

## *Keynote Speech at the Market Discipline Conference*

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### **Overview**

Good morning. I would like to thank President Moskow, Malcolm Knight, and the staff of the Federal Reserve Bank of Chicago and of the Bank for International Settlements for organising and hosting this timely conference. It is a pleasure for me to join your discussion in Chicago today. I can think of few venues better situated to talk about markets and to explore the links between transparency, corporate governance, and the role markets can play to encourage prudent risk taking.

Bank regulators in recent years have begun to view markets as an ally to our system of supervision. We have consequently sought to incorporate market discipline directly into the supervisory framework. Markets value well capitalised and well managed institutions as much as supervisors do, and can create rewards for banks that manage their risks appropriately. Yet banks can be very complex institutions and no market discipline is possible without widespread public access to timely, accurate, and comprehensive information on a bank's exposures, its risk management processes, and its outlook for the future.

I'd like to discuss this morning why the Basel Committee believes that applying transparency and market discipline approaches in the New Capital Accord will help us achieve our objectives to reinforce the safety and soundness of the banking system.

My first point will be that, despite its name, the New Capital Accord is about much more than just capital. It is also about maintaining a level playing field and about strengthening incentives to foster sound risk management through three pillars: risk sensitive minimum capital requirements, coordinated supervisory review and – importantly, given the theme of this conference - enhanced market discipline through greater transparency. The New Accord is therefore much more comprehensive than its 1988 forerunner.

Second, I'll comment on the rationale behind the compound approach followed by the Basel Committee that blends rules, discretion, and market-based incentives. It could be viewed as a portfolio of different policy approaches that allow supervisors to achieve or at least draw close to a kind of efficient frontier.

Third, I'll share with you key issues that the Committee faced in drafting the market discipline component of the New Accord and, specifically, I will mention some of the concerns that arose in our public consultations. Mainly:

- *Proprietary versus public information*
- *Principles versus Rules*
- *Consistency of Accounting Standards and the New Basel Accord*

Finally, I will review the present status of the Accord, the significant progress made in our last meeting in Madrid and I will outline the next steps in its rapid finalisation, as well as our plans for keeping it fit for the future.

***Basel II: A new, comprehensive approach to achieve greater financial stability.***

To begin, I would like to re-emphasise the importance of market discipline to banking supervision, especially in a rapidly changing environment. Supervisors seek improvements in the public's access to information on a bank's condition precisely to bolster the ability of rating agencies, of business counterparties, and even of investors or depositors to evaluate the profile of a bank's risks and the quality of its controls. Yet as safety and soundness regulators, we wish to fortify the stability and resilience of the financial system. In our view this goal requires not just greater transparency, but also significant advances in the state of the art of risk management and adequate capital when unexpected losses materialise.

For the first time, the Capital Accord will include not only explicit economic incentives expressed in the minimum capital requirements but also implicit incentives built into the processes for supervisory review and market disclosure.

I think it is helpful to recall why so many central banks, regulatory agencies, and commercial banks have devoted their best resources to ensuring the success of the New Accord. The existing Accord, as you know, was already considered a milestone in banking regulation. It offered the first internationally accepted "yardstick" for capital adequacy and a simple measure of risk. It had received praise for reversing a downward trend in bank capital levels and for serving as a benchmark measure of a bank's financial health around the world.

But the 1988 Accord was a blunt instrument that quickly fell behind the times. Advances in technology, in banking products, and in risk management changed the way that leading banks measure and manage their risks. By the mid-1990's, bankers and supervisors agreed that the original Accord no longer offered the largest and most sophisticated organisations a meaningful measure of risk.

Under the leadership of William McDonough, former President of the Federal Reserve Bank of New York and my predecessor as chairman of the Basel Committee, the Committee seized the opportunity to achieve more than a simple update of the capital requirements. Bill brought tireless energy to the project and convinced industry leaders, bank supervisors, and central bankers that we should

pursue a far greater objective that would incorporate market discipline and also encourage advances in risk management across the industry .

While he has moved on to new challenges as head of the Public Company Accounting Oversight Board in Washington, the U.S. delegation to the Basel Committee remains in excellent hands. The hard work of leaders such as Roger Ferguson, the Vice Chairman of the Federal Reserve, and Jerry Hawke, the U.S. Comptroller of the Currency, and of other U.S. supervisors in the negotiations, has strengthened the quality of the capital rules. They have helped ensure that the New Accord will be flexible, forward-looking, and fit for the service of twenty-first century banking.

***Basel II: a blend of reinforcing policy approaches.***

The long-term objective of fostering greater financial stability led to our decision to supplement the revised minimum capital requirements, which constitute the first pillar of the New Accord, with two equally important pillars.

Although this may be an oversimplification, one could argue that each of the three pillars can be viewed as representing a different policy approach for a regulatory/supervisory framework. The first pillar emphasises the adoption of uniform rules. The second pillar relies more on the use of discretion in setting requirements for individual banks. And the third pillar can be expressive of a market-based approach.

Each of these choices individually considered has its merits, but also certain downsides. The point I want to make is that the risk/reward features of each of the three options - rules, discretion and market discipline - have their own particularities and are not totally correlated. From a portfolio theory point of view it could be argued that the optimum result is achieved through using a combination of all three approaches, and that this combination is far better than any of the individual options alone.

Rules constitute a very direct approach and one that offers the greatest clarity to institutions on what supervisors expect from banks, thereby leading to a higher level of transparency from both the perspective of the banks and the supervisors, and promoting comparability between institutions ..

However, adopting a rules-based option alone, even if they are market friendly, entails certain disadvantages. It tends to be inflexible and therefore might preclude innovation. It could also fail to take account of bank or business line specificities.

This is why the Committee decided to complement the minimum capital requirements with the second pillar, known as supervisory review. This allows a discretionary approach according to the situation of specific banks or types of business – very much like the principles-based policy approach. The benefits of such an approach are flexibility and adaptability to specific needs, both now and over time as situations and responses change.

But this approach alone would also have its shortcomings. Market participants could find it difficult to compare banks. The lack of a common standard across institutions might actually reduce transparency, since markets might not know or understand why supervisors established particular requirements for certain banks but not for others. This approach alone could also raise competitive equality problems, making it more difficult to ensure a level playing field, one of the key objectives of the Basel Accord.

The third option would be a market-driven solution. As I have already said, the Committee has recognised the importance of market discipline in the third pillar of the New Accord. It draws on the power of markets to create strong incentives for banks, incentives to help ensure that banks manage their risks properly and do not hold unrealistically low amounts of capital for their risk.

There is a lot of merit in this approach, yet all of us know that markets sometimes behave inefficiently. They can overreact to certain minor events yet still overlook significant indicators of risk in the short run. Likewise, markets are not always able to capture some externalities on their own, such as the interests of the broader public. They sometimes focus on the immediate needs of direct participants rather than those of depositors or customers or they can be too short-sighted in their time horizon. I think the thoughtful comments made by Malcolm D. Knight yesterday about gaps and limitations of market discipline clarify these kinds of issues most constructively.

So it is clear that no single one of these three options provides all of the benefits that supervisors seek. We want rules to provide clarity and strong incentives. We want the ability to use discretion to manage diversity, to tailor requirements to the specific businesses of each bank. Finally, we want markets to provide economic incentives for institutions to improve bank management and disclose information that is relevant to end-users' needs.

What I am saying is that the "efficient frontier" can best be achieved through a combination of the three pillars, given the reinforcing/diversification effects of each. Each pillar provides something that the other cannot and is essential to achieving our overall objective of financial stability.

I realise that this presentation of the three pillars as items of a portfolio of policy options is an oversimplification, but I think it helps us visualise why we think that the most "efficient frontier" involves a mixture of minimum rules, tempered by supervisory discretion, and supplemented by market-based incentives.

### ***Current industry practices and issues that arose in consultations.***

Let me now move to current industry practices and how transparency is incorporated into the Basel framework.

In deciding to revise the 1988 Accord, the Basel Committee thought carefully about what improvements to banks' public reporting would mirror the New Accord's incentives-based approach to foster improvements in risk management. In recent years, the Committee has noted some improvements in the quality of bank reporting

worldwide. Annual surveys conducted by the Committee suggest that the extent of banks' public disclosures has increased markedly in some areas.

Still, important deficiencies remain. For example, in 2001 – the most recent date for which comparative global information is available – the most prevalent disclosures covered accounting and presentation policies, on a bank's capital structure and its measures of capital adequacy, and, for those that had them, on the kind of market risk models the bank used. Few banks disclosed much about their credit risk models, the types of credit risk mitigation techniques that they employed, or even the external or internal ratings assigned to their credit exposures.

The relative paucity of data available publicly on a typical bank's credit risk profile appears inconsistent with the fact that, for most banks, credit risk remains the single most important source of potential losses. At present, market participants seem to know only little about the extent of most banks' exposure to credit risk. One could conclude that it seems unrealistic today to assume that they have enough knowledge of a bank's position to exercise properly a benign influence on its handling of credit risk. Disclosure practices do not seem to have kept pace with the very rapid evolution in the ways that banks take on, measure, and ultimately manage their risk positions.

- ***Incorporating Market Discipline into the New Basel Accord***

To improve the ability of markets to contribute to greater stability in the banking sector, the New Accord will contain a series of disclosure requirements. The Committee views Pillar 3 as a further refinement of accounting standards requirements as they should apply to banks in the light of the specific risks they face. Some of the requirements may furthermore be tied to a bank's eligibility for adopting an advanced approach to credit or operational risk or for recognising the benefits of particular instruments and transactions in mitigating risks.

We based our decisions on the information that should be disclosed on the following principles: that market participants require an understanding of how the capital requirements apply to the consolidated banking organisation; that they should know what risks banks face, to what degree, and how they assess those risks; and that they should have details on what capital they hold.

More generally, by emphasising principles in the disclosure rules – that banks should have a formal disclosure policy approved by the board, that internal measurement tools must be credible, that they must adequately capture risk, and that they must be used by banks in the daily management of their operations and not just for regulatory capital purposes – transparency may actually result in more consistency in the application of advanced approaches than detailed quantitative criteria.

- ***Issues That Arose in Consultation:***

The process for transcribing these principles into rules for the New Accord has involved extensive discussion among supervisors, representatives of the accounting profession, and financial institutions. This past summer alone, for example, the Committee received over 200 public comments on the proposals set out in our third consultative paper, or “CP3” as we call it. The third pillar attracted a degree of controversy among many banks mainly in earlier drafts of the rules, but thanks to the very positive discussions that the Committee had with the industry and with accounting standards-setting bodies, all the pillars of CP3 now enjoy broad support. This brings me to the next part of my address, in which I’ll cover the key concerns that arose during consultations.

- ***Proprietary versus public information***

Certainly, an early concern about the market discipline component of the New Accord was that the required disclosures appeared to go far beyond what banks traditionally reported publicly. In some institutions’ opinion, the Committee was seeking to require the disclosure of information previously considered confidential. While the Committee is mindful of the concern that some information should remain private, we believe that concepts of public versus proprietary information require some reflection. In order to determine whether information should be disclosed, consideration should also be given to end-users’ needs. For example, in order for shareholders, creditors, and counterparties to appreciate the risks of their own exposures to a bank, they must understand that bank’s appetite for risk and its approach to, and methodologies for, managing risk. What should drive this debate is what a bank itself would want to know before making an investment or credit decision, rather than the concerns that some have about what had formerly been considered secret.

The Committee believes it has struck an appropriate balance between meaningful disclosure and protection of proprietary and confidential information.

- ***Principles versus Rules***

A second concern that arose in consultations was the Committee’s decision to adopt specific rules for disclosure, rather than articulate broad principles for transparency. But on this point, many institutions seem caught up in a contradiction. On the one hand, banks suggest that we avoid overly detailed guidance on public reporting that might create burdensome and inflexible rules. On the other, nearly all banks have urged the Committee to provide clarity to ensure the consistent application of the New Accord across jurisdictions. Understandably, some banks are concerned that, in the absence of specific rules, competitors in other countries might be subject to less scrutiny than they are.

We recognise that a principles-based approach offers benefits, especially in terms of simplicity and flexibility. But our main intention is to offer markets a clearer picture of a bank's risk profile, regardless of what jurisdiction that bank may call home. To promote both greater insight into a bank's true risks and a more level playing field for all banks, we advocate disclosure rules based on principles rather than looser principles that might be subject to local interpretation. Likewise, the Committee rejected proposals for supplemental disclosures that would be optional under the New Accord.

This has admittedly resulted in disclosure requirements that are more detailed and perhaps less elegant than a simple expression of principles might be. But perhaps supervisors can take some comfort from the physicist who recommended that "if you are out to describe the truth, leave elegance to the tailor."

- ***Consistency of Accounting Standards and the New Basel Accord***

One cannot discuss transparency and market discipline without considering the mechanics through which financial data are recorded and reported. And this brings me to a final key observation raised in comment letters, namely the industry's position that if we are to leverage market discipline through better reporting, the Committee should clarify the differences between accounting standards and supervisory objectives.

Numerous institutions have called on the Committee to continue to align the regulatory framework more closely with the converging standards in accounting worldwide. Many industry representatives have noted quite correctly that a greater degree of accord is warranted especially now that the New Basel Accord includes explicit disclosure requirements intended to promote greater insight into a bank's risk profile. Likewise, the Basel Committee's treatment of provisions and the valuation of financial instruments must keep pace with changes in the relevant accounting standards.

We have made a considerable effort to see that the narrower focus of Pillar 3 does not conflict with the broader accounting requirements, and we have liaised closely with our colleagues in the International Accounting Standards Board in pursuit of this objective. In fact, the Committee views Pillar 3 as a further refinement of the accounting standards requirements as they should apply to banks in the light of the specific risks that they face. The Committee is convinced that such specificity is both appropriate and necessary for prudential reasons.

Market discipline, and hence financial stability, is strengthened when accounting and disclosure requirements reflect sound risk management principles and represent the control practices that banks adopt. Consequently, we recognise our responsibility to participate actively in the development of national and international accounting standards. When designing standards for the disclosure of components of capital, for loan reporting, and for other topics of mutual concern, we have sought out the views of accounting standards-setting bodies. This dialogue will continue.

Where regulatory and accounting principles may not yet be fully consistent, we have sought to align our requirements as best as possible with international accounting standards and to resolve other matters reasonably and based on our understanding of the potential direction that accounting standards might take in the future. Because we recognise that there is still much to be done in this area we will continue to monitor pillar 3 in the light of accounting and market developments. I should add that we are seeking new opportunities for discussion with accounting standards-setting bodies and private sector accounting professionals.

### ***The Status of the New Accord***

The Committee is currently reviewing carefully these responses and other issues that the industry raised. In relation to pillar 3, we are evaluating closely what should be reported publicly, versus what can remain confidential. We are refining the rules so that they will help secure a more level playing field without being overly burdensome. We are aligning our reporting requirements with those emerging from accounting standards.

In terms of the way forward, as you may know, in mid-October the Committee reached an important agreement on a work plan for taking these and other issues into account, and significant progress was made on major issues. What is most important to the Committee is the quality and consistency of the new Accord. At the same time, we recognised the need to provide banks with as much certainty as possible while they plan and prepare for the adoption of the new rules. In our last meeting in Madrid, the members of the Committee agreed on the importance of finalising the New Accord expeditiously and in a manner that is technically and prudentially sound.

We noted in a statement to the press that we expect to address the remaining issues and complete the text of the New Accord in the coming months and no later than mid-year 2004. This period of time will also allow us to take careful note of valuable information coming from domestic consultations under way in some jurisdictions, including the process for the Advance Notice of Proposed Rulemaking in the United States.

The Committee also discussed the importance of ensuring that the calibration of the New Accord achieves its objectives. Accordingly, prior to implementation, a further review of the calibration will be conducted on the basis of additional information, such as further impact assessments in some jurisdictions and the monitoring of banks' parallel calculations.

In terms of specific issues, a number of areas were identified where major improvements were possible: the expected versus unexpected losses calibration issue, securitisation, credit cards commitments and risk mitigation techniques. At present, we have offered for public review a proposal to resolve a fundamental concern raised by the industry on the treatment of expected versus unexpected losses. I would encourage those interested to read the statement outlining our proposed revision on our website and to share any thoughts you may have by the

end of this year. We have also simplified the proposals for securitisation exposures, as we decided to replace the “Supervisory Formula” approach to unrated tranches with a simpler rule.

Also, as we draw closer to finalisation, the Committee has intensified its efforts to facilitate a consistent implementation of the New Accord. A set of principles has been outlined for the cross-border application of the New Accord to promote closer practical co-operation and information exchange among supervisors. These implementation issues are very important to promote consistency and to reduce the burden on internationally active banks.

There are, however, other areas that we can already identify as part of our future work plan to advance risk management, to promote greater transparency, and to strengthen the stability of the financial sector. Given that I have mentioned in this presentation the benefits of utilising the diversification effects of different approaches in the search for an efficient frontier, I'd like to conclude with just one of the potential items on our agenda for future work once the New Accord is implemented.

This item would be to consider the benefits of full credit risk models in the calculation of minimum capital requirements. In theory, a bank's capital requirements would then reflect to the greatest degree the economic benefits of diversification in its balance sheet. In fact, the Committee did at one point evaluate whether advanced banks should be permitted to estimate the degree to which their assets might behave similarly or default together in the New Basel Accord.

As you know, we decided that we are not quite there yet. We know that some banks are making commendable progress in thinking about ways to estimate the value of diversification. Nonetheless, we remain concerned about the degree of confidence one might have in those estimates, given the relative lack of data available. Likewise, we have not yet seen evidence that there is a critical mass of banks that would today consistently meet the “use” test spelled out in the New Accord. In the coming years, and we can start very soon, we look forward to continuing this dialogue with banks, banking associations, and researchers to find ways to move Basel in the direction of full credit risk models.

Although banks and supervisors have much to do in the years ahead, we are confident that the development of an incentives-based capital framework, accompanied by more consistent and focused supervisory review and a concurrent enhancement of market discipline, will improve the management of risk across the industry, promote broader financial stability and resilience, and ensure that the banking system is better able to promote sustainable growth in the economy.