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Keynote address

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Mr Moulds, Mr Pickel, Ms. Septon, distinguished guests,

It is an honour for me to be invited to join your meetings today and it is furthermore my pleasure to welcome you and the International Swaps and Derivatives Association to Spain.

It appears to me that you have all of the ingredients for a stimulating and memorable conference. The agenda is ambitious and addresses the latest topics in the ever-evolving derivatives markets. The speakers are distinguished, deeply experienced, and represent a wide range of perspectives and institutions at the forefront of financial services.

And, of course, I must commend you on your selection of a marvellous location for your annual meeting. Barcelona has undergone a fantastic transformation, is a gateway for the world and a city that celebrates the ancient and the innovative.

I hope that you take some time outside of your sessions to explore its blending of the old and the new. A walk through the “Gothic” quarter serves as a window into our past. A visit to any of the creations of Antoni Gaudí – after whom this conference hall was named – offers a vision of Catalan modernism through architecture.

Selecting Barcelona as the venue for ISDA’s discussions offers us a chance as well to celebrate the ancient and the innovative, the old and the new, in financial services. This conference, for example, will address some of the most sophisticated products in banking and finance and the risk management practices, legal developments, and technological advances that are emerging to support these new businesses. At the same time, our discussions here in Barcelona will remind us that we must all always monitor and control the fundamental – and traditional – risks involved in our activities.

Credit risk, market risk, and operational risk have always been with us in various forms, although they have increased in complexity over recent years. What has changed dramatically, however, is our ability to measure and monitor those risks more comprehensively than our predecessors ever could. We have, moreover, improved our ability to manage or transfer those risks, and I would like

to share with you today some thoughts on work underway in the financial community in this regard.

There are three topics that I would like to address in my intervention. I will begin by sharing first, in my personal capacity, some thoughts regarding the need for standards to evolve and keep pace with the times, whilst ensuring that new standards are not unduly burdensome and do not hinder firms' abilities to innovate.

In this respect, I'd like to look forward and address some of the work we are doing to ensure that the new international capital standard - Basel II - remains flexible and able to adapt to emerging practices and risks. Many of you have a very strong interest in the efforts the Committee is undertaking to consider how best to apply Basel II to certain trading-related exposures using the latest tools being developed by the industry. While this work is still ongoing, I would like to share a status report with you on that effort.

Finally, I will highlight some of the work that we are undertaking to promote a smooth and consistent transition to Basel II, including our plans to conduct a review of the calibration of the framework, as well as our efforts in the field of supervisory co-operation and validation, and the key messages that are coming out of these initiatives.

The evolution of standards and regulatory burden

Allow me to begin by sharing some personal thoughts on a topic that has captured some attention recently: The view, held by at least some in the financial services sector, that the tide of regulation has risen to a high water mark. In my own conversations around the world, I have heard similar concerns from some bankers. Some point to the long debates that have taken place in the accounting profession. Others point to regulatory reforms underway, such as those to transpose and implement the Committee's own work on Basel II, the new capital framework.

It should be said that the industry itself recognises that there is work to be done in these areas. However, I do have sympathy for the sense that much is changing today. I understand that keeping pace with these changes can absorb resources and require attention. In this sense, and especially in relation to our work on Basel II, I see some merit in concentrating, at least for a while, on completing current regulatory work, and on ensuring the quality and consistency of its implementation.

Let me expand a little on this point. Financial service providers often compete on their ability to create value by offering new products and services to customers. As just one example, ISDA represents institutions that are among the most active in the private negotiation of derivative instruments. These instruments are initially tailored to unique sets of circumstances and may involve novel features of risk-taking or risk mitigation.

The challenge, therefore, is to ensure that the rules support and encourage firms in their efforts to improve their ability to manage their businesses while pursuing new opportunities. That is a constant responsibility for legislators, for standards-setters, and for supervisors, but also for the industry. We must all review and ensure that our rules are implemented fairly and in line with our intentions.

Some reforms underway represent efforts to ensure that our rules keep pace with the achievements that the industry has already made. On this note, I would argue that Basel II is just as much about aligning supervisory practices more closely with the industry's latest advances as it is about promoting improvements in the management of risk within the industry itself.

But I sympathise with the sense that the wide range of standards that are evolving in parallel represents a drain on the limited resources that firms have to keep pace with those changes. I agree that we must find a way to balance the dangers we are trying to ward off against the time and resources it takes to adapt to new circumstances and new rules. And I want to work with you to make sure that the labours you undertake are not merely exercises in compliance with new rules, but rather will represent honest efforts to strengthen your practices and your long-term prospects for growth and innovation.

From my perspective as chairman of the Basel Committee, I can say that the Committee's main focus in the near future will be on completing the current work and on implementing Basel II in a sound, consistent, and effective manner. This will allow us all a period to digest the framework we have designed.

At the same time, we have always said that Basel II should be an evolutionary approach. This does not mean a moving target. We have designed a stable framework that we believe will stand the test of time. But we have always been clear that some of the details may need to change over time to ensure that they remain relevant to the ongoing evolution in banking markets and risk management practices.

Indeed, in the text of the Basel II framework that was published in June 2004, the Committee reiterated its intention to maintain an active dialogue with the industry to ensure that the new framework keeps pace with, and can be applied to, ongoing developments in the financial services sector. The framework itself already provides banks with a great degree of latitude in developing new measures of exposures to risk and new means for addressing them. But supervisors – and banks – are still responsible for evaluating whether the framework addresses risk exposures in a sensible manner and in line with our sense of sound and best practices that are being developed.

Status of work on the trading book

There are two areas where both banks and supervisors recognised that this work could already commence. One was to find a prudentially sound treatment under Basel II for exposures to “double default,” where the risk of both a borrower and a guarantor defaulting on the same obligation may be substantially lower than the risk of only one of the parties defaulting. The other area concerns the applying Basel II to certain exposures arising from trading activities. This brings me on to my second topic.

As you know, we have already spent close to three-quarters of a year studying both sets of issues in depth. Because both banks and securities firms have a great interest in the potential solutions to these particular issues, the Basel Committee has worked jointly with the International Organization of Securities Commissions (IOSCO) to consult with industry representatives and other supervisors on these matters. I must say that this co-operation with IOSCO in areas of mutual interest has been a very fruitful and beneficial experience, and the work has been conducted in a very positive and collaborative spirit. Also in this regard, I must extend my thanks to ISDA and its members for being faithful and active participants in these discussions. ISDA and its members have volunteered again considerable data, time, and energy to the work at hand.

As you may already know, there are five specific areas of focus, namely

First, the treatment of counterparty credit risk for over-the-counter derivatives, repo-style and securities financing transactions;

Second, the treatment of double-default effects for hedged transactions, in relation with trading book, but also banking book, exposures;

Third, the short-term maturity adjustment, under the internal ratings-based approach, for some trading book-related items;

Fourth, a limited number of improvements to the current trading book regime, especially with respect to the treatment of specific risk; and

Fifth, the design of a specific capital treatment for unsettled and failed transactions.

I can report informally that I personally am highly satisfied with the progress that the joint Basel Committee and IOSCO working groups have achieved to date, which reflects in no small way the cooperation of the industry in preparing data and responses for the discussions. I expect that the Committee will release a proposal for a six-week period of public comment next month such that the proposals can be released in final form this summer. However, intensive work will continue prior to the discussions at the meetings of the Basel Committee and IOSCO's Technical Steering Committee toward the end of March and the beginning of April.

So I cannot yet comment on the solutions that may be proposed or approved by the Committee and IOSCO. I can tell you that we set, as a guiding principle, a goal to apply Basel II to these exposures in a manner that reflects as best as possible sound practices already in use when those practices appeared to be both prudent and broadly acceptable to many kinds of banks and markets.

Some industry representatives have raised concerns that finding ways to apply Basel II to trading book exposures might lead to a revision of the existing "Market Risk Amendment" to the capital framework that was approved in 1995. Understandably, those industry representatives expressed concern that this might disrupt banks' efforts to prepare for Basel II, which addresses mainly credit and operational risk. The members of the Committee shared this concern when we decided to undertake work on the prudential treatment of certain trading-related exposures under Basel II. We do not intend to overhaul the capital rules for trading book exposures, but rather seek to address narrowly a handful of concerns that relate either to potential inconsistencies that could arise with the new treatment for banking book assets or that relate to a limited number of issues that have arisen since the adoption of the Market Risk Amendment.

The implementation of Basel II

With that, I would like to turn now to my third topic and report on our efforts to smooth the path from the existing capital standards to the new Basel II framework.

On the regulatory side, supervisors are working with national authorities to transform the framework into enforceable rules and regulations, within the context of each jurisdiction's process. This work is well underway in all of the Basel Committee member jurisdictions, but also in many other countries as well.

On the supervisory side, let me mention three areas in particular where we are devoting resources to promote a seamless transition to the new framework.

Calibration

First, we are verifying that Basel II has been calibrated appropriately. 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 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. 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 under the 1988 Accord and under Basel II.

We recognise that these tests and reviews will demand resources from both banks and supervisors. Yet I must emphasise that neither banks nor supervisors will be able to evaluate the calibration of the new framework – and hence its effectiveness – if banks do not participate fully and seriously in these initiatives. Only you can provide the data that all of us will need to ensure that Basel II functions as we intend and that it does not create unintended side effects.

Consistent and co-ordinated implementation

Second, supervisors are working to avoid unexpected outcomes by developing, in advance, a better understanding of how various jurisdictions will apply Basel II. This is also helpful to developing a more consistent set of expectations across countries. In a world where the business of banking is increasingly international, the need for supervisors to cooperate and to strive for more consistent principles would exist even if Basel II did not. But under Basel II, this need is even more pronounced, especially for internationally active banks that wish to adopt one of the advanced approaches to credit or operational risk provided under Basel II. In fact, in many ways, Basel II is acting as a catalyst for enhanced co-operation.

The Committee is finding ways to avoid the need for those firms to endure redundant or uncoordinated reviews of the systems and processes they develop to benefit from Basel II. The Accord Implementation Group, which is chaired by Nick Le Pan, the Canadian Superintendent of Financial Institutions and Vice-Chair of the Committee, has already undertaken a number of practical exercises to encourage supervisors from many countries inside and outside the Committee's membership to consider how they will review those systems and processes for firms that operate across borders.

The AIG, as this group is known, identified two key lessons for banks to consider that may help to ease the transition to Basel II. One lesson is that the more detailed, comprehensive, and clear a firm's plans are for moving to one of the more advanced approaches to risk management, the better able supervisors will be to assess and evaluate those plans in a less intrusive manner. But a second lesson takes this one step further: it is also important for banks to share those plans broadly with their branches and subsidiaries worldwide. Already some host supervisors have found that local managers may be unfamiliar with the parent organisation's plans for Basel II: this understandably tends to make host supervisors less confident about the quality of an organisation's planning and its readiness to move to Basel II. Moreover, it increases their need to ask more questions, some of which may duplicate the questions that the home supervisor or other host supervisors are asking.

If a bank has already developed sufficiently detailed and transparent plans for its application of Basel II, a substantial portion of the hard work has already been done. Sharing those plans with home and host supervisors, and with managers throughout the bank's operations and locations, should not require too much more effort. Instead, the bank should be in an even better position to focus on running its business confidently while still implementing its plans carefully for the future.

Validation

One of the greatest challenges – for both banks and supervisors – of the Basel II framework is the need to validate the systems and processes used to generate the parameters that serve as inputs into the IRB approach to credit risk. Although validation is foremost the responsibility of banks, supervisors must have a thorough understanding of validation in order to ensure overall integrity of bank's activities in this area.

In recognition of the importance of validation the Committee recently published six principles on validation that will guide our future work. We also published a working paper called: "Studies on the Validation of Internal Rating Systems" Let me mention these principles briefly.

Firstly, we set out our understanding that validation is fundamentally about assessing the predictive ability of risk estimates and the use of ratings in credit processes. Secondly, we stress that the primary responsibility for validation lies with the bank itself, while the supervisor's responsibility is to review the bank's processes and outcomes – a point which I think we all agree is very important.

The remaining principles relate more to the process itself. We note that validation is likely to be an ongoing, iterative process which will require an ongoing, iterative dialogue between banks and supervisors. Then our fourth principle reflects that there is no single validation method, or universal tool for validation, even though techniques may converge over time. We also highlight, in our fifth principle, that validation should encompass both quantitative and qualitative elements – validation is not a purely technical or mathematical exercise, but should also include an assessment of controls and other qualitative factors. Finally, we stress our view that validation processes and outcomes should be subject to review within the bank, by parties which are independent of those who are responsible for the design and implementation of the processes.

I think these principles set out clearly what supervisory expectations are, and should provide a useful steer to the industry. Our work on validation will accelerate over the coming months, although our focus will be more on sharing and cataloguing information and approaches, and not on trying to develop a prescriptive method. As we have stated in our principles, the primary responsibility for validation lies with the banks themselves. Close dialogue with the industry in our work will, of course, be of great importance.

In turning to my conclusions, I would like to use this opportunity to make a brief comment from my perspective as Governor of the Banco de España. Although I have talked about the work underway in the AIG on implementation, you are probably also aware of similar work being conducted in Europe, by the Committee of European Banking Supervisors, which is seeking to promote consistency and convergence in the application of Basel II in the EU. As I have said on other occasions, I believe that Basel II represents a great opportunity for the EU – as a single market - to lead the way on international convergence, and I hope that we can seize this opportunity. Certainly, the progress made by CEBS so far is encouraging in this respect.

Conclusion

Coming back to the points I made earlier, even considering the ongoing work on trading activities under Basel II, I believe that the vast majority of efforts being undertaken by banks and supervisors alike today related to Basel II are focused on implementing the very good rules that have already been developed. I believe that this should be the Committee's main focus for the near term.

It is important as well to remember that Basel II is not meant to be an exercise in compliance. Its goals are to improve the quality of risk management across the banking sector; to strengthen the resilience of the financial system; and to promote more sustainable economic growth for the good of both consumers and businesses alike.

I look forward to continuing to work with you as we all enhance our efforts to make those goals a reality.