BANCO DE ESPAÑA

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Basel II : Back to the future

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Introduction

The importance of adopting a forward-looking approach in our framework for financial stability

- “Nothing endures but change”
- “The future influences the present just as much as the past”
- “Whoever wishes to foresee the future might consult the past”

It is opportune to be here

- Dynamism of the region
- Financial relevance and openness

Looking from the future...

...It is my hope that Basel II would be portrayed as:

- A revolution in our approach to financial regulation.
- The introduction of a new regulatory and supervisory paradigm.
- Premised on the need to begin to depart from blunt requirements and instead to develop rules that incorporate nuance.
- Presenting rules that align capital requirements more closely to the actual degree of economic risk a bank faces.
- An important step forward in continuing to replace static rules with rules that offer incentives for firms to improve constantly their internal governance and management of risk.
- A milestone in the trend toward leveraging the power of the market place to exert discipline over firms' decisions and strategies.
- Yet, it might well be judged to be excessively simple = flexibility.

Overview

I would like to:

1. Consider the current framework for promoting financial stability.
2. Explore in more detail some of the most important recent trends and developments in risk management.
3. Address the challenge of devising a supervisory response which harnesses these developments for the benefit of financial stability.
4. Consider the implications of Basel II that have received some attention: namely, the potential impact of the new framework, both on capital flows and on global competition.

My purpose today is not to describe Basel II in detail, but rather to highlight the dynamic processes that it stimulates.

Framework for financial stability

- Although we have a well-developed framework for debating and conducting monetary policy, our thinking on financial stability is less advanced.
- But comfort can be taken from the fact that supervisors, central bankers, policymakers and others have already learned valuable lessons
- First, we have learned of the need for businesses and consumers to have access to credit on fair and reasonable terms ....
- Second, we have identified some characteristics of financial instability.
- Third, we have learned of the importance of sound macroeconomic policies and an appropriate institutional framework ...preconditions...
- There is a fourth lesson we have learned from periods of bank resilience in times of stress… the importance of good risk management and financial innovation

Recent trends in risk management

Financial innovation and recent advances in the measurement and management of risk have fundamentally changed how banks and other financial service providers approach their businesses.

- ***Firm-wide risk assessment***
- ***Risk aggregation and quantification***
- ***Credit risk transfer***

The supervisory response: Basel II

- **Basel II process started more than 5 years ago. Rather than simply resetting the quantitative standards, we sought to develop a new forward-looking approach …..**
- **Basel II incorporates some key basic principles => a flexible and forward-looking approach, anticipatory rather than reactive behaviour to risk, and the need to take into account market views.**
- **The new capital framework is much more comprehensive than the 1988 Accord…… => it is based on three mutually reinforcing pillars.**
- **Four transmission channels for influencing financial stability:**
  - more risk-sensitive minimum regulatory capital requirements
  - incentives to encourage improvements in banks' internal risk management
  - the enhanced mechanisms to exert external market discipline
  - necessary greater co-operation among supervisors across jurisdictions
- **Basel II should remove distortions potentially hindering capital flows, improve the efficiency of the allocation process, and increase the stability and resilience of the financial system.**

How Basel II will affect the flow of capital across borders

- Some observers have suggested that Basel II's heightened sensitivity to risk may reduce the flow of foreign investment in developing economies, since exposures to those economies might typically be considered of higher risk.
  - I believe that, in the short run, Basel II will not have a material effect on the flow of capital.
  - In the medium and long term => higher risk efficiency will improve the financing of all kinds of economies.
- It is important to consider not just the level of capital flowing into a country, but also the volatility of the level of capital inflows.
  - disciplined risk assessment processes may provide for early detection of deviations or mistakes, and that may facilitate smoother corrections at an early stage.
- This is very much related to the discussion about procyclicality.

Basel II impact on global competition

- Some have asked whether banks that choose Basel II's advanced approaches will enjoy benefits over those that choose simpler approaches or remain on the 1988 Accord.
- The issue of competition between banks has also come up in the context of competition between countries.
- Basel II => ensure that international competition in banking markets is driven by the strengths of each bank, rather than by differences in each country's rules.
  - Co-operation, Convergence, Communication and Confidence.

Conclusion

- Aim today has been to highlight the anticipatory and forward-looking elements of Basel II
- It may be that Basel II does not cover all the areas and refinements to complete the financial stability framework.
- It will take some time to fully judge the real benefits of Basel II.
- One essential strength is the dynamic way in which it will contribute to financial stability by promoting risk sensitivity, strong risk management, market discipline, and enhanced cooperation, convergence, communication and confidence.
- Basel II represents a tremendous opportunity for banks themselves. By stimulating them to upgrade and improve their systems, business models, capital strategies, risk management systems and disclosure standards, => overall efficiency and ability to compete globally.

Thank you for your attention.

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