“Revolutions”

Presentation to the BBA’s Risk Vision Conference
London, 8 June 2007

José María Roldán

Outline

1. The revolution in risk management
2. The revolution in banking practice
3. The revolution in banking regulation: Basel II
4. The revolution in supervisory practices
5. Basel II implementation challenges
6. Conclusions

1. The revolution in risk management

- Innovation in financial markets
  - Derivatives products (from plain vanilla to exotic); securitisation (from simple risk transfer to increasing sophistication in the slicing and dicing of risk)
- Theoretical developments allowing for the pricing of more complex financial instruments
  - Beginning with Black-Scholes/ Merton option pricing and ongoing refinements thereafter

1. The revolution in risk management (2)

- Facilitated by rapid improvements in computing power, and data management capabilities.

- Ongoing evolution – with each aspect of innovation (markets / analytical capacity / computing power) feeding off and challenging the other.

2. The revolution in banking practice

- To capitalise on the risk management and measurement revolution, many firms realised that there is a financial benefit to be gained from effective risk management.

- Enter the Chief Risk Officer
  - With greater strategic influence in the organisation
  - With often a direct reporting line to the CEO, Board and/or audit or risk committee
  - With enterprise-wide responsibility for risk management
  - With responsibility for regulatory compliance

2. The revolution in banking practice (2)

- From my perspective, the creation of an independent CRO, with increasing authority and firm-wide influence is a positive development.

- Supervisors and CROs share much in common:
  - It is easier to see and quantify the costs of effective risk management, than it is to see the benefits.
  - Staff and resource constraints

2. The revolution in banking practice (3)

- Supervisors and CROs share much in common (cont.):

  - CROs and supervisors face the challenge of measuring their effectiveness. It's hard to identify and measure the losses that have been avoided by effective risk controls.

  - Both supervisors and CROs have an interest in aligning regulatory and banking practices (the Use Test).

3. The revolution in banking regulation

- Basel II is needed because:
  - Simple Basel I risk measures are no longer very meaningful
  - Increasing complexity of banking and rapid innovation in financial markets
  - Enhanced supervisory practices
- The New Accord provides a stronger link between bank risk, risk management and capital.
  - Basel II is built of risk management approaches developed and adopted by banks
  - Much broader coverage of risks, greater alignment with bank practices, and a much greater focus on risk.

4. The revolution in supervisory practices

- Significant progress has been made in implementing Pillar 1 of the Basel Framework.

- Supervisory colleges have been a significant factor in the success banks and supervisors have achieved around the Pillar 1 approval process.

- The revolution in supervisory practices is perhaps most evident in Pillar 2 of the Framework

- To achieve the full benefits of Basel II, Pillar 2 requires banks and supervisors to take a risk-based approach to supervision, and to avoid taking a tick-box compliance approach to supervision.

5. Basel II implementation challenges

- The current focus of the AIG is on Pillar 2 issues
  - Varying Pillar 2 approaches across supervisors, but similar supervisory objectives
  - Need to better understand the impact of internal supervisory differences on cross-border banks
  - Assessing diversification assumptions at various levels (and the uncertainty around diversification estimates)
  - Home-host aspects of Pillar 2. How well do global models address concerns around transferability of capital and liquidity under stress? Likewise, how much comfort can host supervisors gain from subsidiary-alone assessments?

5. Basel II implementation challenges (2)

- Home-host issues
  - Longstanding issues, but more prominent under Basel II
  - Validation/approval of models – who does what?
  - Different approaches/timing in different jurisdictions
  - Home and host information needs
  - Systemically important subsidiaries

- Challenge: to strike appropriate balance between legitimate home/host supervisory needs and goal of minimising burden on banks and supervisors

5. Basel II implementation challenges (3)

- Home-host information sharing paper released in June 2006. The paper was developed jointly with non-G10 supervisors.
- The paper laid a good platform for addressing coordination issues, concerns around duplicate information requests to banks, but also made clear bank responsibilities.
- Positive feedback from industry on supervisory colleges.

5. Basel II implementation challenges (4)

- Gap year issues
  - Need to keep in mind that the issues are transitory
  - AIG members are working through issues on a case-by-case basis

- Hybrid AMA
  - Comment period on AMA allocation mechanisms paper closed on 18 April
  - Paper tries to break the stalemate – industry waiting for more guidance and supervisors waiting to review models

5. Basel II implementation challenges (5)

- Trading Book - Incremental Default Risk Charge
  - Still in the principle development stage
  - Complex and systemically important issue
  - Addressing potential regulatory arbitrage between trading and banking books
  - Industry views on appropriate modelling methods vary
  - Progress expected by the end of the year / early 2008

5. Basel II implementation Challenges (6)

- The AIG is not Basel II control central
  - Supervisors share experiences and communicate range of practices and sound practices, and learn from each other
  - Current approach is focused on bank specific case studies on pillar 2 assessments. Natural progression from high level principles papers.
  - Discussion of concrete issues (eg assessment of interest rate risk, concentration risk, stress testing and diversification)
  - Information exchanges and outreach to global supervisory community and industry.

6. Conclusions

- Financial innovation, developments in analytical capacity to price financial instruments and measure and monitor risk, together with the enormous leap forward in computing power and data management capabilities have led to a revolution in risk management.

  - This is one factor that has led to the revolutionary role of the CRO

- The increasing significance of the CRO's role within firms is a welcome development, which will continue to evolve over time.

6. Conclusions (2)

- Supervisors and CROs share much in common – we have similar objectives and face similar constraints. But, we also need to understand where our perspectives differ (eg assumptions around the transferability of capital).

- The AIG will continue to address Basel II implementation challenges. Dialogue with the industry and effective supervisory coordination and cooperation are key to maximising the benefits of the new Accord.