# Reflections on Basel II and Financial Stability

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*Luxembourg, September 2005*

# Overview

- There is a growing perception that Basel II is about much more than just compliance for banks.
- This is an idea that the Basel Committee has promoted for a long time. We have often explained that Basel II is much more than a compliance exercise and, in fact, represents an unparalleled opportunity for banks, supervisors and central bankers.
- Today, I would like to make a few reflections about these opportunities and implications, especially in the area of financial stability. I will also take advantage of this opportunity to update you on our work in the Basel Committee.

1. Basel II - Benefits and opportunities beyond compliance
2. Update on the Basel II process

## 1. Basel II - Benefits and opportunities beyond compliance

– Opportunities for banks
– Opportunities for supervisors
– Basel II and financial stability
    - ***An enhanced macro perspective***
    - ***Better risk management***
    - ***Transparency and market discipline***
    - ***Better and more consistent supervision***

# Opportunities for banks

- **Basel II represents an unparalleled opportunity for banks to improve their capital strategies and risk management systems.**
- **Let me quote a recent article: *"…while the road to Basel II is proving harder than expected, those banks that successfully seize the resulting opportunities will be tomorrow's winners."***
- **Basel II represents the recognition of the progress made by banks in recent times to develop and improve their risk management and measurement systems. It is also an encouragement to continue this work.**
- ***"Basel II is the stimulus not the reason"***
- **Incorporating best risk management practices in a regulation requires:**
  - Building on the best practices of the banks themselves, while
  - Avoiding excessive prescriptiveness, so as to allow financial innovation

# Opportunities for supervisors

- Basel II is a new kind of framework for prudential regulation.
- Since capital is the last line of defence against bank insolvency, regulatory capital requirements continue to be one of the fundamental elements of banking supervision.
- But Basel II is about much more than just setting better quantitative minimum capital requirements. It is about establishing an incentive-based approach to risk and capital adequacy management, within a comprehensive framework of three mutually-supporting pillars.
- The new capital framework represents a significant step towards a more comprehensive and risk-sensitive supervisory approach.
- But, more than this, all of the work, papers and discussions about risk management during these 6 years represent a major achievement in terms of improving understanding and awareness, of developing common concepts, a common language and a solid framework for discussions.

# Basel II and financial stability (1)

- **Discussing financial stability issues is always a challenge because we do not have as comprehensive a framework for financial stability as we do for price stability.**
- **We know that a stable financial system is critical to the long-term growth of an economy and also that episodes of financial instability do occur, and not only when systemic financial institutions fail.**
- **Indeed, one can find the seeds of some of the major financial crises (which ultimately led to persistent negative impacts in the real economy) in unbalanced developments in asset and debt markets.**
- **Although low and stable inflation is a clear prerequisite for macroeconomic stability, this does not *per se* eliminate the potential risk of disturbances that can adversely affect economic performance.**
- **Those dangers are often linked to excessive risk-taking in the credit or asset markets, leading to episodes of financial instability.**
- **In recent years, we have also learned that the pursuit of financial stability requires a combination of macro and micro elements. As a consequence, it should be based on a broad range of tools, which we should all seek to strengthen, and should foster financial innovation and ensure a level playing field.**

# Basel II and financial stability (2)

- **The first, and most obvious, contribution of Basel II to financial stability is in strengthening the solvency and, therefore, the shock absorption capacity of banks and the banking system.**
- **In addition to strengthening the soundness of the banking system, I believe that certain important elements in Basel II can contribute, firstly, to restricting the build-up of financial imbalances, thus diminishing the probability of extreme adverse shocks; and secondly, to mitigating their negative consequences.**
- **I will group these elements into four categories:**
  - **An enhanced macro perspective**
  - **Better risk management**
  - **Transparency and market discipline**
  - **Better and more consistent supervision**
- **To what extent can better risk management, within a macro perspective, and greater transparency help to moderate distortions in risk-return behavioral temporal patterns? To what extent can the build-up of financial imbalances be mitigated and the probability of extreme adverse shocks reduced?**

# Macro perspective (1)

- The Basel II framework incorporates not only the micro perspective to risks, but also the macro perspective.
- We have tried to encompass how micro risks can change through the cycle and in stressed economic conditions.
- We have been very conscious of how micro prudential regulation can influence macro behaviour, and also of how different macro scenarios can change the risks that banks face.
- Basel II has been thoroughly scrutinised, not only by ourselves but also by many other parties, to evaluate its consequences in macroeconomic terms, e.g.: procyclicality; implications for cross-border financial flows, especially to emerging markets and areas of strategic importance to the economy (SMEs) etc.
- We welcome all of these contributions, which have significantly improved the framework as well as our understanding of very important issues.
- And it will be important to continue to monitor and analyse the effects of Basel II in the future.
- I believe that the macro perspective of Basel II will contribute to strengthen the stability of the financial system as a whole, and improve the financial sector's ability to serve as a source for sustainable growth for the broader economy.

# Macro perspective (2)

- Let me mention some elements in the Basel II framework that reflect this enhanced macro perspective.
- First: Appropriate time horizon, counter-cyclical elements and the need for stress testing.
  - Risk management decisions, capital and provisioning policies should be set with an appropriate time horizon that allows at least a full business cycle to be considered and avoids excessive emphasis on the short term when assessing risks.
  - The guidance for ratings processes encourages banks to take more account of uncertainty over the full economic cycle.
  - Risk parameters estimated as a long-run average (PD) or to reflect downturns (LGD).
  - The need for capital in a full range of economic scenarios has resulted in a requirement that banks consider stress scenarios when assessing capital adequacy.

# Basel II macro perspective (3)

- **Second: Appropriate and risk-sensitive shock absorbers.**
  - Forward-looking risk management that is aware of how risk-drivers change through the cycle and in stressed conditions will tend to build shock absorbers to be used when difficult times arrive.
  - Basel II encourages the appropriate use of capital buffers. Let me add now that the idea of building robustness in good times is not only a prudent policy, it is also theoretically consistent because we all have a tendency to think that risks increase in bad times. From my perspective, this is only true in part. A better description is to say that exposures and therefore risks increase in good times and that in bad times these risks materialise.
  - Nothing threatens financial stability more than "risk blindness" and poorly-managed and poorly-capitalised and provisioned banking institutions.
  - Basel II also encourages better provisioning etc.

# Better risk management (1)

- The second group of elements is related to the capacity of Basel II to foster better risk management.
- As I said, Basel II is a major step forward in strengthening the incentives for the ongoing improvement of banks' risk measurement and management systems.
- Given that the disorderly granting of credit is often a defining characteristic of an extreme and unstable phase of financial euphoria, a regulatory framework that provides banks with strong incentives for sound risk assessment should be conducive to a more watchful and efficient allocation of credit.
- In this sense, one would naturally expect a more risk-sensitive capital framework to make banks more likely to account for the true risks of lending policies aimed at achieving short-run-focused targets, such as market share or portfolio size, at the expense of putting their medium-term financial health more at risk.
- Since speculative activities naturally fit into this risk-return temporal pattern, given that they usually yield substantial immediate profits at the outset at the expense of a possible once-for-all large loss at an uncertain future date, a more cautious credit strategy will tend to penalise the funding of self-fulfilling asset-revaluation processes

# Better risk management (2)

- The improvement of risk management is an important channel of influence of Basel II.
- A word of caution: Quantifying risk involves making assumptions and judgements. But no model or software package, no matter how sophisticated, can replace the skills and judgement of a trained, experienced and conscientious risk manager (although such judgement should, of course, be reinforced with the best possible information and techniques).
- In other words, risk management is not just about quantitative models, but also about qualitative issues, i.e. promoting a risk culture.
- That is why we have made sure that the Basel II framework is much more than numbers and models.

# Better risk management (3)

- **Improved and more formalized risk management will bring:**
  - **More awareness and better assessment (and quantification) of risks. The firm is less likely to ignore material sources of risk.**
  - **Using the concept of economic capital and its elements, banks can develop sound policies to determine their risk profiles and for monitoring exposure limits, risk-adjusted pricing policies and sound provisioning practices based on the inherent risks of the portfolios. They can measure returns and assign capital on a risk-adjusted basis.**
  - **The ability to understand and use appropriately new mitigation techniques.**
  - **Greater awareness and earlier reaction is likely to lead to a smoother adjustment to new conditions or to correction of mistakes, making decisions less abrupt.**
  - **This early reaction will be supported by the supervisory second pillar and by the transparency of the third pillar,**
  - **Capacity to communicate, in a transparent manner, complex issues such as positions and policies in risk management.**

# Transparency

- A very important reason why I believe Basel II will contribute to financial stability involves greater transparency. The exercise of market discipline should be considered a vital element of successful prudential policies.
- A vast amount of analysis and research on these issues has underlined the role of information asymmetries in financial intermediation. Indeed, it is no overstatement to say that the presence of asymmetric information between lenders and borrowers in financial markets can explain much of their inherent instability.
- Higher transparency in the information provided by banks on their balance-sheet and risk position, along the lines of that set out in Pillar 3, must undoubtedly alleviate such asymmetries, thus reducing the likelihood of an episode of profound disintermediation and, by fostering the public's confidence in the banking system, facilitating market access conditions and easing the recovery of the financial pulse in the event of a downturn.

# In summary

**Shock absorbers that are more risk-sensitive and cycle-conscious**

**+**

**Enhanced Transparency => improved conditions to raise capital as well as incentives to hold adequate capital**

**+**

**Better and more pre-emptive risk management, based on improved control structures and corporate governance, investments in technology, information databases and human capital.**

**A banking system that is more stable and efficient in the allocation of resources, and also more risk-efficient.**

# Better and more consistent supervision

- **Risk-based supervision**
  - Banking supervision has traditionally sought to ensure the solvency of banks by emphasising an accounting review of their financial and capital position.
  - There is certainly still a role for this type of review, particularly in assessing asset quality and ensuring proper provisioning and risk concentration policies.
  - However, the traditional approach is no longer sufficient.
  - It is essential to complement the traditional accounting approach with a greater emphasis on an analysis of the risks that affect banks and the management and control systems that mitigate such risks.
  - Basel II promotes such a risk-based approach.
- **Greater cross-border cooperation among supervisors**
  - The growing scope and complexity of banking groups and financial markets make it necessary to increase international cooperation between supervisors.
  - Basel II not only encourages such cooperation; its success will largely depend on its effectiveness. It will be necessary in the future to foster greater cooperation, coordination, and consistency in evaluating banks' capital adequacy.
  - Work is underway on a variety of fronts to promote such cooperation. First and foremost, the Basel Committee's Accord Implementation Group, or AIG, is working to foster information-sharing among supervisors to promote consistency of Basel II implementation.

## 2. Update on the Basel II process

– Timeline and recent activities
– Calibration
– Work on the trading book & double default
– Lessons for the future and cross-border implementation

# Timeline

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|---|---|
| ▪ June 2004 | Publication of the revised framework: Basel II |
| ▪ April 2005 | Consultative paper on Trading Book issues and Double default |
| ▪ July 2005 | Publication of Trading activities and Double default in Basel II |
| ▪ Fourth quarter 2005 | Data collection for recalibration exercise |
| ▪ Spring 2006 | Recalibration |
| ▪ Jan 2007 | Standardised Approach and Foundation IRB available |
| ▪ Jan 2008 | Advanced IRB available (full implementation) |

# Outline: recent activities

- The Basel II near-term work programme was completed this summer.
- During July and August we published:
  - *The application of Basel II to trading activities and the treatment of double default effects*, which was prepared by a joint working group of the Basel Committee and the International Organization of Securities Commissions (IOSCO);
  - *Guidance on the estimation of loss given default* (Paragraph 468 of the Framework Document);
  - *Validation of low-default portfolios in the Basel II Framework;* and
  - *QIS5* (Fifth Quantitative Impact Study)
- And, not related to Basel II:
  - *Supervisory guidance on banks' use of the fair value option under international financial reporting standards;*
  - *Consultative paper. Enhancing Corporate Governance for Banking Organisations*

# Calibration

- The Committee has long stated its intention to conduct work to re-confirm that the new framework meets our objective to broadly maintain the aggregate level of capital requirements, while retaining the incentives to enhance risk management.
- We will begin the recalibration exercise in autumn this year. Data will be collected during the so-called fifth impact study (QIS5) between October and December 2005. And we will conduct the calibration in spring 2006.
- This early recalibration will allow us to accommodate the needs of the national rulemaking processes and will provide banks and supervisors with more time to reflect and facilitate implementation.
- In addition, national field tests are already underway in some jurisdictions, while there will be a period of time during which banks will calculate their capital requirements in parallel.
- This exercise will provide a significant amount of information. I think we have the necessary tools to understand all the implications, including the cyclical changes, and to complete a sound calibration exercise.

# Work on trading book & double default (1)

- Neither the existing market risk capital rules nor the Basel II proposals went far enough in recognising advances in the management and measurement of certain risks that had taken place during the development of the new framework.
- Two areas were identified by both banks and supervisors in January 2004 where refinements could already commence: “double default,” and the treatment of certain exposures arising from trading activities.
- Because both banks and securities firms have a great interest in the potential solutions to these particular issues, the Basel Committee worked jointly with the International Organization of Securities Commissions (IOSCO) to consult with industry representatives and other supervisors.
- This co-operation with IOSCO in areas of mutual interest has been a very fruitful and beneficial experience

# Work on trading book & double default (2)

- The objective was not to overhaul the capital rules for trading book exposures, but rather to seek to address a handful of concerns that relate either to potential inconsistencies with the new treatment for banking book assets or that relate to a limited number of issues that have arisen since the Market Risk Amendment.
- First, a survey on trading book practices: summer 2004.
- Consultation paper published April 2005, with five specific areas of focus:
  1. Treatment of counterparty credit risk for over-the-counter derivatives, repo-style and securities financing transactions; and the treatment of cross-product netting agreements;
  2. Treatment of double-default effects;
  3. Short-term maturity adjustment, under the internal ratings-based approach, for some trading book-related items;
  4. A limited number of improvements to the current trading book regime, especially with respect to the treatment of specific risk; and
  5. The design of a specific capital treatment for unsettled and failed transactions.
- Final paper published July 2005.

# Lessons for the future (1)

- In trying to devise our agenda for future work, let me express some general thoughts and lessons derived from the years of work preparing Basel II.
- Consultation
  - The open consultation process and collaboration with the industry and with other supervisory bodies has been vital for the culmination of this project. The influence of all these contributions can be seen in the significant changes that were introduced in the text of the new framework during the six years of preparation. We are very grateful for this input.
  - Obviously, different parties do not always share the same views, for example regulators and supervisors have to defend the public good of financial stability. But the results have been so positive that it seems clear that this consultative and cooperative approach should be part of any future work project.
- Principles versus rules
  - We have learned how difficult is to strike the right balance between principles and rules. Most people, myself included, agree on the advantages of principle-based standards, but the reality is that when you introduce other ingredients in the formula (the need to maintain a level playing field, the need for comparable and consistent supervisory practices across borders etc.) you tend to find that some guidance and details are required. We have been actively trying to contain this to a reasonable level and we will continue to do so.

# Lessons for the future (2)

- **Regulatory burden**
  - We should not underestimate the workload that changes in regulation bring about. This is especially the case when, as at present, several implementation efforts coincide in a short period of time. In Europe, the introduction of the new international accounting standards and the preparation for Basel II are demanding significant efforts and resources from the industry and we should try to facilitate this process.
  - We recognise the growing concern about the amount and complexities of the new regulatory initiatives coming out of various international fora, and as a consequence I think we need to pause to digest present changes.
  - It is clear that the Basel Committee is expected to act in a timely manner to address the risks arising from the growth of large and complex financial institutions, increased use of complex financial products and changes in the market structure and practices, but again there are good reasons to concentrate in the quality of the standards and in the consistency of their implementation.
  - Consistency of implementation is going to be the first priority in our future work.

# Cross-border issues

- Cross-border issues are not new. One of the goals of both Basel I and Basel II is to foster a more level playing field for internationally active competitors. BUT:
- Markets are changing. Cross-border activity is growing, financial groups are becoming bigger and transactions more complex and in some countries a systemic part of their financial system is in foreign hands.
- In addition, international banks are centralizing some functions and tend to apply to the whole group common techniques, systems and culture. At the same time, banking regulation and supervision remains predominantly a national responsibility.
- With or without Basel II => need to enhance cooperation in a world that moves towards larger scale cross-border activities and a greater presence of systemic foreign banks in domestic economies.
- Basel II implementation will need carefully structured Home/Host relationships.

# Cross-border implementation of Basel II: a key challenge

- Consistent cross-border implementation of Basel II and enhanced home-host co-operation is a key challenge.
- There are various areas to be considered, e.g.
  - Initial and ongoing validation of advanced Pillar 1 approaches. Consistency across jurisdictions.
  - Recognition of external credit ratings in different jurisdictions.
  - The supervisory review process under Pillar 2.
  - Cooperation among supervisors needs to be enhanced.
- It is important to ensure that banks will focus on managing their risks rather than managing the demands of different supervisors.
- How can Basel II be implemented in an effective and efficient way which minimises the burden on internationally active banking groups and still respects the legal responsibilities and legitimate concerns of home and host supervisors in maintaining safe and sound banking systems?
- The AIG is conducting important work on this issue.

# EU perspective

- From an EU perspective, there are additional particularities, which bring both challenges and opportunities:
  - There is a political objective (Lisbon) to achieve a single market in financial services.
  - We have a well-established body of EU banking legislation, including legislation that clearly sets out home and host responsibilities.
  - We have a new regulatory and supervisory framework for banking: the Lamfalussy approach.
  - As part of this, we have the Committee of European Banking Supervisors (CEBS), which has already made good progress on supervisory cooperation and convergence.
- Therefore, we can, and should, go further in the EU in pushing for consistent implementation of Basel II, including effective home-host co-operation. We should be ambitious and set and example.
- We need an approach that recognises the legitimate concerns of the industry and promotes efficiency – more coordination, and a larger role for the consolidated supervisor
- We must also use to best effect the range of tools at our disposal – not just legislative solutions but also supervisory convergence and co-operation

# Accounting

- Let me mention another strand of work that will continue to pursue in the future: cooperation in the area of accounting.
- Accounting standards are extremely important for bank behaviour and therefore for setting the right incentives to foster financial stability. They may have important implications in bank capital and in the supervisors' ability to asses bank safety and soundness.
- The BCBS has been strongly committed to promoting the development of sound international accounting and disclosure standards. We support:
  - The quest for common, high-quality financial reporting standards and sound implementing practices by banks.
  - The international convergence of accounting standards.
- As supervisors we call for accounting standards that provide an unbiased picture of a firm's condition and at the same time support, or at least are compatible with, sound risk management, that enhance transparency and contribute to financial stability.
- Banking supervisors place a great deal of emphasis on forward-looking risk assessments to promote long-term safety and soundness.

# Conclusions

- **Basel II recognizes the importance of a combination of micro and macro factors for achieving greater financial stability. Furthermore, I would say that Basel II incorporates some of the key basic principles that are also built in modern approaches to monetary policy: a flexible and forward-looking approach, anticipatory rather than reactive behaviour to risk, and the need to take into account market views.**
- **The Revised Framework is intended to promote a more forward-looking approach to capital supervision, one that encourages banks to identify the risks they may face, today and in the future, and to develop or improve their ability to manage those risks. As a result, the Revised Framework is intended to be more flexible and better able to evolve with advances in markets and risk management practices.**
- **Looking into the future, we must direct our resources to ensure that banking supervision in the 21st century is more dynamic, more preventive, more flexible, more inclusive, and more transparent. We should continue adapting and learning. I believe the ultimate objective of financial stability increasingly requires cooperation and properly aligned incentives on the part of the industry, markets, and supervisors.**
- **Basel II is a real challenge and we should not underestimate the workload and complexities of the implementation phase, but I think it is useful to approach it from the perspective of recognising the valuable opportunities it provides.**

**Thank you for your attention.**