

Remarks of Governor Jaime Caruana
Chairman of the Basel Committee on Banking Supervision
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Introduction

- I would like to thank the organisers for inviting the Basel Committee to participate in GARP's Risk Management Convention. Last year, you were kind enough to welcome as a keynote speaker Bill McDonough, the former President of the Federal Reserve Bank of New York and then the chairman of the Basel Committee. Today I am honoured to represent the Committee as Bill's successor.
- The agenda for this week's program demonstrates just how important and tough the job of a risk manager has become. Risk is no stranger to any business, and good business people have long sought ways to control their exposures to risk. Yet advances in technology and marketplace practices have sharpened our sense of the risks we face and of their potential costs should we fail to manage them.
- In recent years, for example, bankers have adopted an ever-widening array of databases, analytical tools, and sophisticated software packages to lend quantitative insight into risks that were once assessed mainly subjectively. Impressive advances have been achieved in measuring and managing exposures to market risk, credit risk and, more recently, operational risk.
- Just as the application of information technology revolutionised the business of banking and risk management in the second half of the twentieth century, I expect that the increasing quantification of risk will drive tremendous advances in the first half of the twenty-first century. But, as prudent risk professionals and bank supervisors, you and I know that quantifying risk involves making assumptions. And no model, and no software package, no matter how sophisticated, can ever replace the skills of a trained, experienced, and conscientious risk manager. Banking, finance, and insurance are, at least in part, an art, not a science. We can and should supplement and enhance our judgement with the best technical tools available. Yet – against the backdrop of unpredictable markets and times – it would

be folly to derive business strategies purely from the projections of a mathematical model.

- And that is why the work of an organisation like GARP matters so much. GARP creates a forum for its 30,000 members to share ideas on new ways to approach risk or to share suggestions on ways to improve current practices. Furthermore, GARP and similar professional organisations encourage all of us to improve our own skills constantly and to probe and understand emerging issues in the market.
- So it is a particular pleasure for me to share some thoughts on the Basel Committee's progress to develop regulatory capital standards that reflect the best practices in risk management today – and that recognise the importance of exercising prudence and sound judgement when taking on risk in banking.

Overview

- In my remarks today, I'd like to share with you the latest news on the status of our work. We continue to move forward on the basis of our commitment last October to finalise outstanding issues by mid-year and have made significant progress in a number of important areas.
- As I will discuss in more detail today, by calibrating regulatory capital to unexpected losses only, we found a better solution which will make regulatory capital requirements for credit losses more consistent with bank's own economic capital models. We have made significant progress in securitisation, credit risk mitigation and operational risk. We have clarified Pillar 2, and we continue to make progress in the implementation of the Accord.
- After sharing this news with you on our progress to date, I'll conclude with thoughts on the work ahead in the final months.

Common factor

- But first let me begin with a reminder of a goal that is a common factor in all our work: namely, the objective to recognise good risk management practices and to create additional incentives to further advance the discipline of risk management.

- This is possibly the most important and powerful channel of the New Accord for fostering financial stability in the medium and long run. And it builds on the widespread acceptance of the existing 1988 Basel Accord while addressing its key weakness. The 1988 Accord was in many ways a success, as it was simple and represented the first internationally accepted standard for defining and measuring the adequacy of a bank's capital.
- But simplicity became its drawback. Leading institutions quickly moved toward more sophisticated risk measurement and management techniques. The Basel Committee believes that this progress in risk management deserves recognition and encouragement.
- So, together with leading institutions worldwide, supervisors began exploring ways to incorporate more sensitive measures of risk into the capital framework. The initiative can be attributed above all to the person who delivered this address last year, Bill McDonough. Bill brought intellectual leadership, exacting standards, and unflagging enthusiasm to a project so important that quickly consumed much more than the two years some initially thought it would take to complete.
- But Bill knew it was worth it. He convinced leaders in the industry, in central banks, and in supervisory agencies that merely revising the rules would be unsatisfactory. Instead, he wanted to advance the state of the art in risk management across the industry. He did not seek a reduction in capital requirements but rather an increase in the stability of the global financial system – a goal that would benefit not just banks, but more broadly businesses and consumers.
- It was a privilege to work with Bill on a project that represents not just good banking policy, but most importantly good public policy. He has moved on to new challenges as head of the Public Company Accounting Oversight Board in Washington, but the U.S. delegation to the Basel Committee remains in excellent hands.

The Three Pillars

- This goal of creating incentives to foster sound risk management is so important that it is reflected in all of the “three pillars” of the New Accord. They are intended to encourage institutions to improve their management of risk on the one hand, which promotes the supervisory goal of financial stability, while calling on banks to remain adequately capitalised on the other hand, which supports the regulatory requirement for banks to operate safely.
- The first pillar is intended to be compatible with the best and most widely adopted practices today for managing exposures to credit and operational risk. By aligning regulatory capital requirements more closely with the actual degree of underlying risk that a bank faces, the Committee is creating an economic incentive for bankers to refine their measures of risk.
- Of course, no two banks are truly alike; a “one-size-fits-all” requirement would actually fit no individual bank very well. Risk profiles vary. Skills and strategies differ. Banks, after all, seek to distinguish their services and products from those of their competitors.
- So the second pillar, supervisory review, is premised on a bank’s responsibility to exercise sound judgement regarding the best way to manage its unique risk profile – and on the duty of supervisors to evaluate that judgement.
- By encouraging a dialogue between bankers and supervisors through Pillar 2, the Committee believes that the New Accord will create additional and powerful incentives for banks to exercise care in their internal assessments. But equally important, by agreeing on shared guidelines for supervisory review, we expect that the New Accord will promote greater consistency in the manner in which supervisors apply the capital framework. When supervisors across jurisdictions share similar expectations for capital adequacy, the regulatory burden on banks operating in different jurisdictions can be eased greatly.
- The third pillar – market discipline – seeks to leverage the influence that other marketplace participants can bring to bear on a bank to manage its risks appropriately. By enhancing transparency in a bank’s public reporting,

counterparties, rating agencies, and even customers will have better access to timely and meaningful information about a bank's activities and exposures. They will, in turn, be better able to make business or investment decisions. That will help markets to reward banks that manage their risks judiciously while penalising those that do not.

- By matching the minimum capital requirements with a robust supervisory review and enhanced financial transparency, the Committee is embracing a philosophy of incentive-based supervision that will encourage banks and supervisors to focus on the quality of their risk management processes.
- So the basic three-pillar structure of the New Accord is rather simple to explain. The challenge lies in specifying principles and rules for banks and markets of many sizes and shapes. The members of the Committee viewed this challenge as an opportunity to advance the state of the art in risk management worldwide. Just over the past few months we have resolved some of the most difficult technical issues that arose in recent discussions with the industry. This brings me to the status of our work today, my second topic.

The Status of the New Accord

- To test the quality of our proposals, and to ensure that our new framework would be more sensitive to risk and would create incentives for advances in risk management, the Basel Committee has undertaken three global public consultations. The third consultation concluded last summer attracted over 200 comments from the industry and the public. We've also conducted massive impact studies, gathering detailed information from over 350 banks worldwide on how the new rules would affect their capital requirements.
- This public consultation process and our series of impact studies would have been impossible without the tremendous support, candour, and hard work that so many banks and other organisations worldwide offered. I would like to express my thanks to the many organisations in North America that, together with peers from around the world, wrote comment letters, participated in discussions, and provided data to the Committee. You have helped us to ensure that the proposals reflect best practices. Your suggestions have helped us to clarify and simplify the

proposals. Thanks to your hard work, and thanks to the cooperation and support from many supervisory agencies and central banks, we are confident that the New Accord will represent the best possible framework.

- In last summer's consultations, the industry acknowledged the many improvements in the proposals that we have achieved to date. At the same time, public comments identified a number of technical concerns related to the treatment of credit-related losses and of some of the most sophisticated financial instruments and activities. We took these comments to heart and spent the next several months developing solutions. In October 2003, the Committee agreed in Madrid on a breakthrough plan to resolve these issues by the middle of this year.
- I must say that I have been pleasantly surprised by the progress the Committee has made in the extremely short period of time since then. Just three weeks ago, for example, we published three detailed technical notes outlining changes to the proposals. These covered revisions to the treatment of expected and unexpected credit-related losses and of securitisation exposures, as well as principles on the recognition of operational risk capital across home and host jurisdictions.
- I'd like to share with you the latest information on each of the areas addressed in the technical papers and in the press releases.

EL/UL

- First, let's turn to the New Accord's treatment of expected and unexpected losses, or "EL" and "UL" as we say in Basel.
- Under the internal ratings-based ("IRB") approach to credit risk, the third consultative paper originally would have required capital sufficient to absorb expected and unexpected credit losses. At the time, we considered this a practical arrangement to address differences in national accounting practices and the authority of supervisors regarding provisioning. However, in the light of the public comments we received on CP3 – including from quite a few banks in the United States – and after subsequent research, we agreed in Madrid to adopt an approach based on unexpected losses only.

- Fifty-two organisations commented on the Madrid proposal to re-orient the IRB capital charge to unexpected losses only. The Committee was pleased to note the tremendous level of support for the solution and the strongly expressed view that this change will align the calculation of regulatory capital requirements more closely to the economic capital calculations that leading institutions already perform.
- The technical note issued last month on the treatment of credit-related losses set out details concerning how risk weights would be calculated only on the basis of unexpected losses. Of course, banks should provide for expected credit-related losses, so the New Accord will require banks to compare their actual level of provisions with expected losses. Any shortfalls will be deducted from capital – equally from Tier 1 and Tier 2 components – while excess provisions will be includable in Tier 2 capital up subject to a limitation.
- With regard to this last point, the Committee has decided that the amount of excess provisions that can be included in Tier 2 capital will be limited to a certain percentage of a bank's risk-weighted assets, which is still to be determined.
- This change represents a major improvement that will go a long way toward ensuring that a bank's capital will adequately protect it against unexpected losses and that it will provide incentives to sound provisioning. I am also pleased to note that the early reactions to these changes have been positive.

Securitisation

- The second note published in January addressed changes to the treatment of securitisation exposures. We are particularly committed to developing an appropriate and balanced treatment for banks' exposures to securitisations since the 1988 Accord does not address this important risk management tool. At the same time, a securitisation transaction can result in an extremely intricate structure, which makes it hard to specify a simple rule.
- Public comments on our proposals acknowledged this challenge, as many found the proposed capital rules in the third consultative paper for securitisations to be among the most complicated parts of the New Basel Accord. Many also thought the treatment to be perhaps too conservative.

- In response, members of the Committee pledged in Madrid to streamline the relevant proposals. Equally important, we wanted to adopt, where possible, requirements that are more compatible with the best practices in use today.
- The note released in January illustrates the progress we've made. For example, the industry had previously criticised the differences in the treatment of banks that originate and hold rated securitisation tranches versus banks that invest in the same exposures. The Committee will eliminate this difference. Instead, it will treat all rated exposures to securitisation structures in the same manner, regardless of whether they are held by an investing or an originating bank. This will furthermore streamline the proposals.
- Likewise, the Committee is introducing an internal-assessment approach for determining capital charges against exposures to certain low-risk unrated securitisation positions. Under the new treatment, banks will be allowed to derive the risk weights for unrated exposures to asset-backed commercial paper conduits (mainly liquidity facilities) by mapping their internal risk assessments to external credit ratings. This simplifies the rules by allowing qualifying banks to rely on existing processes and, at the same time, incorporates best practices into the securitisation framework.
- Other simplifications and improvements include the introduction of greater flexibility in calculating the capital charges on certain pools of assets that may underlie a securitisation transaction and the review of the calibration of the securitisation RBA risk weights to ensure a closer alignment with the level of risk inherent in the positions.
- Based on the positive initial reactions that we and our member agencies have received from the industry to date, the Committee is confident that the revisions will help to clarify and simplify the treatment of securitisation exposures.

Home-host operational risk capital

- The third paper published in January laid down key principles regarding the cross-border recognition of operational risk capital charges for those banking organisations that use the advanced options.
- As you know, one of the improvements of the New Accord is that it will “unbundle” operational risk from other risks and apply a separate capital charge for it. This reflects the emerging view among leading banks and supervisors that we should evaluate and seek ways to reduce losses arising from failures in processes, systems, people, or external events. While operational risk is not as readily quantified as these other exposures, the Basel Committee has noted genuine progress among leading institutions in measuring and controlling it. Assigning an explicit capital charge was intended to support these private-sector efforts and to reward firms that develop better measures of operational risk.
- For the most sophisticated institutions, the “advanced measurement approach” – or “AMA” – is the ultimate expression of the Committee’s goal to incorporate banks’ own sense of risk into the capital framework. Because the AMA is not subject to supervisory “floors,” the Committee expects it to serve as a true catalyst for innovation.
- The January technical note on operational risk addresses an issue that banks raised concerning the allocation of AMA capital across the subsidiaries of an internationally active banking organisation.
- Many banks questioned whether operational risk capital requirements should be calculated on a consolidated, institution-wide basis rather than on a legal entity basis. Most banks, and especially large and internationally active institutions, would understandably prefer to calculate the relevant capital requirements on a firm-wide basis. Their comments highlighted the technical and logistical constraints on developing an AMA, indicating that it is more difficult, from a modelling perspective, to estimate the potential for operational losses at even a medium-sized entity because of the need for a large body of data.

- Internationally active institutions in particular cited the practical challenges of developing, and seeking approval for, a separate model for each legal entity in every jurisdiction in which they operate. Many banks thought the New Accord should recognise fully the economic benefits they gain from operating across a diversified mix of business lines and entities, since they believe it unlikely that a large organisation would suffer high losses from operational failures in many businesses or entities at once.
- The Committee acknowledges the technical and practical challenges associated with developing and implementing AMAs for large, diversified firms. We are likewise working to reduce unnecessary burdens on banks adopting them.
- Still, the question of whether capital requirements could be allocated not just across legal entities, but also across national borders, raises difficult legal questions. The Committee must respect the legal mandate given to national supervisors in regulating locally chartered banks, branches, or subsidiaries. This usually includes the duty for the national supervisor to verify that local banking subsidiaries are adequately capitalised on a stand-alone basis.
- In our note, we explain that the Committee is pursuing a “hybrid” approach to recognised operational risk capital across jurisdictions for such institutions. Under this hybrid approach, a banking group would be permitted – subject to supervisory approval – to use a combination of stand-alone AMA calculations for significant internationally active banking subsidiaries and an allocated portion of the group-wide AMA capital requirement for its other internationally active subsidiaries. As a consequence:
 - First, a significant, internationally active institution will be expected to calculate its capital needs under the AMA on a stand-alone basis. It will be able to consider a well-reasoned estimate of diversification within its own operations, though not across the rest of its group. Where a significant internationally active institution is a subsidiary of a larger organisation, it will be allowed to rely on resources, data, and parameters calculated at the group level.

- Second, an institution that is not considered significant could receive approval from its supervisors to apply a capital charge against operational risk that is allocated to it from a group-wide AMA calculation.
- The principles articulated in the January note are intended to facilitate the implementation efforts. They should, moreover, ease the burden on institutions that adopt the AMA across jurisdictions yet still respect host countries' laws that may require local subsidiaries to comply with a minimum standard on their own. Achieving this balance should encourage more institutions to improve their management of operational risk and to strive to adopt more advanced approaches as their capabilities grow.

Credit risk mitigation

- With regard to **credit risk mitigation**, although no paper was released on this topic, the Committee has made good progress in this area. While some issues are not yet finalised, the Committee has agreed to make some refinements to the rules. For example:
 - The Committee decided to eliminate excess conservatism in an approach to assess repo-style transactions. That is, it decided to reduce the level of multipliers to be applied to the outcome of the VaR model (backtests) from the level proposed in CP3 to that which would restore the 99th percentile confidence level.
 - It also decided to recognise credit risk mitigants whose maturity does not match that of the underlying exposures up to three months before these mitigants mature.
- In the January press release we signalled that we recognise that the existing treatment of credit risk mitigation must continue to evolve in order to reflect industry practices, particularly as they relate to double default effects.
- The Committee plans additionally to undertake a review of counterparty credit risk and trading book issues in coordination with the International Organisation of Securities Commissions (IOSCO).

- This brings me to a concept that we have emphasised many times: the Basel 2 approach is evolutionary. This means that some issues - such as those just mentioned plus others such as recognising the economic benefits of diversification in credit risk models - will be considered by the Committee as part of its future work.
- This evolutionary approach requires two things: first, a stable framework which provides certainty for the industry so that the accord is not a moving target; second, enough structured flexibility to be able to adapt to relevant changes in best practices.

Schedule

- With the release of the three papers on unexpected losses, securitisation, and the recognition of operational risk capital across home and host jurisdictions, the Committee has come a long way toward resolving many of the most complicated issues raised in consultations. These revisions to the framework will, moreover, help to ensure that the New Accord is more sensitive to the actual degree of risk that banks face and even more supportive of future improvements in the measurement and management of risk.
- The Committee's working groups are refining these and other technical matters in the New Accord and will report their solutions to the Committee by May 2004. That will allow the Committee to meet its goal of resolving outstanding issues by the middle of this year and agreeing on the text of the Accord that will provide a solid basis for national rule-making processes and for the industry's preparations to continue.

Concluding Thoughts

- Over the next two days, you will have an opportunity to discuss and share ideas on the latest risk management practices in the areas of market, credit, operational, and insurance risk. A great deal of what you will discuss has direct relevance to developing and implementing advanced risk management techniques. That will help all of us to consider the work ahead and make us even better prepared for the implementation of the New Accord by the end of 2006.

- Indeed, those of you in the audience from institutions that anticipate adopting the most advanced approaches available when the New Accord is implemented have already begun to collect and process the necessary data. You know, as well as anyone, that the required commitment is substantial, and that supervisors' expectations are high.
- Reading the results of the global Basel II survey conducted by GARP during the month of January, presented in your monthly newsletter, I was encouraged to see that "Most financial institutions (77%) across the globe are confident that they will achieve full compliance with the Basel II risk-capital accord in time for the 2006 implementation deadline." Perhaps even more important is the conclusion that "these institutions are confident that their internal risk management will be at least somewhat improved (86% somewhat or greatly improved) following the rollout of Basel II".
- This is why I think that what you will discuss at this conference mean much more than simply complying with new regulations and calculating capital requirements appropriately. We want banks to manage risks, not to manage Basel II. The essence of Basel II is not just the set of rules and formulas to calculate regulatory capital, these are necessary and very important but, in my view, the heart of Basel II is the incentives for banks and risk management professionals to advance risk management and the recognition of this progress.
- Studying and understanding the drivers of credit, market, and operational risk, and probing the relationships between them, will help all of us to get a better sense of the risks and rewards we face today, and how well we are prepared to navigate changes in the landscape of opportunity and challenge tomorrow.
- Improving our understanding of risk, and strengthening our ability to manage it, offers the promise not just of better administered banks, but more importantly the promise of a more stable financial system – one that is better able to serve as a source of credit and sustainable growth for businesses and consumers alike.
- Thank you again for welcoming me to this conference, and I offer my best wishes for an enjoyable and educational event.