BANCO DE ESPAÑA

Brussels, 18 January 2005

Notes for the testimony before the Committee on Economic and Monetary Affairs, European Parliament

Committee on Economic and Monetary Affairs. European Parliament

Jaime Caruana
Chairman of the Basel Committee on Banking Supervision and Governor of the Banco de España

1. Introduction

I am honoured to appear before the Committee on Economic and Monetary Affairs today to discuss the reform of the international standard for bank capital. In past years, members of the European Parliament have kindly welcomed Bill McDonough, the prior Chairman of the Basel Committee, as well as other Basel Committee representatives.

I would like to thank you for giving me this opportunity to contribute to the debate and to support your important work in considering the proposed directive on capital adequacy requirements for banks and investment firms. These hearings are extremely valuable and represent a vital stage in the European legislative process, where the European Parliament has a crucial role.

I will be speaking today in my capacity as Chair of the Basel Committee. But I hope you will allow me to digress on one or two occasions to supplement my remarks with my perspectives as Governor of the Banco de España. The Banco de España is a central bank and banking supervisory authority within the European Union; it will therefore be a direct subject of the legislation that is enacted on capital adequacy. This legislation will not only affect the banks that we supervise, but also our own supervisory system and the tools we use to carry out our responsibilities, so I hope my additional perspectives will be useful.

The publication of Basel II in June 2004 was a milestone which marked the culmination of a worldwide and unprecedented effort spanning more than five years. It involved extensive and open discussions among bankers, central bankers, bank supervisors, market observers, and the public. The Basel Committee published three proposals for public comment. It conducted several impact studies and it engaged in extensive discussions with interested parties.

I believe that this broad and often highly technical dialogue was of mutual benefit as a learning process. It contributed greatly to the thorough examination of banks' risk management practices. This was necessary in order to find ways to harness recent advances in these practices to promote financial stability. It also allowed us to take into account concerns and suggestions and to make a considerable number of changes that have significantly improved the framework. Let me mention, for example, improvements made in important areas such as SMEs, procyclicality, complexity, recognition of collateral, and the treatment of securitisation, etc.. Likewise, the global nature of the consultations led to changes which increased the relevancy of the new framework to all kinds of banks, something that is important for the European market.

As a result of the dialogue, we were able to design a solid, comprehensive and balanced new capital framework. Basel II represents a significant step towards achieving a more risk-sensitive supervisory approach. It will enhance banks' safety and soundness, thereby

strengthening the stability of the financial system as a whole and ensuring that it can better serve as a source for credit and growth for the economy. I believe that the framework should be adopted as soon as possible, according to the proposed implementation date, to realise the benefits of a stronger and more stable financial system in a global competitive world.

I like to think of the new capital framework as an opportunity. An opportunity to ensure that regulation and supervision takes a forward-looking approach to capital and risk management, that it remains up-to-date with sound practices in the industry and that our supervisory framework motivates sound capitalisation, responsible risk-taking, transparency and prudent behaviour.

It also represents an unparalleled opportunity for banks to improve their capital strategies and risk management systems. And finally, it provides supervisors with an opportunity to improve their dialogue with the industry and to enhance co-operation among banking supervisors across jurisdictions. This last point is crucial to achieving effective and consistent implementation and it is an area in which I strongly believe that the European Union is in a unique position to lead the way. As I will comment later, I believe that the EU can make faster and more tangible progress in this area than is currently possible on a wider international basis.

In my intervention this afternoon, I would like to offer first some views on why the new capital framework is necessary. I would then like to address two topics: firstly, co-operation among supervisors; and secondly, the work that must continue to maintain the relevancy of the framework.

2. The benefits of Basel II. Why the new framework is the one we need.

- **Forward-looking approach to capital and risk management.**

As I mentioned before, the new capital framework takes a forward-looking approach to capital and risk management that will remain up-to-date with sound practices in the industry.

In the sixteen years since the 1988 Accord was adopted, the tools for measuring and managing risk have evolved in ways that its architects could not have anticipated. Improvements in technology and telecommunications, the explosive growth in the markets for securitised assets and for credit derivatives, and the emergence of new disciplines in risk management – such as operational risk management – have changed the ways that banks measure and manage their risks.

As risk management practices become more sophisticated, the static and very simple rules of the 1988 Accord are becoming less relevant to the most sophisticated and complex banking businesses. Therefore, in the mid-1990s, the Basel Committee agreed that it was time to

develop a new framework for capital. Our goal was to develop a new approach that would be more sensitive to the actual risks that banks take on and that would ensure a level playing field for banks that compete globally.

Rather than simply resetting the quantitative standards, we sought a framework that would be better able to evolve with, and indeed encourage, future improvements in the measurement and management of risk, and one that would be well-anchored on a solid corporate governance structure and a sound risk culture. On a grand scale, we sought a capital framework that would promote greater financial stability, a public good that benefits consumers, businesses and banks alike.

- **Comprehensive approach.**

The new capital framework is much more comprehensive than the 1988 Accord for many reasons: it applies to a wider scope of entities within banking groups; it offers a menu of different alternatives to fit different circumstances; it encompasses additional risks, in particular operational risk; it widens the recognition of credit risk mitigation techniques; it sets out a thorough framework for securitisation transactions; and, most importantly, it is based on three mutually reinforcing pillars.

As you may know, the first pillar refines the measures of minimum capital requirements. It aligns capital charges more closely and comprehensively to the actual economic risks a bank faces, and creates explicit incentives for banks to improve their internal measures and approaches to risk.

Let me just add that this better alignment of capital to risk is a principle that we supervisors hold dear. It can sometimes be tempting to vary the capital rules in favour of particular sectors, but in my view this divorces capital requirements from risk, which ultimately benefits no one. It does not stimulate a culture of appropriate risk management, may lead to an inefficient allocation of resources in the economy and does not, therefore, promote stability.

“Pillar 2” reminds bank managers that ultimately they are responsible for the adequate capitalisation of their institutions, and creates an incentive for banks to conduct their internal reviews carefully and responsibly, on the basis of a well-defined strategy.

Finally, “Pillar 3” recognises that markets can serve as an ally to official supervision when participants have access to sufficient and timely information on a bank’s risk profile.

Together, the three pillars are intended to complement each other and promote a more flexible, forward-looking and comprehensive approach to capital supervision. Elements of all three pillars certainly already exist in the supervisory systems of leading economies: but Basel

II represents a concerted effort to apply those pillars more consistently across countries within a common framework. That, in turn, will help to reduce the burden on internationally active banks and promote a more level playing field for global competitors.

While Basel II is a large step forward for safety and soundness standards, in many ways it is building on the advances that banks have long been developing on their own. We believe that it is important to recognise those advances so that supervision remains relevant to banking activities today. Likewise, adopting Basel II now will maintain banks' momentum in innovating and in strengthening their products and processes so that they can better serve as sources of credit and growth to businesses and consumers tomorrow.

- **Incentive-based approach.**

It is clear then that Basel II is about much more than just setting better quantitative minimum capital requirements. It is about establishing incentive-based approaches to risk and capital adequacy management, within the framework of the three mutually supporting pillars.

On a micro level, the new approach will promote better risk management, adequate capitalization and transparency. On a macro level, it will contribute to financial stability and the resilience of the banking system. Let me expand a little on the latter point.

I am convinced that when banks have the right incentives to manage their risks appropriately, to hold sufficient capital and to improve transparency, the banking system will become more resilient, more stable and better able to serve as a source for credit and growth. Those characteristics matter greatly to the livelihood of our citizens, to the outlook for commerce and business, and more generally to the health of our economy as a whole.

In order to reinforce its relevance as a macro standard, the new framework incorporates a number of elements such as the requirement to use longer time horizons in the design of internal rating systems and in the average calculations of key variables, and also the need to carry out stress tests and conduct calculations in downturn conditions. All these elements will ensure that bank managers are conscious of how risk-drivers change through the cycle and in stress conditions, and that they incorporate these elements into their decision-taking processes and capital strategies.

Let me move now to the work under way to implement the new framework. I'd like to highlight two areas in this respect.

3. Catalytic role in promoting supervisory co-ordination and convergence.

The effective implementation of Basel II will depend to a large extent on the ability of "home supervisors" and "host supervisors" of internationally active banks to co-operate efficiently.

Certainly one of the goals for any international framework is to foster a more level playing field for internationally active competitors. The Basel Committee wishes to ensure that competition between internationally active banks is driven by each bank's individual strengths, rather than by differences in each country's rules.

Basel II is intended to promote a more level playing field for internationally active banks. Yet Basel II cannot and should not be expected to create perfect harmonisation across all jurisdictions. Differences in legal systems, market practices and business environments in each country make it an extremely difficult task – and, indeed, an impossible one – to even out all distinctions across all borders.

Our goal should instead be to facilitate the application of minimum standards and to work together, across borders, to promote a more consistent implementation and application of the new framework.

This enhanced co-operation is a process that will promote consistency and convergence of supervisory practices. It will help to avoid redundant and unco-ordinated approval and validation work, thereby reducing the implementation burden on banks, and conserving supervisory resources.

In this regard, the Committee's Accord Implementation Group continues to encourage practical work among supervisors on applying Basel II effectively and efficiently to internationally active banking organisations. The AIG is currently working with supervisors of different areas of the world to conduct a number of "real case" studies to gain better insight into the practicalities of co-operation between home and host supervisors.

In this context, if you will permit me, I would like to speak from my perspective as a European banking supervisor, and pick up on the statement I made at the beginning of my intervention. As I said, I believe that Europe is in a unique position to lead the way in the cross-border implementation of the new framework and to make faster and more tangible progress than is currently possible on a wider international basis. I think we need to seize this opportunity with both hands, because it will not just benefit us in the EU, contributing to the fulfilment of the Lisbon objectives, but, I believe, will also have a positive impact beyond our borders.

We have two major advantages in this respect. Firstly, the division of supervisory responsibilities between our countries is embedded in our common single market legislation in

the banking field, founded on harmonisation and mutual recognition. And with particular reference to the new capital framework, the Commission has chosen to address key elements of supervisory cooperation within the proposed directive, and has adopted an approach that strikes me, as a European supervisor, as a step in the right direction.

Secondly, from a practical perspective, the work already done by the Committee of European Banking Supervisors – CEBS - is very encouraging. This committee, directly charged with promoting co-operation and convergence of supervisory practices, has a key role to play in the implementation of the new capital framework in Europe, for example in finding practical ways to apply the provisions which provide for an enhanced role for the consolidating supervisor, and on model approval processes. And it is already producing tangible results - for example in designing a framework for public disclosures by supervisors on Basel II, and preparing a common framework for institutions to report their solvency ratios.

For these reasons, I believe that we as supervisors can go further than others may be able to go in our efforts to ensure consistent implementation of the new capital framework and effective supervision on a cross-border basis. We can deliver results on a number of fronts, including the specific initiatives I have just mentioned. I think that by making rapid and real progress, we can also promote greater convergence beyond the EU, as others may find our experiences of benefit to the wider search for greater international consistency in the implementation of Basel II.

4. Ongoing work in the Basel Committee to ensure that the new framework functions as intended

Let me turn now to the ongoing work in the Basel Committee to ensure that the new framework functions as intended. I would like to report on the current status of two initiatives that were announced by the Basel Committee some time ago: the treatment of "double default" and trading book issues; and the work to re-confirm that the new framework meets our objective to broadly maintain the aggregate level of capital requirements, while also providing incentives to adopt the more advanced risk-sensitive approaches.

Before I turn to the detail, let me say that neither initiative is expected to lead to significant changes in Basel II's overall structure. However, the Committee has always said that Basel II should be sufficiently dynamic to allow for evolution.

As I have already stressed, we must ensure that Basel II serves the needs of the banking sector into the twenty-first century. In this regard, the Basel Committee has pledged to monitor industry developments and to continue its public dialogue on emerging issues that are relevant to capital supervision.

The Basel Committee has already begun to honour this promise, in two areas especially. One topic that we are discussing with the industry is the treatment of "double default." Some industry representatives believe that Basel II takes an overly conservative approach to the risk of loss associated with exposures covered by guarantees: they suggest that the risk of both a borrower and a guarantor defaulting on the same exposure is lower than the risk of just one party defaulting. The Committee believes that the new framework should recognise some double default effects, and we are currently considering all of the implications of doing so, including those associated with measuring the effects.

Another topic we are discussing with the industry concerns the treatment of certain trading-related issues under Basel II. In the view of some industry representatives, neither the existing market risk capital rules nor Basel II go far enough in recognising advances in the measurement and management of risks arising from trading activities. We are evaluating these matters.

Our work on double default and trading book matters is making good progress. We are consequently confident that we will issue papers for public discussion on these topics by early April this year so that we can finalise the rules during the summer, with a view to allowing their implementation at the same time as the rest of the new framework.

As Chairman of the Basel Committee, I would of course like to see consistent implementation of these changes on an international basis, both in terms of content and timing. Also from a European perspective, I believe that the EU should seek to implement the trading book changes at the same time as other major countries.

Moving now to the second initiative, the Basel Committee has long intended to conduct work to re-confirm that the new framework meets our objective to broadly maintain the aggregate level of capital requirements, while keeping incentives to adopt the more advanced approaches that are offered.

In order to establish a common data set on which to base this review, the Committee has decided to begin a recalibration exercise in autumn this year, some months earlier than anticipated.

As I said earlier, I don't believe that this will imply a significant change to the framework. We are already satisfied that the new capital framework clearly differentiates the degree of risk in particular transactions on a relative basis. What we need to confirm is that the absolute requirements are right and that the appropriate incentive structure is maintained.

5. Conclusion

In my testimony today, I have sought to outline the reasons why Basel II matters so much and how it will support the continued safety and soundness of the banking system. When we motivate banks to improve their understanding and approaches to risk, I believe that banks will become less sensitive to the ups and downs of the business cycle, better able to weather periods of distress and better able to serve as a source of credit and growth to the economy.

While we have completed a vast amount of work in developing the international standards, we cannot rest yet. The ultimate success of Basel II still demands a high level of dedication and energy from all of us. I commend and thank the members of the European Parliament for their contributions to the international discussions on Basel II and for their hard work in European discussions on the Capital Adequacy Directive. I know that you will give the directive careful consideration, taking account of the global environment in which European banks are operating. I would like to pledge any assistance that members of the European Parliament believe may be necessary and I would be honoured to participate in future parliamentary discussions on Basel II and the Directive.

The considerable efforts that the European Parliament, the Council, the Commission and the Committee of European Banking Supervisors have already demonstrated give me great confidence that we will achieve our goals. Our citizens, businesses and banks deserve nothing less than the promise and benefits of greater financial stability and more sustainable economic growth.