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“The Practical Implementation of Basel II: Current Challenges and the Way Forward”

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Introduction and overview

It is an honour to be invited to join you for what looks to be a very timely and interesting conference, and it is also my great pleasure to welcome you to Spain.

I hope that you will have the opportunity to explore the great city of Barcelona during your time here. It is one of the most innovative cities in the world for art, architecture, cuisine, and even...football.

You may be aware that Barcelona underwent a major transformation when it hosted the Summer Olympics in 1992. What you may not know is that the history of Barcelona is filled with similar transformations. It is a city that risk professionals should be able to appreciate, as it has not only survived countless “tail events” over the years, but has managed to thrive and continually reinvent itself in response. With that in mind, I would like to talk today about how supervisors and the industry have been responding to risk and positioning ourselves to continue to grow and evolve.

My talk today is likely to be one of my last public addresses as Chairman of the Basel Committee. Therefore, while the focus of my comments will be on the current situation and looking forward to the future, I hope you will allow me also to reflect on some of the things I have learned over the past years.

In the first part of my intervention today, I will discuss the current state of the new framework for bank capital adequacy, or Basel II, as well as how supervisors are carrying out work related to Basel II and sound risk management practices.

Second, I would like to discuss some of the key lessons that I've learned in the development of Basel II, which are factors that I believe will contribute not only to its successful implementation and longevity, but also more generally to financial stability and effective banking supervision.

And I will close with some more detailed comments on a lesson we have learned during this process that I think has broader implications for risk management in general – that is, the importance of taking account of the macroeconomic perspective and the effects of the cycle.

Basel II update

One of Barcelona's greatest claims to fame is its *modernista* architecture, exemplified by the work of Antoni Gaudí. The *modernistas* looked to the past for inspiration, but applied modern tools and techniques to create something new with a focus on intricate details. Of course, the Basel II Framework does not have the beauty of Gaudí's *Sagrada Família*, but I nevertheless think that both supervisors and the industry have accomplished something similar. Basel II builds on long-standing principles of bank safety and soundness, but with greater emphasis on modern tools of financial

risk management and differentiation of drivers of risk. And, like the *Sagrada Família*, the framework for Basel II is firmly in place but much work still remains until the plans are finally executed.

As I'm sure you're aware, with the publication of documents on trading book/double-default and downturn LGDs last year, the Basel Committee has completed its work on Basel II policy development. Our efforts are now firmly focused on the challenging task of implementing the Framework as efficiently and effectively as possible. With that in mind, I would like to now touch on some issues relating to the calibration and implementation of Basel II, as well as work in both the Committee and the industry on complex financial products and risk management

Calibration

One of the Committee's objectives throughout the development of Basel II has been to maintain the overall level of capital in the banking system. To meet this objective, the Committee introduced a so-called "scaling factor" of 1.06 into the Framework, with the agreement that this would be reviewed prior to final implementation.

The Committee has just completed its fifth Quantitative Impact Study, or QIS 5, and I would like to express my gratitude to those of you here today whose banks submitted data as part of this exercise. The Basel Committee will be meeting in Berlin next week, and one of the main items on our agenda will be to discuss the results. We hope to be able to say more about calibration shortly thereafter.

What I can say at this moment is that I have not seen anything that would call into question the framework, or which cannot be addressed through implementation. . We are carefully reviewing any dispersion of results to better understand the underlying reasons. Some dispersion is to be expected within a risk-based system, but it is important that material dispersions are driven by actual differences in risk. In addition, while there is still a need for better data quality in the future, it appears that the quality of data submitted in QIS 5 was greatly improved over the data submitted in the previous QIS exercises. This is certainly a positive development, and I hope banks continue to make strides in this area.

What is important to keep in mind about QIS 5 is that it represents a point-in-time view. We know that models and validations processes are still under development, just as banks are working to take into account the recent updates to the trading book regime and the guidance on incorporating economic downturn effects in LGD estimates. We cannot know the true impact of Basel II until it has actually been implemented, which is why we have built safeguards such as transitional floors into the Framework. That is one reason the Committee is placing so much importance on an effective Basel II implementation process, which brings me to my next point.

Implementation issues

From the outset, one of the key objectives of both Basel II and, indeed, the current Accord, has been to maintain a level playing field across jurisdictions. Since experience has shown that this was difficult to achieve even under the fairly rigid Basel I rules, the challenge will be even greater in the more flexible Basel II regime. One of the key lessons we have learned in this whole process is that having similar national rules, which are based on common international agreements, does not of itself create a level playing field.

What is essential is how the rules will be applied. The success of Basel II will depend to a large extent on our ability to achieve greater convergence in our supervisory practices in implementing these rules. This will require a much higher level of cooperation among supervisors than hitherto. Home country and host country supervisors will need to work closely with each other and with banks to provide effective supervision while minimising burden and duplication of effort. Although changes in financial markets mean that these efforts would in any case be necessary, Basel II has raised the stakes.

To promote convergence, the Committee has established an Accord Implementation Group, or AIG, which is chaired by Nick Le Pan, Superintendent of Financial Institutions in Canada and Vice-Chairman of the Basel Committee.

When the AIG began its work, it quickly became clear that there was no “one-size-fits-all” approach to implementing Basel II. Rather, implementation should be tailored to the specific circumstances of a bank and the jurisdictions it operates in. In this regard, one of the primary methods the AIG uses to promote convergence is to encourage home supervisors of the 50 or 60 largest internationally active banks in Basel Committee member countries to engage in practical outreach to host supervisors and the banks to open clear lines of communication and cooperation in based on banks’ own implementation plans. Each home supervisor coordinates the work in a way that is most practical in light of the particular bank circumstances and its own supervisory approach. It is clear that successful implementation rests on adequate flows of information, as well as trust among supervisors.

As we go forward, we need to strike an appropriate balance between top-down and bottom-up consistency. That is, the top-down rules and the bottom-up convergence of supervisory practices should work together to reinforce a level playing field. This balance will naturally be dynamic. Early on, the scales were tipped toward developing a common set of rules. Now that these rules are in place, the scale is tipping the other way toward enhancing communication and convergence among supervisors in the implementation of these rules. I expect that this dynamic process will accelerate through work within the AIG, with supervisors outside of the Committee, and by banks in the months and years ahead.

Risk management and complex products

Our response to changes in risks must also be dynamic, and it is to this aspect that I would like to turn now. In recent years, we have seen tremendous growth in the derivative markets, which include a range of quite complex products. In addition, these markets have attracted new participants, in particular hedge funds, whose risk profiles and exposures may not be transparent to regulators or to other market participants. While these developments have had the beneficial effect of diversifying and spreading credit risk, they have also posed new risks. I would like to briefly discuss steps that both supervisors and the industry are taking to promote better management of these risks, and to ensure that supervision keeps track with market developments.

Supervisory efforts

One important area where we are working within the Basel Committee to promote sound risk management practices is through a review and, if necessary, update of the Committee's 1999 paper on sound practices for banks' interactions with highly leveraged institutions. As part of this review, we are looking at emerging best practices related to banks' interactions with credit derivatives markets and hedge funds. In addition, we have had informal discussions regarding the potential impact on bank safety and soundness of prime brokerage activities.

We are also looking into how to better capture risks associated with banks' trading book positions in credit derivatives and highly structured and complex products. The AIG has established a working group that is following up on the Committee's July 2005 trading book guidance. This working group, in consultation with the industry, is in the process of identifying possible principles for the implementation of so-called incremental default risk charge for trading book capital, and will be exploring other issues related to the measurement and modelling of risk in the trading book.

And work is also going on outside the auspices of the Basel Committee. Many of you are probably aware that the Federal Reserve Bank of New York and the UK Financial Services Authority, in conjunction with other supervisors of major credit derivative dealers, have encouraged the industry to focus greater attention on sound risk management practices and the infrastructure of the credit derivatives markets by improving controls around assignments, reducing confirmation backlogs and increasing the use of electronic matching platforms. Other supervisors are reviewing bank stress testing practices and potential risks arising from banks' private equity activities and exposures to hedge funds. The Basel Committee supports these efforts, and members will continue to keep each other informed on the results of their reviews.

Private sector initiatives

The public good of financial stability is not just of interest to supervisors and public authorities, but also to the financial sector. The industry has therefore undertaken a number of valuable initiatives

aimed at responding to financial risks in the marketplace. One key example is the Report of the Counterparty Risk Management Policy Group II, better known as the “Corrigan report.”

There is no question that the global financial system has become more interlinked, which, when combined with the introduction of new and complex products, raises the question of how well market participants could absorb a potential major financial shock in the future. In response, a group of the largest players in the global financial markets developed a series of recommendations and guiding principles to strengthen the resiliency of the financial system.

Given the complexity of the subject, it is not surprising that the Corrigan report is a long and complex document. We found the same challenge in developing Basel II, I might add. But I think that this is a very valuable piece of work, and that the supervisory community can very much welcome its recommendations and guiding principles. We are certainly taking it into account in our work on the issues that I have mentioned.

In reflecting on the various strands of work that are underway in both the industry and in the supervisory community, I am encouraged by the fact that many of the findings of industry projects such as the Corrigan report are consistent with the lessons we have learned from the Basel II process and from other strands of the Committee’s work.

Lessons learned

That brings me to my second broad topic, which is the lessons we have learned over the years as we have developed Basel II. I am not looking back simply for the sake of nostalgia. Rather, in looking to the past, I would like to share some thoughts on how the things we have learned and reflected in the process of developing Basel II will help to make Basel II successful in the future, to stand the test of time and to have the impact that we intended.

Focus on risk management

First, Basel II is fundamentally about establishing incentive-based approaches to risk and capital within the three-pillar framework. We should never lose sight of the fact that Basel II is built around both qualitative and quantitative risk management elements.

Why is this so important? As a bank supervisor and central banker, what most concerns me is financial stability. When I review the various reports on this subject that cross my desk, one thing they almost always have in common is an emphasis on the link between sound risk management and financial stability. It is my hope—indeed, it is my belief—that the incentives for risk management in Basel II will therefore promote greater financial stability in the future.

Improved and more formalised risk management, as fostered by Basel II, will bring more awareness of risks and better quantification of these risks. To the extent that risk assessment and

control methods become more formalised and rigorous, this will lessen the likelihood of making bad decisions. It will also contribute to the prompt detection of errors and deviations from targets, allowing banks to implement corrective measures and develop buffers as appropriate at an early stage. Banks should be encouraged to develop systems that allow managers to identify and understand the risks they are facing, consider the risks that may arise in the future, and respond promptly and actively to both. This will maximise the likelihood that they can continue to operate, even in the most difficult of conditions.

Continued outreach and dialogue

A second lesson I have learned through the development of Basel II is that communication with interested parties is absolutely essential. One reason we were able to incorporate leading practices into Basel II is because of the open and transparent process by which the Framework was developed. There has been a steady dialogue with the industry since the Committee began discussing revisions to the capital Accord back in 1999. Many of the firms represented here today contributed extensive and valuable feedback to the Committee on its proposals over the years.

The Committee has tried to explain to the industry as clearly as possible its objectives and methods during this process, and in turn firms and industry associations have shown a willingness to engage in a serious dialogue to find practical, prudent solutions. This has helped supervisors to better understand the state of industry practice. Where we have found these practices to be reasonable and appropriate we have tried to incorporate them into the revised Framework in a sound manner. Looking ahead, one of the benefits of this transparent process is that it has set the tone for discussions between banks and supervisors as industry practices evolve going forward.

We have also greatly benefited from the dialogue we have maintained with our supervisory colleagues outside of the Basel Committee. I believe that it is in many countries' best interest to adopt the new Framework when they are ready, so it is critical that supervisors in these countries be part of the Basel II conversations. The Basel Committee has established several mechanisms for heightened dialogue with our fellow supervisors, and we are fully committed to further enhancing this dialogue.

Principles versus rules

A third lesson I have learned is that it is important to strike the right balance between principles and rules. Of course, we want to ensure that banks apply principles in the same manner and that supervisors interpret them in the same way even in different jurisdictions.

But while the temptation is to do this through ever more detailed rules, I am reminded of the words of the famous Surrealist painter Salvador Dalí, who said: "Have no fear of perfection—you'll never reach it." We have learned from the Basel II process that adding detail to the rules does not

guarantee a level playing field or equal application. The marginal utility of adding detail falls rapidly as you move ahead in a process such as Basel II, so we need more than detail and prescriptiveness. We need a bottom-up, cooperative approach that maintains a focus on principles of effective risk measurement and management.

As we have moved into implementation, the Committee has placed greater emphasis on principles-based guidance, for example through the use of so-called Basel Committee Newsletters. We have found that these Newsletters, which clarify supervisory expectations rather than establishing more rules and making the Framework more complicated, have been well-received. Examples include recent Committee guidance on the use of vendor products in the IRB framework and the treatment of expected losses in an operational risk AMA. In my view, such an approach to communication with the industry allows for a range of sound practices and encourages further work by both banks and supervisors, but does not “lower the bar” in terms of supervisory expectations for risk management and capital adequacy.

The importance of the macroeconomic perspective

Let me close my intervention today by dedicating a little more time to something which has been increasingly recognised over recent years, and which I think will become even more critical to risk management in the future - the macroeconomic perspective.

It is clear to me that taking a point-in-time approach to transactions, or looking at them from a narrow “micro” perspective, does not provide a sufficiently comprehensive picture of the underlying risks. It is important to take a broader “macro” approach, and one that builds in the impact of possible changes in the cycle.

This is a philosophy that we have built into Basel II. In fact, I would say that there is no other international regulatory initiative that gives more attention to these questions. For the sake of brevity, I will give you just three examples of how the new framework encourages banks to consider how risk determinants change over the cycle and in stressed conditions.

First, banks are expected to use sufficiently long time series of historical data in designing their rating systems. The aim is to capture as much data as possible about how relevant factors have behaved in the past. Furthermore, when assigning ratings to borrowers, they should also consider how the borrower’s ability to meet contractual obligations may change in the future as a result of possible changes in economic conditions over the course of the cycle.

Second, banks’ LGD estimates should reflect economic downturn conditions. The potential for realised losses to be higher than average during times of high default rates may be a material source of unexpected credit losses for some exposures. The Committee has elaborated principles

that banks are expected to fulfil in this respect, and will continue to monitor industry practice and encourage the development of appropriate approaches to this issue.

Third, Basel II places much emphasis on stress testing in the assessment of capital adequacy. Indeed, the new framework sets specific stress test requirements for banks using the advanced approaches to credit risk, but also encourages the use of these tests more generally. And the value of stress testing and scenario analysis is even more important in those situations where risk measurement is based on scarce or incomplete data or unproven quantitative tools.

The above mentioned examples demonstrate the clear view we have taken in the Committee that the sound and stable functioning of credit institutions requires consideration not only of micro conditions, but also, and very importantly, incorporating a macro, long-term and forward-looking perspective.

I think these principles also make good business sense. I believe that risk managers, should incorporate macro perspectives into their risk management models and into the design of the bank's capital strategy. That is, to analyse how risks may change through the cycle and in stressed economic conditions, and incorporate these elements into the decision-making process.

It is often thought that risks increase during times of economic downturn. But this is only partly true. Banks' risks increase as they take on more business and extend more credit during times of economic expansion. The risks may not crystallise until times of difficulty, but the seeds are sown during the good times. It seems to me to be both prudent policy and consistent with risk management objectives to take a long term perspective, using the results to make decisions that gain room for manoeuvre in the good times in order to face up to difficulties that arise in the bad times..

In the end, the most risky behaviour is one characterised by over-optimism, and lack of consideration of all the relevant risks. This means that when shocks occur, entities are unprepared and tend to react abruptly, causing problems for their institution and, sometimes, for the whole system. On the contrary, adopting a forward-looking approach, which takes account of the possible impact of broader changes in the cycle, should help institutions to avoid mistakes and bad decisions, and to detect and respond to problems in a smoother fashion and at an earlier stage.

Conclusion

In closing, I would like to thank you as risk professionals for your inputs to the various Basel Committee initiatives during my Chairmanship, especially Basel II. A unique element of Basel II is that rather than imposing a purely regulatory approach, it incorporates what the Basel Committee views as leading practices in bank risk management. In developing the revised Framework, the

Committee sought to incorporate rigorous and comprehensive risk management approaches into the regulatory structure. We could not have come as far as we have without the advances in risk management that you in the industry have developed. Moreover, as industry practices continue to evolve, I believe the Framework is flexible enough that these advances can be incorporated on an ongoing basis.

These past several years have been among the most interesting and challenging in my career, and I will always look back on the accomplishments of the Basel Committee over this period with a mixture of pride and humility.

Thank you very much, and I would be happy to take any questions.