Basel II and Financial Institution Resiliency*

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Introduction

I am pleased to join you today to speak about Basel II and financial institution resiliency. I would first like to commend the conference organisers for putting together such a comprehensive programme of events this week.

I am grateful for the opportunity to discuss the Basel II Framework and how it was designed to help make banks more resilient in the face of turbulent waters and constantly shifting currents. Resilience comes from the Latin word for "rebound", which implies change from the status quo and change is the only constant in the business of banking. Banks sometimes need to adjust to unexpected and unwanted shocks, though change also arises in a more positive way, such as innovation. Today I will focus on our changing financial landscape and how the work of the Basel Committee and, most notably, the Basel II framework helps firms and financial systems to become more resilient to these changes.

From my perspective, financial resiliency has three distinct elements. First, it includes the existence and promotion of sound economic and financial policies. The second element is a resilient financial market infrastructure underpinning the system, which includes sound payment systems, robust exchanges, prudent accounting standards and sensible governance standards. Third, it is essential to have robust and resilient core firms at the centre of the financial system operating on safe and sound risk management practices. A sound global capital adequacy framework is critical to ensure the robustness and resilience of these firms. It is on this third dimension that Basel II plays an important role and on which I will focus my remarks.

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Basel II – General

We are witnessing a rapidly changing financial environment, which in some cases represents a sea change from traditional practices. We have seen significant advances in technology and financial product innovation that have reshaped the role played by banks in the credit process. An example is the shift in business models. Core institutions are moving away from traditional buy-and-hold strategies to an originate-to-distribute or market-based model. Changes such as these create new challenges – as well as new opportunities – for bankers as well as for supervisors.

Innovation has led to new techniques and tools for managing credit portfolios and this has been accompanied by increased complexity. A regulatory framework based on a simple risk weight scheme has become less and less effective in assessing an appropriate level of regulatory capital against these new, complex risk exposures.

Basel II – Pillar 1

The Basel Committee's response has been to capitalise on the improvements in banks' risk management systems to better address the complexity and innovation that we see today. This is reflected in the first pillar of the framework that relates to minimum capital requirements. In order to meet the challenges, the Committee leverages off the core building blocks of banks' risk management systems, namely the probability of default, loss given default and exposure at default. These are concepts that are integral to the risk management systems developed by large banks. By utilising these concepts, Basel II provides a more meaningful signal between risk taking and capital. This, in turn, reinforces sound risk measurement techniques and the framework is sufficiently flexible to accommodate new techniques and products.

There are many aspects of Basel II that were drawn from modern risk management techniques and industry best practice. Banks themselves have indicated that Basel II has produced improvements in their risk management processes by spurring innovative work in several important areas. Let me give you a few concrete examples to illustrate this.

First, under Basel II, we have seen substantial advances in operational risk measurement and management, particularly with respect to complex risk transfer arrangements. Since the Basel II discussions began in the late 1990s, there has been a tremendous increase in research on operational risk, including the forms it can take, the ways in which it arises, measurement methods and techniques to mitigate the risk. As a result, the industry has witnessed a surge of innovation and development in these areas.

Second, with respect to stressed conditions, Basel II seeks to advance comprehensive stress testing frameworks and risk management practices more generally. Strong risk management is a critical component of a bank's ability to withstand shocks. The Basel II framework requires that stress scenarios capture the effects of a downturn on market and credit risks, as well as on liquidity. Such an improved firm-wide approach to risk assessment is essential to ensuring that banks have a sufficient capital buffer that will carry them through difficult periods.

Third, Basel II better assesses the risk inherent in arrangements using evolving technologies, such as securitisation and credit derivatives, that are used to buy and sell credit risk. This is clearly evident in the originate-to-distribute model. Basel II provides a framework that allows supervisors to focus discussions with banks on the robustness of their risk measurement and management of the complex financial instruments that are typically used in this model. Basel II also establishes benchmarks for recognising risk transfer and mitigation in securitisation and credit derivatives structures. It sets a boundary between the point at which a firm transfers risk and actually retains the risk. These enable supervisors to assess the degree of risk transfer and mitigation under both normal and stressed market conditions.

And finally, Basel II requires that firms strengthen their frameworks for assessing appropriate capital for the trading book. This has taken on increasing importance given the rapid growth of trading book assets relative to the banking book. For example – the Basel Committee – in consultation with the industry – continues to work on developing a framework for better capturing the default risk associated with credit exposures in the trading book. In addition, Basel II permits firms to use their own models to measure counterparty credit risk exposures. This risk arises, for example, in OTC derivatives, which are becoming increasingly complex and more difficult to measure. This approach is closely aligned with industry best practice as well as the underlying economic risks of these activities.

Basel II has also paved the way for improvements in other, less visible ways. One example is Basel II's greater focus on firms' risk management infrastructure. For instance, the Framework requires fundamental improvement in the data supporting PD, LGD, and EAD estimates that underpin economic and regulatory capital assessments over an economic cycle. This has spurred improvements in areas such as data collection and management information systems. These advances, along with the incentives to improve risk management practices, will support further innovation and improvement in risk management and economic capital modelling.

Pillar 2

Let me now turn to the second pillar – the supervisory review process. Pillar 2 really starts with you, the banks. First and foremost, responsibility lies with bank management for developing an internal capital assessment process and setting capital targets that are commensurate with the bank's risk profile and control environment. A sound risk management process is the basis for an effective assessment of the adequacy of a bank's capital. And bank management bears the primary responsibility for ensuring that the bank maintains adequate capital to support the risks beyond the minimum requirements. Excessive participation by supervisors in a bank's capital adequacy assessment process or firms' over-reliance on supervisory review of their assessments are both counter to Basel II's objectives and raise the risk of moral hazard. The better banks measure and manage their risks, the more comfortable supervisors and the market will become with respect to their Pillar 1 processes, as well as the amount of overall capital that Pillar 2 indicates is appropriate.

This is not a compliance exercise! Senior management and boards of directors need to lead the process and ensure that their institutions establish robust internal systems that capture all material risks for their institution in a rigorous manner. Management should make certain that the economic substance of risk exposures is fully recognised and incorporated into the bank's systems. This is extremely important, particularly in the instance of securitisation and other complex risk transfer arrangements where the risks retained by the firm are more difficult to measure. These estimates of risk must translate into robust capital assessments that can be validated by banks and supervisors.

When supervisors assess economic capital, they should leverage off of banks' systems. Supervisors need to understand the global perspective within which banks operate. Local approaches may be warranted, but we need to ensure that local deviations are proportionate and that the costs do not outweigh the prudential benefits.

To achieve the full benefits of Pillar 2, supervisors need to avoid falling into the trap of establishing a check-list approach to supervision. It is not in anyone's interest to engage in a tick-the-box compliance exercise. Let me stress this - Basel II goes beyond merely just meeting the letter of the rules. The framework is more about a risk-focused approach to capital and risk management.

I understand that for banks and supervisors to realise the full potential of Basel II, more work must be done on home-host issues. With respect to Pillar 1, we have resolved a number of concerns and have come quite a long way. The same vigour and energy needs to be applied to the home-host issues related to Pillar 2. I am confident that with the development of the home-host principles, increased use of the supervisory colleges and further dialogue with the industry we will make progress on the outstanding issues. Many of these Pillar 2 issues, such as diversification, are particularly challenging and supervisors need to work with the industry to resolve them.

I expect that over time bankers and supervisors will engage in a dialogue around Pillar 2 that ultimately will turn out to be one of the most important benefits coming out of the implementation of Basel II. For instance, I have already heard from a number of banks about the fruitful discussions of how credit risk mitigation is reflected in their risk models and about the robustness of risk measures for complex structured products. I have also heard discussions about how diversification is treated in risk management systems and how the dialogue surrounding credit risk stress testing is becoming more focused.

Pillar 3

Since the release of the Basel II framework, most of the focus has been on the first two pillars but we should not forget the third – and certainly not the least – of the three pillars. Market discipline is made possible by effective disclosure requirements and is a critical complement to the other two pillars of Basel II. Indeed, in the light of recent and rapid financial innovation, state of the art disclosure needs to keep up.

Basel II seeks to raise the bar on the quality of disclosures, especially related to more complex credit risk intermediation activities, covering areas such as counterparty risk, securitisation and credit risk mitigants. It provides clearer industry benchmarks and its required qualitative disclosures will allow banks to put their quantitative disclosures into context and help explain their approach to risk management.

To help advance the use of market discipline, Pillar 3 disclosures are, in many instances, required to utilise an advanced Pillar 1 approach, such as the internal ratings-based approach or the recognition of securitisation. This will help the industry move forward collectively. Further, Pillar 3 disclosures will enhance discipline around risk measures since banks must show the actual outcomes versus estimates. An example of this is the required disclosure of actual losses compared with estimated losses in the preceding period for each IRB portfolio, combined with qualitative information to explain the outcomes.

However, challenges remain. There needs to be more discussion with a broader group of institutions to discuss their views regarding Pillar 3. In particular, banks have expressed their concern about the potential for misinterpretation of the purportedly complex disclosures by investors and the market in general. Another concern relates to potential inconsistencies and differences across banks and the unclear signal this may send to the users of such disclosures. Clearly, broad dialogue on this topic involving supervisors, bankers and market participants is necessary to prevent any unintended consequences. A strong understanding by the market of Pillars 1 and 2 will make Pillar 3 more understandable and market discipline a more reliable tool for supervisors and the market.

Before I conclude I would like to say a few words about the costs associated with Basel II's implementation and compliance, particularly costs related to information technology and human resources. Clearly, a shift in capital regulation as fundamental as Basel II entails significant transition costs for both banks and supervisors. However, even in the absence of Basel II, well managed financial institutions would have continued to update and improve their IT systems and risk management practices simply to keep pace with the evolving marketplace. Basel II has pushed firms further than they may have gone on their own. In addition, Basel II confers other benefits, including greater operational efficiencies, better capital allocation and greater shareholder value through the use of improved risk models and reporting capabilities. One might reasonably expect such improvements to lead to more consistent profits and reduced volatility of credit losses as a result of consistent risk spreading, more effective deployment of capital, and the ability to make better business decisions.

Conclusion

I would like to close by reiterating the importance of Basel II in support of financial resiliency, especially in this age of rapid change and innovation. Basel II encourages better measurement and management of risk exposures and the treatment of complex financial instruments. It seeks to advance the practice of stress testing as well as other risk management techniques. Under Pillar 2, banks take the lead in developing internal risk management processes that support robust estimates of regulatory and economic capital. Through enhanced transparency and market discipline, Pillar 3 will become more important because of increasing intermediation of risk through the capital markets.

Both banks and supervisors need to take a long-term perspective when considering the benefits of Basel II. Regulatory capital, risk management and risk-based supervision are aligned in a more consistent manner that can accommodate financial innovation. This capital framework is a long-term investment that if done properly will lay the foundation for further evolution. It is through strong coordination among supervisors and with you – the industry – that we can realise the full potential of the Basel II framework.

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