BANCO DE ESPAÑA
Eurosistema

Washington, 2 March 2009

Enhanced Supervision of Risk Management Activities and Possible Revisions to the Basel II Framework

Annual Washington Conference. Institute of International Bankers

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I want to start by thanking the Institute of International Bankers for the invitation to speak to you today about the steps the Basel Committee is taking to address the lessons of the crisis as they relate to the regulation, supervision, and risk management of banks.

My remarks will focus on the Basel Committee's recent actions and initiatives related to the implementation of the Basel II Framework. Basel II has taken on even greater prominence in light of many of the lessons learned so far from the financial crisis. However, before I begin I would like to make a few general remarks.

One of the defining characteristics of the crisis has been both the combination of the severity of the developments and the speed with which they unfolded. Given the magnitude and systemic implications of some of these developments and the startling rate at which they have occurred, official sector responses have been formulated just as rapidly. While this is appropriate – even necessary – it is important that we strive to ensure that the actions that are taken today do not have adverse implications for the long-term management of international banking and financial markets. Many financial innovations as well as policies and practices have been fundamentally sound and our long-term prosperity depends on strengthening them – not weakening them. Clearly, other practices have been shown to be fundamentally flawed and need to be systematically addressed.

To be more specific, three things that we have learned over many years and should not be forgotten in times of crisis relate to:

1. the benefits of international banking and financial markets
2. the need for global coordination; and
3. the long-term benefits of private ownership and management of banking institutions

A safe, sound and open international financial sector is vital to support international trade and economic growth. The Basel Committee, in its efforts to promote sound supervision and risk management practices, has focused its work primarily on large internationally active banks. This work has promoted both sound international practices and a level playing field. We should be careful in the actions we take to ensure that the benefits of international trade and finance are not compromised.

The benefits of global cooperation and coordination also need to be stressed, as various domestic responses – in combination – may have unintended, counter-productive effects, and create level-playing field issues. As you know, the Basel Committee has a long standing commitment to coordination of regulation and supervisory practices. As Chairman of the Basel Committee's key implementation group, fostering greater cooperation and coordination between supervisors in relation to implementation of Basel II has been one of my main activities over the last few years. This experience has confirmed me that international coordination is indeed a critical success factor when considering the preparation or the implementation of any significant international standard or action. We should never forget that, since any standard or regulation can only be as good as its implementation, international regulation should go hand in hand with international coordinated enforcement.

Few of us here would doubt the long-term benefits of private ownership and management of banks. The financial crisis has, however, in some cases called for unprecedented actions by the official sector such as guarantee schemes, capital injections, partial and full nationalizations. While the public sector response has been forceful and necessary, we nevertheless still need to think about an effective and smooth retreat from the various government interventions. A feasible exit strategy must be articulated in a clear and coordinated manner, and keeping in mind a long term strategy to ensure financial intermediation again performs its vital function of promoting economic growth.

I could point to more examples to illustrate where policy proposals run the danger of causing collateral damage rather than benefit. This is not a call for inaction. On the contrary: There is a wide consensus about the need to make significant changes to the regulation and supervision of the financial system. But we should not lose sight of what has worked well in the past and guard against causing collateral damage.

Let me put an example. We have all heard this talk about markets not working. But in some cases what we have had is precisely not enough markets. For instance, compensation policies are flawed due to a lack of market discipline: while the upside, the profit, goes to managers, the downside, the loss, if sizable, is absorbed by the taxpayers through government intervention. The sole action that needs to be taken in the area of compensation policies is to restore long term market discipline. More, not less, market is what is needed. As President Obama said in a recent speech, “It is time to put in place tough, new common-sense rules of the road so that our financial market rewards drive and innovation, and punishes short-cuts and abuse”.

Let me now turn to the Basel Committee’s response to the crisis.

At the end of 2008 the Basel Committee outlined its comprehensive strategy to address the lessons of the crisis as they relate to the regulation, supervision, and risk management of banks. The strategic response of the Basel Committee is certainly not limited to capital-related issues, and other issues such as liquidity risk are also key components of it, however I will focus on the Basel II related issue.

The Committee and others have devoted significant attention to assessing the role that regulatory capital incentives played in contributing to the crisis and ways that the capital framework could be strengthened to make the banking system more resilient to future periods of financial and economic stress. In this context, it is important to keep in mind that the crisis built up over many years under the Basel I capital regime. The move to Basel II will certainly help correct a number of the weaknesses revealed by the Basel I capital framework. Among other things, these include

- a better treatment of off-balance sheet exposures and liquidity commitments,
- capturing all risks and promoting earlier intervention by supervisors
- the introduction of greater risk differentiation for on-balance sheet and securitisation exposures,
- explicit capital requirements for operational risk,
- standards for more rigorous management of risk mitigation techniques, and
- the publication by banks of significantly new risk information (eg data on PDs, LGDs and EAD) will promote transparency and market discipline.

Basel II has only been adopted relatively recently in most Basel Committee member countries (and some countries are still in the process of moving to Basel II). Nevertheless, the crisis has revealed a number of areas where the framework could be strengthened to enhance the resilience of individual banks, the banking sector and the broader financial system. The objective is to help ensure that the banking sector serves as a shock absorber, rather than an amplifier of risk between the financial and real sectors.

As you are aware, the Basel Committee published in January 2009 a package of consultative documents to strengthen the Basel II framework. In line with the overall architecture of the Basel II framework, the proposals cover each of the 3 pillars:

- concerning the minimum capital requirement (Pillar 1), the proposed changes mostly aim at better reflecting the risks associated with trading activities, securitisations and exposures to off-balance sheet exposures. Banks have suffered significant losses in these areas and there is a need to make sure that appropriate and higher capital charges are held against the risks.
- To address the weaknesses and limitations in risk management practices revealed by the crisis, the Committee will promote more rigorous supervision and risk management of risk concentrations, off-balance sheet exposures, securitisations and related reputation risks.

The Committee is also promoting improvements to valuations of financial instruments, management of funding liquidity risks and stress testing practices. These fall under the category of Pillar 2.

- In order to promote greater transparency and market discipline, enhanced Pillar 3 disclosure requirements for securitisations and sponsorship of off-balance sheet vehicles are proposed.

The Committee has outlined significant enhancements to the Basel 2 framework, but this is only the first step of the Committee's response. The Committee is also currently working on other important aspects, from a more fundamental and long term perspective.

In developing its capital-related recommendations, the Committee is guided by broad financial system policy objectives. These include efforts to promote financial system stability by focusing supervision not only at the level of individual banking institutions but also on the risk dynamics of the banking sector as a whole.

Among the key issues currently under consideration, I would like to mention the following areas:

- further enhancing the risk coverage of the Basel II framework, by revisiting for instance the treatment of counterparty credit risk and reviewing the use of VaR for the calculation of trading book capital charges;
- strengthening over time the quality and consistency of minimum capital requirements, as having a strong capital base is critical for banks to be able to absorb losses and maintain lending during periods of severe stress;
- taking steps to mitigate the potential procyclicality of regulatory capital requirements and promoting capital buffers above the minimum in good economic conditions that could be drawn upon in stress; and
- considering the pros and cons of an independent, simple measure to supplement the risk-based capital charge.

These issues are of course interrelated and therefore need to be considered and assessed as a broad package. Let me illustrate by sharing a few personal thoughts with you on procyclicality.

The issue of procylicality of capital requirements has received a great deal of attention, both before the crisis, and definitely over the past 18 months or so. It is in a sense very easy for supervisors to be counter-cyclical after the fact. We could for example now reduce minimum capital requirements across the board and that would be clearly counter-cyclical. The problem with such an approach as we all know is that it won't work since markets are requiring banks to hold both a higher level and quality of capital (not less); and it may be difficult to distinguish such counter-cyclical actions from regulatory forbearance.

The point I would like to stress is that the most important and effective way of reducing procyclicality is to capture risk appropriately during the up-swing. Unless adequate capital and provisions are set aside during the good times, there it nothing left to run down when the bad times eventually come. What this requires is for regulatory rules and supervisory actions to bite the most at the point in the cycle when it hardest for them to bite. That is at the peak of a cycle when memories of crises have faded; when prophets of new paradigms are blossoming; and when high returns and profitability may be more due to riding a wave of optimism than skill and good management. Unless we make regulation bite during the good times our ability to reduce procyclicality during the downturn is severely limited. To me that points to the critical importance of improving the risk capture of the Basel II framework. That however does not mean that there needs to be ever increasing complexity in approaches – instead more pragmatic risk measurement and management approaches may be appropriate.

The various policy actions and initiatives outlined by the Basel Committee are of course of utmost importance. In addition, important steps that have been taken by the Committee to further increase its efforts to promote the sound and coordinated implementation of its standards, and this is also a direct consequence of the crisis.

This is illustrated by the creation in January of this year of the Standards Implementation Group, the S.I.G. This new group replaces the Accord Implementation Group (AIG). The S.I.G. mandate is much broader than the AIG, as it includes implementation of all Basel Committee standards and guidance, not just Basel II implementation. However, Basel II will remain a top priority for the S.I.G.. In this regard the S.I.G. will continue to work on home-host issues; supervisory colleges; and implementation of the three Pillars of Basel II.

The subtle change is in fact a quite important one. Indeed many of the current weaknesses exposed by the financial crisis are the result - certainly of gaps in the regulatory framework - but they are also the result of inadequate implementation of existing risk management standards and guidance (for example, pre crisis guidance on liquidity risk management). The financial crisis has demonstrated the need to follow-up on supervisory guidance and standards to promote consistent implementation by banks and supervisors.

In short, addressing deficiencies in implementation are thus just as important as addressing deficiencies in policies.

Conclusion

The financial crisis has, and will continue to, test bankers, policy makers and supervisors. The events of the past year and a half have been truly remarkable, and well outside what even some of the most bearish participants could have expected or imagined. But the problems have been endogenous to the financial system and are the result of various complex interactions. The supervisory community is fundamentally addressing the incentive problems through a combination of steps – some of which have already been taken, and others that are of a more fundamental and long term nature.

Thank you.