

BASEL II AND OPERATIONAL RISK: OPPORTUNITIES AND CHALLENGES

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OVERVIEW: 5 KEY MESSAGES

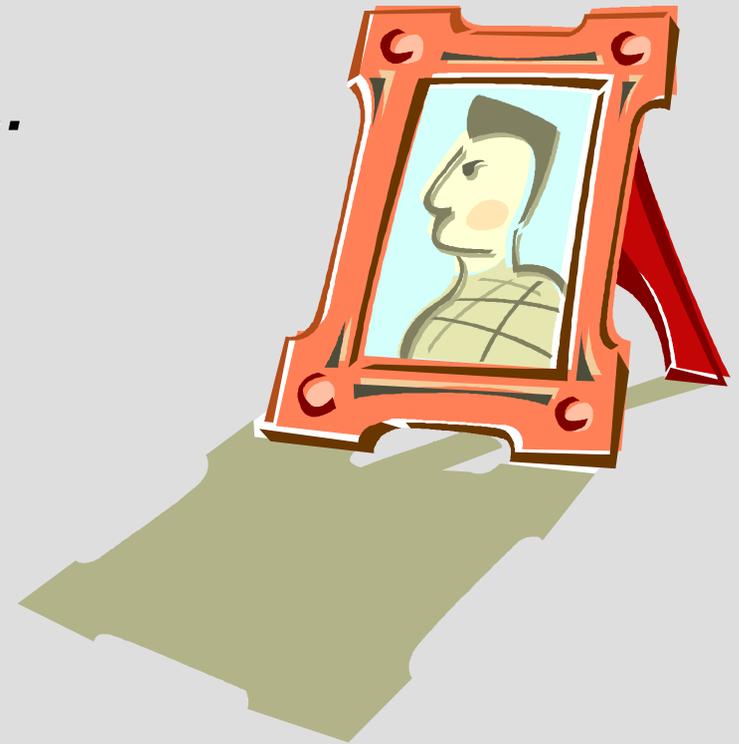


- ✓ ***Simplicity of Basel II***
- ✓ ***Macro-economic impact***
- ✓ ***Basel II as a business tool***
- ✓ ***Depth of implementation***
- ✓ ***International cooperation***

BASEL II IS A SIMPLE FRAMEWORK (!)

This might seem an odd statement, given the number of pages contained in the Capital Requirements Directive, and in CEBS' guidelines...

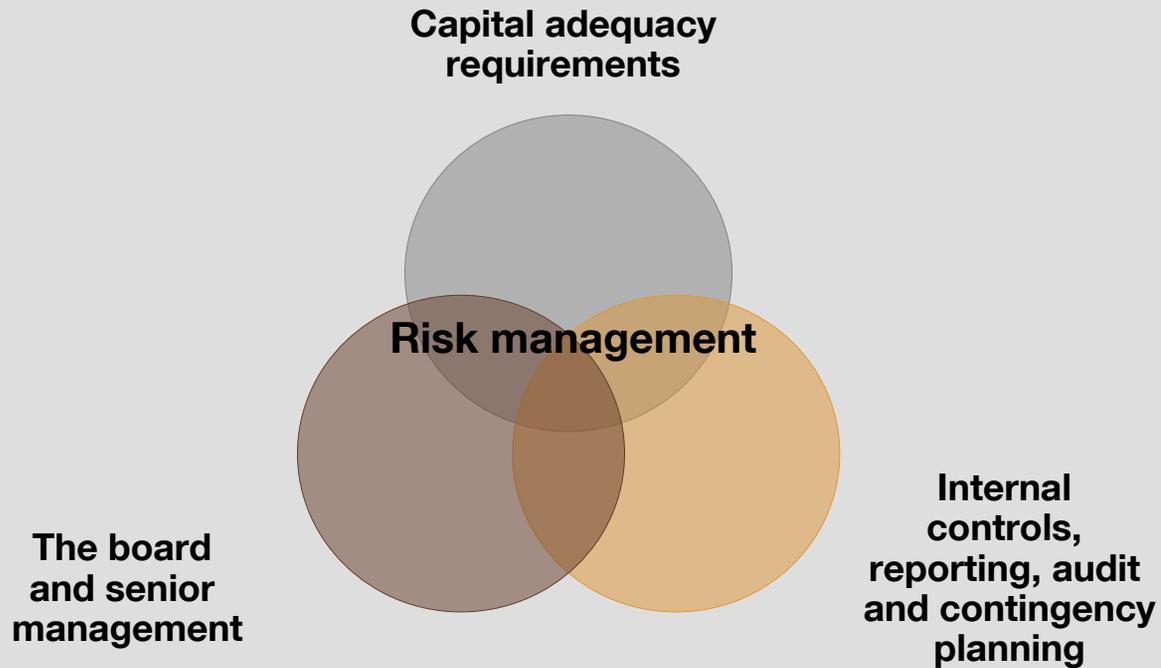
...But, like a painting, it is best understood when standing back from the detail



THE UNDERLYING AIM IS SIMPLE

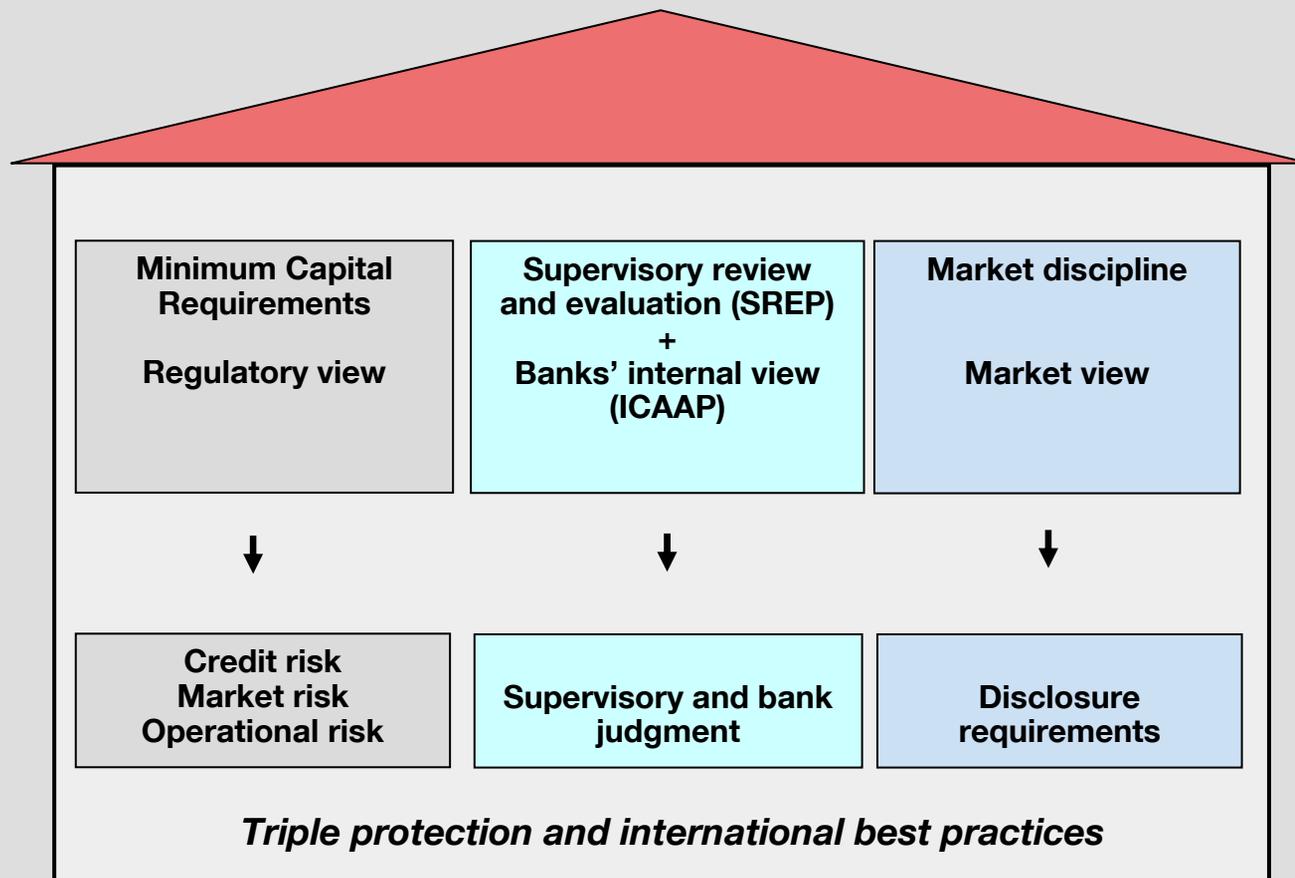


=> *To promote better risk management*



THE UNDERLYING ARCHITECTURE TOO

=> *Three mutually-reinforcing pillars*



WIDER BENEFITS

- => Even disregarding its public policy objectives, Basel II makes macro- and micro-economic sense**
- **Better allocation of resources**
 - *Economic capital and regulatory capital move closer together*
 - *Minimises distortion in the allocation of capital to risk*
 - **Less procyclical behaviour**
 - *Better risk management means*
 - being better able to anticipate adverse events
 - better prepared and
 - more likely to react in a smooth way
 - **An effective business tool**
 - *Proper risk identification, monitoring, management and mitigation make good business sense*

CHALLENGES OF IMPLEMENTATION: DEPTH VERSUS TICK-BOX



- ***A “tick-box” approach to Basel II implementation could be the biggest threat to its effectiveness***
- **The principles of Basel II should be deeply embedded**
 - In high-level strategy,
 - In management, and
 - In day-to-day business decisions
- **The AMA approach to operational risk is a key example**
 - It is really the first window open for implementing internal modelling techniques

“TICK-BOX” NOT SUITABLE FOR AMA



- ***A “tick-box” assessment would mean that the assessment of a total is done through the assessment of its components***
- **A pre-requisite for a meaningful assessment is that the relationship between a “total” and its components is perfectly known, and particularly**
 - The role and importance of each component within a module
 - The interaction between components and modules
 - The impact of external conditions (e.g. environmental)
 -
- **A bank’s AMA approach should be analysed and well understood**
 - It is not possible to assess the reliability of an AMA approach based on the isolated assessment of each quantitative and qualitative requirement (components)
 - It will take a long time before supervisors become confident of the real functioning of each AMA approach

CHALLENGES OF IMPLEMENTATION: SUPERVISORY COOPERATION (1)



- ***There is absolutely no need to convince supervisors that cooperation is necessary***
 - They are fully aware of the importance of consistency and efficiency in supervision
 - Especially in relation to pan-EU institutions

- ***But while Basel II is a catalyst for cooperation, it also undoubtedly makes it more complex***
 - Achieving a level playing field between 25 countries is not easy
 - And uniformity of approach is neither possible nor desirable

CHALLENGES OF IMPLEMENTATION: SUPERVISORY COOPERATION (2)



- Supervisors are working hard - bilaterally, multilaterally, through CEBS and other fora - including in relation to validation of advanced approaches of EU groups
- There are difficult trade-offs, for example:
 - Rules versus discretion
 - “Hardwiring” versus soft guidelines
- This work behind the scenes will not always be visible, but the results should be felt

THANK YOU FOR YOUR ATTENTION

BANCO DE **ESPAÑA**



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1856 - 2006