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“Is it implementing Basel II or do we need Basel III?”

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It is a pleasure to join you today at the occasion of the BBA Annual International Conference and to speak to this distinguished audience about quite a provocative question. Let me phrase it a bit different than in the program: Are we moving to Basel III? Or should we focus our attention on implementing Basel II? For me the answer is straightforward – don't forget I am the chairman of the Basel Committee's Standards Implementation Group. Without going into any detail, let me first recall that the Committee introduced Basel II to achieve the following basic aims:

- (i) to create a risk sensitive framework,
- (ii) to more comprehensively capture the risks a bank is exposed to, and,
- (iii) To strengthen risk management, governance and transparency.

I think we would all agree that these are sensible targets, which should apply to any regulatory framework. Nevertheless, the financial crisis has highlighted gaps in the Committee's regulatory framework which need to be addressed.

Before outlining the Committee's response to the crisis let me first start with an obvious but nevertheless important observation. The crisis built up over many years under the Basel I capital regime, not under Basel II. As a matter of fact, Basel II has only been adopted relatively recently in most Basel Committee member countries (and some of them are still in the process of moving to Basel II). The new framework was certainly well known in advance but until its actual implementation, it is doubtful that it was a significant driver of bank behavior. In this regard, it is quite interesting to see that some commenters even want to go back to the past – the 1988 Accord – which admittedly did not address any of the causes of the crisis.

I think we have a strong framework which has also recently been supported by the G20 leaders. In their declaration of 2 April 2009 they state: all G20 countries should progressively adopt the Basel capital framework.

Firstly, Basel II corrects a number of the weaknesses revealed by the Basel I capital framework as well as by the crisis. These include, for example:

- Better treatment of off-balance sheet exposures, securitisation exposures and liquidity commitments.
- greater risk coverage, with for instance explicit capital requirements for operational risk
- Better differentiation of risks and capital charges, with higher capital charges for riskier activities.

These improvements relate to the minimum capital requirements but as you know, the calculation of the capital requirements is only one part of the overall Basel II framework which also has two other pillars.

- As part of the second Pillar, Basel II puts greater emphasis on sound internal capital assessment, stress testing and risk management practices. It also promotes earlier intervention by supervisors.
- As part of the third Pillar – market discipline - Basel II forces banks to disclose detailed information about their risk profiles.

If we consider the events that have been taking place since the crisis begun, these few examples demonstrate that Basel II was in the right direction in many fields. Greater risk capture and transparency, and more forward looking assessments of risk through stress testing have been key elements of the response to the crisis.

However, while recognising that Basel II was an important step forward, the reliance on models has been subject to criticism. I fully agree with the idea that excessive reliance on complex modeling may not be appropriate. The modeling of complex structured products has provided clear examples of the limitations of models. However, it has also demonstrated that very simple approaches (such as excessive reliance on ratings) also did not perform very well. Moreover, it should be remembered that Basel II, even in its most advanced approaches for measuring credit risk, is far from fully relying on modelling by firms.

Indeed, the use of models in the Basel II framework is subject to strict requirements. In the internal ratings based approach, the estimations of the risk parameters (PD, LGD and EAD) are based on conservative assumptions and supervisory approval. Banks' estimation of correlations that particularly broke down during the crisis is not permitted. By the way, what is commonly called Basel III would go a step further than Basel II and permit banks to calculate those correlations. Thus, the Basel II framework is very different from banks' internal economic capital models.

The crisis in particular has highlighted the importance of sound risk management. Firms with more rigorous risk management tools and practices generally performed better during the crisis. The design of the Basel II framework, which closely links capital requirement and risk management practices, is interesting in that respect. The incentives created by the framework and its calibration have been designed to encourage and promote the adoption of better risk management practices. Internal approaches are certainly used in the Basel II framework to promote better risk measurement and greater risk-sensitivity, but, as I mentioned before, they are subject to strict requirements that have a quantitative dimension (we need to make sure the models are robust) but also a qualitative dimension, to ensure that a sound environment is in place for the use of the

models, in terms of risk management, corporate governance and internal validation. As chairman of the Standards Implementation Group, I have observed that supervisors have paid particular attention to those aspects when reviewing applications for the use of the Basel II internal models. To say it differently, a sound and full implementation of Basel II, of its most advanced approaches in particular, should contribute to strengthen banks by forcing them to implement better practices and not only by ensuring that sufficient capital is held.

For the various reasons I briefly described (architecture with 3 pillars, broad risk coverage, incentives to improve risk management), Basel II is the best way forward to build banks capital requirements on.

But I would be mistaken if I were not acknowledging that there is room for improvement.

Basel II is not a perfect system. The crisis has revealed a number of areas where the framework could be strengthened to enhance the resilience of individual banks, the banking sector and the broader financial system. The Basel Committee is currently working on several initiatives and issues to address the lessons from the crisis and to develop the next generation regulatory framework. In December 2008 the Basel Committee outlined its comprehensive strategy to address the lessons of the crisis as they relate to the regulation, supervision, and risk management of banks. This strategic response is certainly not limited to capital-related issues, but it will for sure impact the Basel II framework. Basel II will remain a key component, but it will be an updated regime, supplemented by other tools. I would like now to briefly present the main changes that the Committee intends to make:

(a) Firstly, the Basel Committee is preparing significant enhancements to strengthen the Basel II framework. In line with the overall architecture of Basel II, the changes will cover each of the 3 pillars:

- Concerning the minimum capital requirement (Pillar 1), the changes will mostly aim at better reflecting the risks associated with trading activities, securitisations and off-balance sheet exposures. Banks have suffered significant losses in these areas and there is a need to make sure that appropriate and higher capital charges are held against the risks.
- To address the weaknesses and limitations in risk management practices revealed by the crisis, the Committee will promote more rigorous supervision and risk management of risk concentrations, off-balance sheet exposures, securitisations and related reputation risks. The Committee is also promoting improvements to valuations of financial instruments, management of funding liquidity risks and stress testing practices. These fall under the category of Pillar 2.

- In order to promote greater transparency and market discipline, enhanced Pillar 3 disclosure for securitisations and sponsorship of off-balance sheet vehicles will be required.

A consultation was conducted during the first quarter of this year on these proposals and I expect the final versions to be released soon. In addition, the Committee has also started reviewing the role of external ratings and will make sure that adverse incentives will be mitigated. The Committee is also revisiting for instance the treatment of counterparty credit risk. These updates will ensure that the Basel II framework reflects all the lessons learned and are part of the normal life of any regulation.

(b) Other areas of improvements include:

- Strengthening the definition of capital, with a particular focus on Tier 1 and common equity. As we have seen a strong capital base is critical for banks to absorb losses and maintain lending during periods of severe stress;
- Another important area is procyclicality. We need to make sure that banks have capital buffers above the minimum in good economic conditions that could be drawn upon in stress, in order to reduce the cyclicity of the Basel II framework;
- We also need to supplement the Basel II ratio, which is a risk-based measure, by a simpler non-risk based measure, in order to contain the leverage in the banking system. The idea with such a simple measure is certainly not to replace Basel II but rather to add another layer of safety ("you don't give up using seatbelt just because you have an airbag...").

These measures the Committee is currently considering are fully compatible with the Basel II framework.

(c) Thirdly, it is important to keep in mind that several actions undertaken by the Basel Committee go beyond Basel II and are independent from the capital rules. Capital requirements are key to ensure that banks are robust but the Basel II framework cannot address all the issues. Among the areas on which the Committee is working, I would like to mention notably liquidity, remuneration, and stress testing.

(d) Another important lesson from the crisis is the need to have a global view of the banking systems, in relation to the financial and economic conditions. That is why we continue working on practical approaches to address system-wide risks, and to better understand the link between firm-level risk and broader financial system stability. Our work in the areas of liquidity risk, counterparty credit risk, stress testing, and the development of counter-cyclical capital buffers is

particularly relevant to ensuring not only the stability of individual banks, but also the financial system.

(e) Finally, the financial crisis has also highlighted the importance of not only writing guidance but implementing the guidance in a rigorous and robust fashion, and in an internationally coordinated and consistent manner. Indeed many of the current weaknesses exposed by the financial crisis are the result - certainly of gaps in the regulatory framework - but they are also the result of inadequate implementation of existing risk management standards and guidance (for example, pre crisis guidance on liquidity risk management). Addressing deficiencies in implementation is thus just as important as addressing deficiencies in policies. This observation has resulted in the creation in January of this year of the Standards Implementation Group or as we call it the SIG. This new group replaces the Accord Implementation Group. The SIG mandate is much broader than the one of the AIG, as it includes implementation of all Basel Committee standards and guidance, not just Basel II implementation. However, Basel II will remain a top priority for the SIG and I confirm that the SIG is still busy working on supervisory colleges, analysing IRB outcomes, AMA practices, the implementation of Pillar 2 and Pillar 3.

All these aspects regarding the current work of the Basel Committee show that a stronger and sounder regulatory framework is being developed. The various on-going initiatives certainly go beyond Basel II, but Basel II will remain the core component of this framework. As we need to fully incorporate all the lessons from the crisis into the regulatory framework, Basel II will evolve and will look different in the future, but we are certainly not going in the direction of Basel III. I would even say that Basel III is nowadays even less of an option, as the crisis has clearly demonstrated the limitations of excessive modeling and the fundamental importance of sound risk management. Our priority is thus to strengthen Basel II and also to ensure that it is fully implemented.

But let me be clear. If my words sound too reassuring, then I am not setting the right tone. The job is currently far from done. Yes, we have a plan, and that's a good start. But we will need to deliver in the coming years, and in order to do so we will have to do a better job than in the last decade. On the industry side, there is an urgent need to improve risk management systems, well above the standards we have seen during the crisis. A tick the box approach to risk management is not just unacceptable: it is extremely dangerous for the survival of financial firms in the medium run. With the support of a sound regulation, risk management practices should improve and evolve in a way that is commensurate with the complexities of business.

But the challenges on the side of supervisors are also enormous. The crisis has demonstrated the case for strong host supervision but also the crucial role that a strong Home or consolidated supervisor plays. Looking forward we need more of both Home and hosts supervisors, and the only way to achieve this is through a greater supervisory cooperation. And this is not just a slogan,

but rather an enormous challenge. Supervisors, locally, need also to do a better job in implementing regulations and in supervising firms, and we need to do it in a way that fosters sound financial innovation conducive of economic growth and financial stability, whilst keeping the benefits of the international financial system we have created in the last decades.

The task ahead of all of us is daunting, and the forces towards disintegration and fragmentation are enormous. The first step in doing our job is recognizing this and to ensure that supervisory coordination and cooperation will be there to counter those centripetal forces. Without the support from the industry, this will be mission impossible.