After-Dinner Remarks of Jaime Caruana,
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"Accounting, Transparency and Bank Stability Workshop"
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I. Introduction

Good evening. I hope that you are enjoying this opportunity to dine and unwind after your deliberations on emerging issues in accounting, transparency, and financial stability. You represent a wide range of views and institutions and, based on the animated conversations taking place during dinner, it seems that you bring great enthusiasm and interest to this workshop. In my view, that mixture enlivens the exchange of ideas and helps us to sharpen our understanding of the questions we face and the options we have to address them.

It has been said that "learning is achieved only in company." In this connection, we are all indebted to the workshop's coordinators and sponsoring organisations for bringing together such select and highly qualified company in which to learn. Here I'd like to thank in particular Urs Birchler from the Swiss National Bank, along with Reint Gropp from the European Central Bank. On the academic side, I'd like to thank Mark Flannery (University of Florida), Rafael Repullo (CEMFI and CEPR), Ernst-Ludwig von Thadden (Université de Lausanne, CEPR and JFI), and Anjan Thakor (Washington University). Together with staff from the Secretariat of the Basel Committee on Banking Supervision and its member agencies, they have selected timely topics, invited speakers who have sparked our discussions, and encouraged informed public discussion and debate on these matters.

At this half-way point on the conference agenda, I would like to take a few minutes to share with you the very good news that the Basel Committee reported last week on Basel II. I'd also like to add some thoughts from my perspective on the some of the issues you are discussing and especially their relevance to the new international capital framework.

II. Summary of 12 May 2004 Press Release

As you will probably know, the full Committee met just last Tuesday, actually in a conference room not far from the auditorium where you are meeting. Tuesday's meeting may have been one of the most historic for the Basel Committee. Three results make this meeting especially significant in my view.

First, and most important, we achieved consensus on the remaining outstanding issues that we faced in our efforts to revise the international capital framework. Over the last few months we have completed significant changes in a number of important areas: we decided to calibrate regulatory capital to unexpected losses only; we have made significant improvements to the provisions relating to securitisation, credit risk mitigation and operational risk; we have clarified Pillar 2 and the calibration process; we have specified the treatment of revolving retail exposures, and we continue to make progress in preparations for the implementation of the Accord.

Having reached consensus on the framework, the Basel II process is entering a new stage. Member authorities will now focus on transforming the text of the framework, which will be published at the end of June, into national rules. This will require national supervisors to conduct rule-making and adoption processes relevant to their jurisdictions, something that is well under way in many countries.

In addition, the Committee agreed on the timetable for the implementation of the Accord in member countries. This is the second important development of last week's meeting in my view.

The Committee confirmed that the new framework will be implemented by year-end 2006 for those banks adopting the standardised and foundation approaches to risk.

With regard to the most sophisticated approaches to risk measurement and management, the Committee considered the needs of national supervisors and of the industry and decided to provide an additional year. This additional year of data collection and analysis will be invaluable to the prudent and consistent implementation of the advanced treatments.   Let me explain in more detail the supervisory perspective.

As you know – and perhaps many of you have been involved – supervisors, bankers, and others have discussed intensively the technical requirements for the most advanced treatments of credit and operational risk over the past few years. This exchange of views has helped us to improve the requirements tremendously. The Committee wishes to have the best information possible to assess how the recent changes will improve risk sensitivity, enhance the role of supervisory judgement, and promote sound disclosures regarding a bank's measures and processes for controlling risk.

The Committee agreed that this could be done by requiring additional impact analysis, perhaps through national field tests in those jurisdictions that plan them. An alternative is to require banks to calculate their requirements under the 1988 rules and the new framework in parallel for two years, rather than just one as originally proposed.

Consequently, those banks that will adopt Basel II's advanced approaches to risk will be permitted to implement the new rules at year-end 2007, or just one year after the standardised and foundation banks. I believe that this decision responds to the views of both national supervisors and the industry that a limited amount of additional time is necessary to prepare consistent approaches to the implementation of the most sophisticated rules. I believe that it will lead to a more optimal implementation of the new framework. Furthermore, possible concerns about competitive equality can be alleviated thanks to the existence of temporary capital floors.

The third significant result of last week’s meeting is that the Committee agreed on the way forward for the implementation and evolution of Basel II.

The framework and timetable have been agreed. Yet we have much hard work still ahead of us, as the implementation of the rules will be a challenging task and also because we have recognised that the Basel II approach is intended to be evolutionary.

At our meeting, the members of the Committee discussed several implementation issues that we will “iron out” in consultation with other supervisors and the industry. This includes finding ways for home and host jurisdictions to coordinate and cooperate when applying the new rules to banking organisations that are active in multiple jurisdictions. More than ever before, supervisors will need to work together to reduce the regulatory burden on banks and to conserve supervisory resources.

We also face some difficult technical matters. For example, the Committee’s press release noted that we must determine acceptable methods for banks to estimate a key driver of credit risk. Banks that adopt the advanced internal ratings-based approach to credit risk will be required to estimate how the loss-given-default parameter for borrowers may vary when the economy experiences a downturn. On this specific matter, the Committee will continue its dialogue with supervisors and the industry to ensure that banks use appropriately conservative methodologies for this driver of credit risk.

Another topic that the Committee has agreed to study prior to implementation is whether there is a reliable way to estimate the lower likelihood that a borrower and a guarantor will default on the same obligation. Recognising “double default” effects may help the new framework to avoid an overly conservative treatment of exposures that are guaranteed. Moreover, the Committee has already begun discussions with securities supervisors on trading book issues and ways to determine the potential future exposure of derivative positions purchased “over-the-counter.”

Together, these results mark the end of a phase of Basel II. Now we must all work hard to implement it so that we can realise the benefits of the new capital framework.

III. Transparency as part of the “blend” of approaches in Basel II

In talking about the benefits of Basel II, I would like to turn to the second half of my remarks to share my thoughts on how transparency contributes to stability. Supervisors seek to achieve much more than simply a revision of the existing rules to calculate regulatory capital. By aligning capital requirements more closely to economic risk, we expect that, on a microeconomic scale, Basel II will encourage individual banks to improve the quality of their risk management.

But the rewards of Basel II are more notable on a macro scale. When banks have the right incentives to improve their management of risk and they are well capitalize, we believe that the banking sector becomes more resilient, less sensitive to the business cycle, and better able to serve as a source for credit and sustainable growth of the economy.

This workshop explores the role of transparency in promoting the resilience and stability that Basel II has as its overarching goal. The Basel Committee certainly agrees that markets can serve as powerful allies of official supervision. We recognise that, in some cases, market discipline can exercise a more binding constraint on banks' activities than regulations do. But I would emphasise that transparency does only part of the job. For transparency to promote stability, it must be combined with other policy approaches to achieve a goal that is as far-reaching and as significant as greater financial stability.

Certainly, the Committee would agree that, when banks disclose sufficient information about their activities and controls, marketplace participants can create strong incentives for prudent behaviour. Markets can reward banks that manage their risks properly and penalise those that hold unrealistically low amounts of capital for their risk. So there is a great deal of merit in a markets-based approach.

But we must remember that markets can behave inefficiently. They may overreact to minor events yet ignore significant indicators of risk, or they may be too short-sighted. Likewise, markets may not capture external concerns: they may focus on the immediate needs of direct participants rather than those of depositors, customers, or the public.

That is why transparency is one "pillar" of Basel II's three-pillar approach. The pillars we selected are meant to complement and to supplement each other. The first pillar – which specifies the minimum capital requirements – constitutes a very direct approach to supervision. By applying a uniform set of rules to banks, the first pillar adds transparency to the regulatory process and makes it easier to compare banks to gain a sense of their relative degrees of solvency.

On the other hand, uniform rules have certain drawbacks. They tend to be inflexible and therefore might preclude or ignore innovation. Applying uniform rules may also fail to account for a bank's unusual businesses or risk profile.

The second pillar, supervisory review, addresses some of those drawbacks. It introduces judgement into the policy mix. Banks and supervisors will exercise discretion in determining capital needs relevant to their particular businesses and risk profiles. That degree of discretion makes the supervisory framework more flexible and better able to adapt to change and innovation. In a way, we might think of the second pillar as being analogous to the "principles-based" policy approach that some have advocated in accounting and financial reporting.

Yet relying on a system that would permit discretion without boundaries would have its shortcomings as well. Transparency may be reduced if it is unclear why supervisors set certain requirements for one bank, and a different requirement for another. Allowing a discretionary approach in the absence of the other pillars also makes it difficult to ensure a level playing field, since banks would not necessarily be held to the same standards. That would certainly harm competitiveness across jurisdictions, and possibly even within the same jurisdiction.

So the third pillar, market discipline, adds greater transparency. When a bank discloses information that offers meaningful insight into its risk positions and exposures, marketplace participants can better assess the financial health of the institution. They can then provide economic incentives for banks to strengthen their management of risk and hold realistic levels of capital against their risks.

One might say that Basel II seeks an "efficient frontier" of policy objectives through the three pillars. Each pillar provides something that the other two cannot, and each is essential to achieving our overall objective of financial stability. I realise that this analogy of the three pillars as a portfolio of policy options is an oversimplification. But 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.

IV. Consistency of Accounting Standards and Basel II

Of course, it would be impossible to improve transparency and promote stability without examining the mechanics that define how financial data are recorded and reported. Because those mechanics are governed by national accounting standards, global markets face significant hurdles in exercising discipline across jurisdictions. Business practices differ. Legal systems may be unfamiliar. Deciphering balance sheets prepared under national accounting systems can be an extremely taxing undertaking.

Considering those burdens alone, it is easy to agree that market discipline would be more effective under more harmonious – if not completely harmonised – accounting rules. But the task is formidable: a reporter from the Wall Street Journal questioned recently how accounting rules could be harmonised when, for example, Europeans and Americans do not even agree on which set of measures should be used in the kitchen.

In our efforts to strengthen financial stability, central banks and supervisors have a legitimate interest in the quality of accounting standards and their effective implementation. We believe that in order to contribute to strengthening the banking system, accounting standards should support - or at least be consistent with - sound risk management and control practices in banks. In addition, they should facilitate market discipline by promoting transparent financial reporting of banks' financial position and performance, risk exposures and risk management activities. Finally, accounting standards should facilitate the effective supervision of banks.

This is why, as you know, the Committee has attached great importance to taking an active role in the international debates on accounting and promoting the supervisory perspective on key accounting issues, and we very much support the work towards convergence in international accounting.

We have worked closely with our colleagues in the International Accounting Standards Board to avoid conflicts between Pillar 3 and the broader accounting standards. In fact, the Committee views Pillar 3 as a further refinement of the accounting standards that apply to banks' specific exposures.

Because we recognise that we have much to do in this area, we will continue to monitor accounting and market developments in the light of Pillar 3. Our dialogue with accounting standards-setting bodies and the accounting profession will continue to grow in the years to come.

Conclusion: Basel Committee & the Global Research Community

I hope that this conference will help to identify the policy options that supervisors have in order to address emerging issues in risk management, financial reporting, and transparency so that we can work toward a more stable banking system. We can expect the financial services industry to quantify new aspects of risk while refining the existing measurement and management techniques. Innovation and advances in the banking industry's quantitative tools will open up many new areas for us to study that may enhance our ability to interpret financial information, to aggregate and report data, and to leverage the power of markets to motivate responsible business behaviour.

On that note, on behalf of the Basel Committee, I would like to thank the research community in member agencies, in academic circles, and in the industry for your contributions to our work. Many of Basel II's advanced methods for quantifying risk were first explored in research units within individual financial institutions, but also in central banks, supervisory agencies, and universities. Our contacts with researchers, the work of the Research Task Force, has helped us to gain access to some of the best research being done in risk management. Equally important, it helped to translate the results of some of the most sophisticated technical advances into tangible tools for implementing public policy objectives.

Applied research cannot be conducted in a vacuum, and good research is rarely achieved alone. In that vein, I look forward to continuing a vigorous dialogue with researchers from many institutions as we explore ways to safeguard depositors' savings, to ensure prudent risk management in banks, and to secure more stable growth in the economy. I hope that you find tomorrow's sessions to be equally stimulating and enjoyable, and I thank you for your attention this evening.