BASEL COMMITTEE ON BANKING SUPERVISION

BANK FOR INTERNATIONAL SETTLEMENTS

Global implementation of Basel II and the recent market turmoil

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Some personal thoughts on the recent market turmoil

- The fundamentals of risk management always apply
- Having guidance is key, but how this guidance is implemented is even more critical
- Understanding risks embedded in complex financial instruments is a fundamental prerequisite for taking on that risk
- Capital arbitrage does not equal risk transfer
- Regulators should have a forward-looking focus, but always building on lessons learned in the past: Spanish experience

- The AIG is not Basel II control central
- Supervisors share experiences and communicate range of practices and sound practices, and learn from each other
- Information exchanges and outreach to the global supervisory community (ILGC) and industry
- Shifted over time from writing high-level papers to addressing practical problems using case studies – issue of communication
- The AIG is promoting a number of methods by which it can better share externally the experiences and outcomes (apart from its regular meetings with the ILGC and industry). Examples:
  - electronic library accessible to all supervisors,
  - case-study papers.

Addressing home-host issues

- These issues are longstanding (the basic guidelines were set out in the 1975 Concordat). However, Basel II has raised the importance of home-host issues
- They affect all three pillars and there are no simple solutions
- Challenge: strike the appropriate balance between legitimate home and host supervisory needs while minimizing the burden on banks and supervisors.
- This is not simple, but achievable, (examples)
- Colleges: ongoing supervisory dialogue, cooperation and information sharing. There is potential for further improvement
- Though significant progress has been made in alleviating home-host issues, there remain several ongoing questions that supervisors need to address.

- Credit risk issues being addressed by the AIGV
  - PDs (TTC versus PIT; sufficient data histories)
  - LGDs (ability to measure downturn LGDs)
  - EAD (more progress needs to be made)
  - Stress testing
  - Significant risk transfer

- AMA issues being addressed by the AIGOR
  - In 2007 the AIGOR published a paper on home-host information sharing and allocation mechanisms for AMAs
  - Plans to undertake a new Loss Data Collection Exercise (LDCE)

- AIG works to promote the consistent implementation of Pillar 2 through its dialogue among the global supervisory community and with the banking industry
- Pillar 2 workshops (first held in Washington DC in Sept. 2007; second to be held in Bangkok on 9 May 2008)
- Joint AIG/ILGC statement on "Progress in Basel II Implementation"
  - Need to distinguish between economic capital models and the internal capital adequacy assessment process (ICAAP) more broadly.
  - "**I**" stands for Internal to the bank; "**P**" stands for process - not necessarily a model.
  - Supervisors do not intend to take a prescriptive approach to assessing diversification benefits. However, banks are expected to apply conservative assumptions reflect data and modelling uncertainties

- Insufficient attention has to date been given to Pillar 3, however, the recent market turmoil has further emphasised the importance of effective disclosure
- Pillar 3 benefits will grow over time as market analysts become more familiar and comfortable with the enhanced disclosures
- As more data becomes available, the AIG is planning to undertake an assessment of banks' Pillar 3 disclosures (Japanese experience)

Initial reactions to Pillar 3 disclosures by Japanese Banks in Sep-Nov 2007

- A generally positive market reaction to the increased transparency particularly in the area of securitisation disclosures, however less attention was paid by the market to the details of banks' internal rating systems
- Banks tend to use the Pillar 3 disclosures for their own internal benchmarking. Importance of continuity of the Pillar 3 disclosures so that effective time-series analysis of an IRB bank can be undertaken
- Banks on the standardised approaches generally based their Pillar 3 disclosures on guidelines from industry associations

Initial reactions to Pillar 3 disclosures by Japanese Banks in Sep-Nov 2007

- Across all banks there is diversity in both the qualitative (related to risk management practices) and quantitative disclosures (eg number of PD bands, granularity of industry and geographical distribution of exposures). However, in general there is a clear improvement in disclosures and an expectation of further improvements in the future.
- Pillar 3 disclosures ranged from 21–136 pages (with an average of 40-50 pages). All 12 FIRB banks published the Pillar 3 disclosures in their annual reports and on their websites.
- See Japanese bank websites for examples

  http://www.smfg.co.jp/english/investor/library/annual.html (eg Sumitomo Mitsui)

Implementation of Basel II in the context of recent market developments

- Effective implementation of the principles and methodologies underlying Basel II will improve the safety and soundness of banks and the financial system:
  - It will deliver greater risk differentiation
  - Off-balance sheet contractual exposures to SIVs and conduits will be subject to regulatory capital, whatever the accounting treatment
  - There will be a much more risk sensitive treatment for securitisation exposures.
  - More rigorous approaches to measure and manage operational risk exposures
  - Banks will have to develop more rigorous methodologies for capturing counterparty credit exposures, including so-called wrong way risk (monolines)
  - Stress tests of on- and off-balance sheet exposures: adequate capital cushions to manage through a down cycle.
  - Banks will have to provide much better transparency to the market about the range of exposures they hold, including to securitisations and conduits ,

Basel Committee's areas of focus in response to the market turmoil

- Treatment of highly rated securitisation exposures, especially so-called CDOs of ABS
- Introduction of a credit default risk charge for the trading book
- Stress testing (including contingent credit exposures)
- Pillar 3: monitor the type of information that banks make available for structured credit products
- Liquidity risk management and supervision
- Valuations (developing guidance to assist supervisors in assessing banks valuation practices)

- The Framework will evolve over time to reflect financial innovation. In light of recent developments, the Committee has already begun to evaluate certain aspects of the Basel II Framework.
- The AIG will continue to address Basel II implementation challenges. Effective supervisory coordination and cooperation, and dialogue with the industry are needed to maximising the benefits of the Basel II Framework.
- The market turmoil has emphasised the paramount importance of Basel II
- The effectiveness of the Basel II Framework is only as good as the implementation (by banks and supervisors) of the Framework.