our monetary policies. Interactions between the real economy and financial markets are becoming more intricate on a domestic level and more relevant to the global economy. Indeed, sound fiscal policies, combined with monetary stability aims based on strong financial institutions, and prudent regulations in technical areas such as accounting, provisioning and bankruptcy are valued and necessary companions to financial regulations such as the New Capital Accord.

In my remarks today, I'd like to begin with a brief reminder of why bank supervisors and banks around the world believe that we need a "New Basel Accord." Then, I'll discuss the New Accord's structure and share some of the latest news on what the Committee is doing to finishing the framework so that banks will be ready to implement it in the coming years. Finally, I'll conclude with some thoughts on the transition to the New Capital Accord.

Why We Need a New Accord

We might begin by recalling why we care so much about capital – and why we felt that we needed a new capital accord, which is the first topic I will address today.

In many ways, supervisors view capital as the last line of defence in a bank. When risk management is insufficient, when reserves are exhausted, capital absorbs losses to prevent a bank's failure. But when capital runs out, the bank may become insolvent, leaving public authorities and taxpayers responsible for restoring depositors' savings.

The challenge is determining how much capital is sufficient. As you know, one of the Basel Committee's best-known achievements was the release in 1988 of an agreement on how to define and measure the adequacy of a bank's capital. The 1988 Basel Capital Accord was a milestone. For the first time, supervisors agreed on a definition of capital and a minimum requirement that has been adopted in over 100 countries. More importantly, the Accord reversed a downward trend in internationally active banks' capitalisation, thereby strengthening the health and stability of the global banking system.

In the years since 1988, the drawbacks of a simple approach to capital regulation have become more apparent. Advances in technology and telecommunications, innovation in banking products and services, and the increasing globalisation of financial markets have changed the way that many banks measure and manage risk. Today, the 1988 Accord no longer provides these banks – and their supervisors – with reliable measures of the actual risks they face.

The Structure of the New Accord

In response, the Committee decided in the late 1990's to refine the measures for assessing and managing risk in the Basel Accord. But we wanted to achieve more than a simple update of the rules. Instead, we wanted to incorporate the best practices used by leading organisations across the industry. By doing so, we hope to strengthen the stability of the global financial system, something that would benefit not just banks but the society at large.

In undertaking this challenge, banks and supervisors recognise that having adequate levels of capital is not enough to ensure success in banking – or even long-term survival. A bank's long-term success is determined chiefly by the quality of its management and controls, which together make up its first line of defence. The New Basel Accord seeks to capture the relationship between the adequacy of capital and the quality of risk management by relying on three important and mutually reinforcing "pillars." These consist of, first, the minimum capital requirements; second, supervisory review; and third, market discipline. The three pillars themselves reflect the trend among bank supervisors to embrace a balanced philosophy of regulation that provides incentives to banks to manage their risks appropriately.

The first pillar, for example, seeks to align capital requirements more closely to the actual risks that banks face. But the minimum requirements provide economic incentives – in the form of lower capital charges – for those banks that develop better measures for their exposures to risk and better techniques for managing their risks. Banks with more traditional exposures and less complex operations will be better able to ensure that the their capital base is sufficient for the level of credit risk they face by aligning their capital requirements with external measures of their borrowers' creditworthiness.

The most sophisticated approaches to credit or operational risk will allow banks to rely increasingly on their own assessments of risk to determine how much capital to hold. This puts the responsibility for assessing and responding to risk in the most appropriate place, namely in a bank's own management and directors. They are in the best position to know their customers and their risks, and it is therefore most appropriate – and critically important – that they understand their responsibility for administering the bank's assets and its activities in a responsible manner

The second pillar highlights the important role that supervisors play in ensuring that each individual bank is holding adequate capital. Under the New Accord, supervisors will be responsible for evaluating the internal processes banks use to determine their need for capital to ensure that managers are exercising an appropriate degree of judgement.

The responsibility of a supervisor is to ensure that the banking system operates in a safe and sound manner and that individual banks are run by capable and competent leaders. But supervisors are not the managers of the banks. The decision on how each bank should best respond to different risks: that job should always rest with senior managers and a bank's board of directors. Instead, by engaging managers in a dialogue about the risks they face and the controls they have adopted to address them under the second pillar, supervisors create incentives for managers to behave prudently and find ways to improve their performance.

The third pillar seeks to leverage the ability of markets to provide discipline to banks to ensure that they are not holding unrealistically low levels of capital. By improving the quality of banks' public reporting of their risks and the measures they take to control them, we intend to strengthen the ability of other market participants to understand a bank's risk profile. When investors, customers, and even other banks have access to better information on how well a bank is managing its risks, they are better able to make business and investing decisions relevant to that bank, which can create a powerful incentive for bank management to improve their handling of those risks.

Together, the three pillars of minimum requirements, supervisory review, and market discipline are intended to ensure that banks understand their risks and take adequate precautions to protect themselves against those risks through their control structures and their holdings of capital. But most importantly, banks will have incentives to find better ways to identify, measure, and manage their exposures.

Current Status of New Accord

This past summer, we concluded our third round of public consultations on the proposals, and I'd like now to give you a sense of the current status of the New Accord, which is the second topic I will address today.

By now you may have read that the Basel Committee reached an agreement last month to address the final issues raised in public consultations over the summer and to complete the new rules by mid-year 2004. This was no easy task, as the Committee received over 200 comment letters on the Third Consultative Paper, or "CP3". While we might have been somewhat surprised by the number of responses that we received, we were not surprised by the hard work that was evident in the letters.

On this note, I would like to offer the Committee's appreciation to the banks, banking associations, , including the members of the IIF, and public agencies in Asia and elsewhere that devoted considerable time and resources to the consultations. If you've been following our work since the first consultative paper was released in 1999, you know that the proposals have evolved and improved considerably thanks to the honest responses and letters that you and others shared with us.

At the Committee's meeting last month, all members acknowledged our responsibility to consider carefully all comments. At the same time, we recognised the need to resolve the open issues and release the New Accord as soon as possible so that banks can continue to prepare for the new rules. In a statement to the press after our meeting, the members of the Committee noted that we expect to take account of the remaining issues and complete the text of the New Accord in the coming months and not later than mid-year 2004.

Let me briefly mention some of the issues present in the comment letters.

Complexity and the balance with risk sensitivity and comparability.

Certainly a key issue that we are addressing is balancing the complexity of the agreement with the need to be sensitive to risk and to offer different kinds of banks comparable approaches. It is true that the New Accord offers a far more sophisticated view of risk than the far simpler 1988 Accord does. But that is our intent. We seek to adopt the best measures of credit and operational risk. In the field of credit risk, for example, loan officers and risk managers in leading banks worldwide have at their disposal a constantly evolving array of databases, software, credit risk models, and risk rating systems, all of which provide supplemental empirical insight into a risk once not readily quantified. And all of these new tools were initially developed or refined to promote a bank's competitiveness and protect it against loss – and not just to respond to a regulatory mandate.

Nonetheless, the Committee is seeking a balance between complexity and risk-sensitivity. When a complex rule fails to add much to the New Accord's measures of risk, the Committee has worked to remove it. Most recently, for example, we announced in our Madrid press release that we will simplify the proposals for securitisation exposures.

At the same time, the industry has asked that the Committee not sacrifice risk sensitivity where it makes sense. The New Accord is a complex document partly because some banks felt disadvantaged under a simpler rule and wanted rules that were more comparable to their situations. They asked us to adopt more options for addressing the risks unique to a particular business or activity which, in some cases, required some complicated considerations. If you read just a few of the comment letters on our website, you will see that many of the latest suggestions from the industry would tend to increase the complexity of the New Accord even further.

Still, we know that it is easier to enforce a simpler rule than a complicated one. As we complete the text of the new rules, we will continue to simplify and streamline the framework.

Conservatism and the balance between soundness and conservatism.

A second issue that respondents to the proposals have raised is the sense that the New Accord may be highly conservative in its assumptions about how much risk exists in certain exposures. Questions about conservatism matter to us because we are trying to align capital more closely to risk and in a way that is conceptually sound.

A good example would be the treatment of retail exposures, including the small and medium enterprises that fall into this category, where the Committee found persuasive economic evidence to support a significantly lower requirement compared to earlier drafts of the new rules.

Another example we are evaluating currently concerns the treatment of credit losses for banks adopting one of the more sophisticated approaches to credit risk, the “internal ratings-based” or “IRB” approach. Our current rules for the IRB approach derived capital charges on mathematical estimates of a bank’s credit losses – both those that could be anticipated versus those that could not. Banks have criticised these proposals, since traditionally capital exists to protect a bank against only unexpected losses, while reserves are held when bank expects to experience credit losses. We are now seeking to revise the treatment of credit losses to calibrate capital only to losses that are not anticipated – or “unexpected losses” – and we have issued a proposal for comment on how to do so on our website.

We will continue to evaluate the soundness of our assumptions in the New Accord and their relative degrees of conservatism in the final months ahead.

Competition and the balance between flexibility and consistency

Applying the New Accord consistently across countries is an essential goal for the Committee. By incorporating minimum standards in the New Accord, we want global competition in banking markets to be driven by each bank’s strengths, rather than by differences in each country’s rules. Moreover, Pillars Two and Three were created to a great degree to level the playing field for banks by encouraging more consistent supervisory approaches and public reporting.

To advocate greater consistency in the application of the new rules, the Committee created the Accord Implementation Group to share experiences and encourage shared approaches. We expect these discussions to help supervisors apply the New Accord more consistently and to encourage greater cooperation among supervisors, which was one of the three words – together with balance and consistency – that I mentioned at the beginning as guiding the Committee’s work on the New Accord.

Based on the Implementation Group’s work to date, the Committee published a paper last August on the “high level principles for the cross-border implementation of the New Accord.” In this paper, we reiterate our view that the traditional allocation of responsibilities to home and host supervisors will continue. Cooperation will be critical for effective supervision under the New Accord, especially considering the need for an internationally active bank to receive the approval to adopt, and then validate, advanced approaches to credit and operational risk at home and in host jurisdictions. Similarly, supervisors will need to find practical ways to cooperate in the evaluations of capital adequacy under the second pillar and ongoing reviews of compliance with the minimum operational requirements of the New Accord.

The Implementation Group and the Core Principles Working Group, which is made up of senior regulators from a variety of countries plus representatives of the World Bank and the International Monetary Fund will meet for a second time in December to continue the discussions on issues related especially to the responsibilities and cooperation of home and host supervisors and issues that significant or systemically important foreign subsidiaries may pose for different jurisdictions.

Based on the progress that leading banks worldwide have made in adopting more sophisticated approaches to risk management, many countries have indicated that they are planning to implement the New Accord, whether in the short or long run. This leads to the final topic I'd like to discuss, namely the issues related with the transition to the New Accord across the world.

Broad application of the New Accord around the world. Transition to Basel II.

In drafting a replacement for the 1988 Accord, the members of the Committee sought to ensure that the capital guidelines could be applied around the world to many kinds of banks. This means that our rules must build on the best practices, yet remain relevant to conventional banks in more traditional markets. The New Accord provides a "menu" of options for measuring risk, thereby offering the degree of flexibility necessary for banks of various sizes and strategic orientiations to adopt the new framework.

Now that the New Basel Accord is moving away from a "one-size-fits-all" approach to capital, supervisors in every jurisdictions have the opportunity to evaluate what would be most appropriate for banks that are not large, complex, or internationally active. At the same time, we could say that Basel has moved away from a "one-schedule-fits-all" approach to implementing the new rules worldwide. Or, if you prefer, the Committee is saying to each country, "pick flowers when flowers bloom".

This suggestion is particularly crucial for supervisors who have adopted the 1988 Accord only recently. Some supervisors believe that their banks may still be strengthening their credit risk management functions and consequently would not benefit substantially from the New Accord at the moment. For these situations, the members of the Committee have long expressed their views that those banks and supervisors should concentrate on the fundamentals first.

Banks in those countries should work toward developing an adequate understanding of the risks they face and a sense of the best practices in use worldwide. For example, banks should develop their understanding of the credit underwriting cycle, skill at credit analysis, and insight into the dangers posed by operational risks. They should nurture a healthy environment for corporate governance, such as by strengthening their systems of internal controls, by promoting robust internal and external audit processes, and by adopting sound standards for accounting, loan analysis and classification, provisioning and reporting.

In turn, supervisors who are still fortifying the foundation of their banking systems may consider a variety of approaches to capital regulation. For some countries, the application of the simplest approaches from the New Accord may be appropriate. But others may feel that their banks are not yet ready and may decide, after careful review, that it would continue to apply the 1988 Basel Accord for several more years as banks continue to strengthen their risk management capabilities.

I want to emphasise that the Basel Committee supports the decisions of those supervisors who believe that their markets may not yet be ready. We would encourage those countries that choose to remain on the 1988 Accord to look to the principles of the New Accord, and especially to strengthen the second and third pillars. Moreover, whether a country intends to implement the New Accord by the end of 2006 or perhaps later, the Basel Committee recommends that supervisors everywhere encourage their banks to strengthen their abilities to identify, measure, and manage the full range of risks they face through internal processes.

At the same time, I am very encouraged to hear that banks and supervisors share the notion that none of our countries, regardless of our stage of development, can foster our own economic growth unless our banks are adequately capitalised and well managed, our financial systems stable, and our markets transparent and open. I believe that the New Basel Accord goes a long way toward achieving and strengthening those three objectives.

Certainly we hope that, over time, more banks and more banking systems will adopt the more advanced approaches to risk measurement and management laid out in the New Accord. When banks are adequately capitalised and well-managed, they are better able to promote growth by providing credit to consumers and businesses alike. But more broadly, when banking systems worldwide are adequately capitalised and well-managed, the international financial system becomes more stable, better able to promote sustainable growth, and more resilient during periods of distress.

Thank you for your attention.