

## **Jaime Caruana: Basel II - a new approach to banking supervision**

Remarks of Mr Jaime Caruana, Governor of the Bank of Spain and Chairman of the Basel Committee on Banking Supervision, at the Fourth Annual International Seminar on Policy Challenges for the Financial Sector: "Basel II - the international banking system at the crossroads", Washington DC, 1 June 2004.

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It is an honour to be invited to join you, the members of the global supervisory community, at this seminar on the future of banking supervision. I would like to thank our host, Chairman Greenspan, for his warm welcome into the hallowed halls of the Federal Reserve. Likewise, all of us express our gratitude to the World Bank, the International Monetary Fund, and the Federal Reserve for organising this seminar. To ensure rich, lively, and informed discussions, our sponsors have assembled an impressive array of speakers and participants, including senior supervisors, central bankers, and others from over 50 countries, an achievement that demonstrates, for the fourth time, excellence in international and inter-organisational cooperation.

### **Overview of remarks**

The new capital adequacy framework, or "Basel II," figures into virtually every discussion today on the outlook for international banking tomorrow. This seminar will tackle its policy implications. They include the new framework's potential effects on risk management within an individual firm; on competition between firms; on the stability of the financial sector and the future of supervision; and, most broadly, on the long-term growth of the economy.

What makes this seminar unique is its focus on the perspectives of countries that are not members of the Basel Committee and particularly those of emerging market countries. Consequently, I will try to focus most of my remarks from this very relevant perspective.

I would like to discuss three of the most sensitive policy questions that national banking authorities in those markets - but also elsewhere - have raised about Basel II. First, will Basel II harm the flow of capital to emerging and developing markets? Second, is Basel II appropriate for banks in those markets? And third, will Basel II lead to a deterioration in the level playing field?

In my answers to these three questions, I will also highlight other related issues in the new capital framework, such as complexity and procyclicality.

In some of the discussions that I have heard or read about these important issues, I have had the impression that perhaps too much attention is placed on the constraints of regulatory capital, when in my view the most binding constraint for the majority of banking decisions taken by leading institutions is economic capital. At the same time, too little attention seems to be placed on another channel of influence of Basel II: the improvement of risk management practices fostered by the incentives and transparency enhancements contained in the new framework. In fact, this is one of the key innovations of Basel II compared to Basel I. Basel II is about much more than just setting quantitative minimum capital requirements. It is about establishing incentive-based approaches to risk and capital adequacy management, within a framework of three mutually-supporting pillars: minimum capital requirements, supervisory review and transparency.

I think that Basel II represents an unparalleled opportunity for banks to improve their business strategies and risk management systems. In my view, the combination of better risk management, a stronger capital structure and improved transparency standards in the banking system could significantly improve the access of emerging economies to financial markets.

This raises two additional groups of relevant questions that I will also address later in my presentation: the first group relates to the transition by different jurisdictions to the new framework, and the second to the necessary cooperation between home and host countries to make its implementation more effective and consistent.

Our discussions on all of these topics will bear on the very well chosen title for this event: "the international banking system at the crossroads." That wonderful image of a "crossroads" suggests two metaphors that we should keep in mind.

The most immediate image that the term “crossroads” calls to mind is, of course, a place where four roads meet. It is where a traveller, having followed one road to this point, must reflect to select one of the next three roads to continue a journey. That is an appropriate metaphor for us today. We must evaluate the environment we and our banks are entering and choose a way forward that enhances supervision and that contributes to the safety and soundness of our banks. At the same time, we should not invent new roads. There are already ‘roads’ of good practices used by leading banks that we can follow and support.

We might discover a second relevant metaphor if we allow ourselves to be inspired by the beauty of the Federal Reserve’s Eccles Building and its architectural references to antiquity. In classical times, scholars divided the liberal arts into seven subjects. The first three related to language and formed the “*Trivium*,” which in Latin means “three roads.” In contrast, the “*Quadrivium*” - which is the Latin term for “four roads,” but also for “crossroads” - represented the study of four subjects related to numbers - namely, arithmetic and geometry, but also music and astronomy.

The classical metaphor of the *Quadrivium*, or of the “crossroads” of subjects related to numbers, seems equally well suited to a discussion of contemporary banking and supervision. Leading banks in recent years have sought to augment subjective assessments of risk with more objective and formalised, more rigorous, and more numerically oriented analytical techniques. After all, good numbers are the best friend of good judgement.

Credit scoring, advanced statistical analysis, and financial modelling are among the ever expanding range of tools that credit officers and others use to lend more rigorous insight into risks that were once thought not readily quantifiable. The businesses of banking and risk management will always be more art than science. Still, the metaphor of the crossroads of subjects related to numbers reminds us that, for our system of supervision to remain relevant in the twenty-first century, it must reflect the industry’s advances in quantifying risk and in developing other tools to measure and manage risk.

At the conclusion of this seminar, I hope that all of us will return to our home countries with deeper insight into Basel II and into our own readiness for a new approach to banking supervision. A Spanish proverb reminds us to “drink nothing without seeing it; sign nothing without reading it.” It is in that spirit that I would like to begin the substance of my remarks with my thoughts on why we need Basel II.

## **Do we need Basel II?**

As you know, Basel II has attracted much more attention, from more segments of society, than probably any other reform of bank supervision. Mainstream newspapers have reported extensively on it. Politicians of all views have addressed it. Even non-financial business owners have discussed it extensively. The level of public debate reminds us that banks are charged with a special public trust and that capital requirements are intended to safeguard their ability to discharge that trust. Banks serve as custodians for the public’s wealth and as intermediaries of credit to consumers and businesses alike. No bank can discharge those duties for long if it lacks sufficient capital. When capital is exhausted, the bank fails, leaving public authorities - and taxpayers - responsible for making depositors whole again.

The 1988 Basel Accord established the the first internationally accepted definition and measure of bank capital. In many ways, the 1988 Basel Accord was a tremendous success story. Perhaps because it was simple to apply, it was adopted in over 100 countries, including most of the countries represented here today. As a result, it became acknowledged as one of the benchmark measures of a bank’s financial health.

While the simplicity of the 1988 Accord was an asset in promoting its acceptance, today its simplicity is quickly becoming a liability for some bankers and supervisors alike. Over the past 16 years, the methodologies for measuring and managing risk have evolved in ways that the architects of the 1988 Accord could not have anticipated.

For one, advances in technology, telecommunications, and markets have changed the way that banks collect, measure, and manage their risks. Having gained experience in quantifying exposures to market risk, leading banks today are quantifying and using increasingly reliable estimates of the credit risk associated with particular borrowers. Likewise, banks seek to quantify in a more reliable manner their exposures to operational risk, or the risk of losses stemming from failures in internal processes or systems or from damage caused by an external disruption. Evolution in markets has likewise provided

banks with more tools for managing and transferring credit risk, such as through securitisation transactions and credit derivatives.

As risk management becomes more sophisticated, the simple and static rules of the 1988 Accord are becoming less relevant. Leading banks increasingly view the old rules as a burden, constraining their abilities to administer their businesses relative to the best information and practices available today. Supervisors, for our part, have less confidence in the 1988 Accord's measures of risk for banks that engage in the most sophisticated forms of risk taking and risk mitigation.

By the late 1990s, it became clear to banks and supervisors that we needed a new capital framework. But one person in particular knew that we should do more than merely revise the minimum requirements. Bill McDonough, the previous chairman of the Committee, and the former president of the Federal Reserve Bank of New York, convinced leaders in the industry, in central banks, and in supervisory agencies that we should provide incentives to advance the state of the art in risk management across the industry. He did not seek to reduce the amount of capital held by the banking system but rather sought to increase the stability of the global financial system - a goal that would benefit not just banks, but more broadly businesses and consumers.

To work toward greater financial stability, the Basel Committee is blending several policy approaches to replace the existing capital framework. As I have mentioned, Basel II consists of three mutually reinforcing pillars. The first pillar aligns the minimum capital requirements more closely to banks' actual underlying risks. Qualifying banks will rely partly on their own measures of those risks, a rule that helps to create economic incentives for banks to improve those measures. The second pillar - supervisory review - allows supervisors to evaluate each bank's assessments of its own risks and to determine whether those assessments seem reasonable. The third pillar, market discipline, strengthens external incentives for prudent management. It strengthens the ability of marketplace participants to reward well managed banks and to penalise poorly managed ones by enhancing transparency in banks' financial reporting.

One might say that Basel II seeks an "efficient frontier" of policy objectives through the three pillars. Each pillar provides something that the other two cannot. Each is essential to achieving our overall objective of financial stability.

The three pillars represent a far more sophisticated view of risk and a far more comprehensive approach to supervising bank capital than the "one-pillar" approach contained in the 1988 Basel Accord. As a result, the Committee has engaged in an exhaustive - and sometimes exhausting - public dialogue with bankers, supervisors, and other observers on Basel II's structure and merits. That dialogue was critical to improving the quality of the new framework, and I would like to express my gratitude to all who took great pains to share their views and concerns. You provided us with the perspective of other markets and countries. You shared detailed comments on the proposals. You encouraged your banks to participate in our consultations. The improvements that the Committee made to Basel II would have been impossible without your contributions.

Indeed, it was during those public discussions that policymakers in emerging market countries raised three sensitive questions. I would like to turn now to address those questions and help explain my belief that Basel II represents an opportunity for banks and supervisors in many countries.

### **1. *Will Basel II harm the international flow of capital?***

The first key question in the discussion about the new framework and emerging markets is whether Basel II will harm the flow of capital across borders and especially to emerging markets. In this context, some observers suggest that the new capital framework'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. As I will explain, I believe that Basel II will not have a material effect on the flow of capital. Basel II seeks to align capital regulations more closely to banks' current practices - it will not change the way that banks actually evaluate risk to decide whether to invest in emerging market economies.

To understand this answer, we must first understand the issue that may have triggered this debate. One of the valid criticisms of the 1988 Accord concerns its rather arbitrary treatment of country risk. The 1988 Accord assigns risk weights, and hence capital charges, to sovereign governments and related borrowers, as well as to banking organisations, based on whether the country in question is a member of the Organisation for Economic Cooperation and Development. The "OECD Club Rule," as it has become known, assigned a zero percent risk weight to exposures to sovereign government

borrowers that were members of the OECD, which means that no capital had to be held against such sovereign exposures. In contrast, exposures to all other countries were assigned the standard 100 % risk weight, which is equivalent to an 8% capital charge.

The Club Rule was meant to help distinguish between higher and lower risk sovereign borrowers and their banks. In retrospect, it seems to be an unfair way to divide the world. Indeed, some OECD member governments have experienced serious economic shocks that threatened their repayment abilities, while several non-OECD member governments have performed extremely well in the international debt markets.

When the Committee set out to revise the 1988 Accord, we wanted to resolve the arbitrary treatment of country risk that the Club Rule introduced. Our solution in Basel II was to assign risk weights, and hence capital charges, to exposures to sovereign borrowers and to banks that reflected a measure of their credit risk. Banks on the standardised approach to credit risk will determine the risk weights on their exposures to sovereigns and to banks based on those borrowers' external credit ratings. Banks adopting the internal ratings-based approach to credit risk will rely on their own sense of the credit risk involved.

Basel II eliminates the arbitrary distinctions imposed by the Club Rule and sets capital requirements based on external or internal measures of credit risk. Yet some observers have assumed that a more risk-sensitive approach might drive up not just capital requirements, but also the pricing of credit for loans to emerging market countries and banks.

This assumption is where the debate breaks down. Indeed, the arguments suggesting that Basel II will reduce flows of capital into emerging markets requires us to accept the view that regulatory capital drive loan pricing - something that has not been proven in any research.

In fact, research and the Committee's own discussions with banks suggest that something else drives loan pricing. When determining the price of a loan, banks consider all of the economic risks associated with a particular borrower. It is "economic capital" that drives loan pricing, not regulatory capital.

Research on the pricing of international syndicated loans has confirmed that "pricing clearly varies positively with credit risk." That finding should be no surprise to any banker or supervisor - banks that do not price their loans based on a borrower's credit risk probably will not be in business very long. When applied in the context of sovereign or bank borrowers, this finding suggests that loan pricing already takes into account the credit quality of the borrowers.

Studies such as this one have concluded that, consequently, even those countries that have the lowest credit quality will not likely experience a marked contraction in capital flows. Why would that be true? It is because banks that are managing their risks appropriately are already considering all of the risks that they face when they lend to higher risk borrowers - and thus a country's lower credit quality is already priced into a loan, even under the existing capital rules today.

Furthermore, there are additional elements in Basel II that can contribute to alleviate concerns about the impact on capital flows. Let me mention the reduction in capital charges for retail lending, residential mortgages, small and medium enterprises (exposures below €1 million) and well-provisioned past-due loans.<sup>1</sup> Also, the recognition of credit risk mitigants, such as collateral and guarantees is significantly better in the new framework of Basel II.

In a similar vein, I would like to address a related comment that I have often heard. Some observers argue that Basel II will have a detrimental effect on capital flows to emerging market economies because the new framework does not recognise the diversification benefits that characterise investments in such markets.

It is true that Basel II falls short of recognising the diversification benefits of full credit risk models, although the internal-ratings based approach recognises the benefits of diversification to some degree by assuming that a bank's assets benefit from the same degree of diversification as that of an average, internationally active bank. Under the evolutionary approach of Basel II, the Committee recognises the importance of continued active dialogue with the industry regarding both the

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<sup>1</sup> In the standardised approach the risk-weight of residential mortgage is 35% instead of 50% in Basel I. For SME's and other retail the new risk weight is 75% versus 100% in Basel I. Past due loans can have a capital charge of 50% when there are enough provisions (loss reserves > 50%).

performance of these models and their comparability across banks, and we have included this issue in our agenda for future work.

Nevertheless, the main reason that we have not fully recognised diversification effects at this stage is because first we need to see clear evidence from many banks that they have robust systems in place themselves to assess and quantify such effects and that they rely on their measures of diversification in their daily risk management. Of course, as systems improve in the future, we would be happy to discuss them, and once there is a “best practice” in this field we will be better able to recognise it in the capital framework. In the meantime experience with internal credit models will provide us with highly valuable information.

In addition, since loan pricing is mainly driven by economic capital considerations, and not by regulatory requirements, banks are free to recognise diversification benefits in their internal economic capital calculations. Consequently, they can indeed capture their sense of the benefit of diversification in their credit decisions and loan pricing for every borrower, whether in an emerging market country or not.

From a different perspective, I think that what should be of concern to emerging market is not just the level of capital flowing into a country, but also the volatility of the level of capital that is flowing inwards. Abrupt changes in capital flows can be just as harmful as contractions in flows. Volatility erodes the confidence that businesses and governments have in the future supply of credit, rendering long-term planning meaningless.

I believe that banks adopting especially the advanced approaches to credit risk will increasingly take longer-term views of their international investments, as stress testing and other requirements will ensure that they consider how their risks would react to certain changes in the market environment. When banking systems are adequately capitalised, well-managed and risks are correctly assessed within the appropriate time horizon, the financial system becomes more stable, less procyclical, better able to promote sustainable growth, and more resilient during periods of distress. Risk assessment processes that are more formalised and disciplined may facilitate early detections of deviations or mistakes, and that may facilitate making smoother corrections at an early stage, reducing the probability of sudden changes in investment decisions. This, in turn, should benefit emerging market economies by improving the degree of confidence that they can have in the future level of capital inflows.

#### *Procyclicality*

This is very much related to the discussion about procyclicality, an important issue that we at the Committee have taken up and addressed seriously.

In particular, some have suggested that the ratings-based approaches will drive up the cost of credit for borrowers precisely at times when its supply is falling, namely during downturns in the business cycle. This has led to concerns that Basel II may exacerbate fragility in emerging markets.

There is some degree of procyclicality inherent in banking behaviour. The question that we should consider is whether Basel II will unduly exacerbate this behaviour. In response, I believe that concerns in this respect may reflect the perception that I have already challenged - that regulatory capital charges directly drive credit pricing decisions. As I noted, research suggests that it is economic capital that drives credit pricing, not regulatory capital. Consequently, Basel II will simply align regulatory capital rules more closely to banks' actual practices; it will not change how they price credit facilities.

Nonetheless, the Committee recognises that any risk-sensitive capital framework will cause the capital requirement to fluctuate for the same exposure if a borrower's creditworthiness strengthens or weakens. To mitigate excessively wide swings in capital requirements, the Committee has flattened the risk weight curves that apply under the “internal ratings-based approach” to credit risk so that a small change in credit risk does not lead to a large change in capital requirements. At the same time, the Committee will require banks adopting the more advanced approaches to credit risk to adopt a more forward-looking approach to credit risk management by requiring meaningful stress testing of their credit portfolios. Stress testing is intended to help banks understand how their exposures to credit risk may change in the future should sudden shocks affect the market in some way.

## **2. *Is Basel II appropriate for banks in emerging market countries?***

The first key question addressed Basel II's potential impact on investment and capital flows between countries. The second key question is whether Basel II is even appropriate for banking systems in emerging markets, which I would like to address now.

In my view, the principles and vision of supervision in Basel II are valuable for supervisors and banks in all markets. I must acknowledge that its advanced approaches to risk measurement are mainly intended for those internationally active banks that have the greatest potential to increase systemic risk, and are very demanding in terms of the investments that they pre-suppose in the banks' own systems, and the qualitative requirements that they set. The 1988 Accord itself was created initially to apply a more consistent set of rules to globally competitive banks, and the shortcomings of the existing rules today are especially evident in the context of these highly sophisticated organisations. However, many supervisors apply the 1988 Accord to less complex organisations that may be active mainly or even only in domestic markets. Is Basel II appropriate for those banks as well?

I think that the great level of diversity in markets and in financial systems worldwide makes it difficult - and perhaps even counterproductive - to try to specify a single rule that could be applied to all banks in all countries. Fortunately, Basel II is moving away from a "one-size-fits-all" rule. In fact, Basel II's menu approach provides supervisors and banks with a range of options that make its basic standards more readily available to many kinds of organisations in countries that face different economic circumstances. It also makes greater supervisory cooperation essential, in order to ensure consistent implementation.

One concern which has been expressed many times is that excessive reliance is placed on External Credit Agencies for those banks that do not have sufficiently robust internal rating systems. The Committee has been mindful of this concern and if supervisors are uncomfortable with external ratings in their countries, there is an option whereby all corporate claims are weighted at 100% and sovereigns and banks can be risk weighted according to the risk scores of export credit agencies, in which case there need not be any reliance on external credit agencies at all.

Indeed, our discussions with colleagues and counterparts from countries outside the Committee have been instrumental in revising the capital framework. Thanks to our consultations, we have endeavoured to address several broad issues in the new framework, which I will set out now.

### *Complexity*

One inevitable by-product of designing a comprehensive three-pillar framework with built-in options to suit different circumstances is increased complexity. The members of the Basel Committee certainly recognise that complexity is not a virtue for supervisory guidelines. It is far easier to enforce a simple rule than a complicated one. However, achieving a balance between simplicity and comparability, and also between simplicity and risk sensitivity is particularly difficult in an industry like banking, where a culture of constant innovation makes it a tall order for regulators to develop simple rules that fit all banking products and services in all their permutations. Paraphrasing Einstein 'a good framework should be as simple as possible, but not simpler'

Much of the complexity in Basel II actually stems from the diversity existing in real world and from the many options that the rules provide. Many of those options reflect banks' own requests to address the rich variety of risks and practices in existence today; some banking organisations thought that a "blanket rule" would unfairly burden them. By providing a range of options, we are better able to fit the regulatory framework to each bank's profile, rather than the other way around.

Similarly, some of the complexity in Basel II stems from the details we provide to clarify expectations for banks and supervisors and to promote a more level playing field. Many bankers and supervisors asked the Committee to provide greater details where they thought a danger existed for differences in interpretation to arise across jurisdictions.

We have worked hard over the past years to clarify the rules, to simplify those thought to be the most complex, and to provide options for those wishing to use a simpler approach. In fact, as the Basel Committee demonstrated in an annex to the third consultative paper, supervisors can select options that would result in a very simple set of rules that can be specified in just 12 pages of text. That is approximately equal in length to the original 1988 Accord.

The "simplified standardised approach", as we call it, is intended to be useful for those countries that do not wish to adopt all of the options available under the new framework. The trade-off, however,

reflects the fact that the policy balance at stake is between simplicity and risk-sensitivity; if one chooses simpler rules, the cost is less sensitivity to risk and hence greater conservatism in capital requirements.

### **3. *Competition and consistency of application.***

Another broad concern that the Committee has worked to address is Basel II's impact on global competition. In particular, some have asked whether banks that choose Basel II's advanced approaches will enjoy benefits over those that choose simpler approaches. Others have wondered whether banks that remain on the 1988 Accord for some time will be disadvantaged.

To respond to these concerns, we should understand that adopting an advanced approach does not automatically reduce a bank's capital requirements. In fact, a more risk sensitive capital framework is intended to align capital requirements more closely to risk. This could mean that capital requirements for an advanced bank may actually rise relative to the current rules if the bank's exposures are actually riskier than the measures under the 1988 Accord would have suggested. Furthermore some national supervisors in emerging economies may set higher capital requirements than implied by Basel I, perhaps even higher than those implied by Basel II, depending on the risk environment.

For those banks that do experience reductions in capital as a result of Basel II, some observers have questioned whether the lower requirements might provide certain advantages and make it easier for those banks to acquire other banks that do not share in the same benefits. History suggests that this particular concern may be unfounded. In a paper published this past February by the Federal Reserve, researchers reported that they did not find convincing evidence that past changes in capital requirements have had a substantial impact on mergers between banks.

The issue of competition between banks has also come up in the context of competition between countries. Here, we should remember that Basel II is intended to help ensure that international competition in banking markets is driven by the strengths of each bank, rather than by differences in each country's rules.

One way that the Committee has sought to promote a consistent application of the new framework is by providing banks and supervisors with detailed requirements where necessary. As I have already mentioned, these details may add to the appearance of length and complexity in Basel II, but that is a small price to pay for greater consistency and a more level playing field.

However, given the need to have a framework which can be adapted to a wide range of circumstances, cooperation among supervisors is clearly the most important tool in achieving an appropriate level of consistency. The Committee has established a working group of supervisors, called the Accord Implementation Group, or "AIG," that shares information on implementation efforts among Basel Committee member countries. The AIG works with other supervisors as well, including through the Core Principles Liaison Group, a group of supervisors from many other countries that shares views and exchanges information.

By promoting the sharing of information on practical issues, the AIG's discussions will help to foster greater consistency in the implementation and application of the new framework across countries. For example, thanks to the work of the AIG, the Committee has been able to publish its thinking on the implementation of the supervisory review process - Pillar 2 - and on home-host co-operation in implementation of the framework.

Let me just come back to this latter point. Given the internationalisation of banking groups and their increased reliance on group-wide risk management, it is clear that the cross-border implementation of the framework is more complex than it was in 1988. The AIG has been actively discussing this issue, and in August 2003 the Committee published a set of principles to promote closer practical co-operation and information exchange among supervisors. The principles re-emphasise the traditional responsibilities of home and host supervisors, but also how those responsibilities will continue under the new framework on the basis of enhanced co-operation. More recently, at the beginning of May, the Committee published an elaboration of the principles.

Of course, we recognise that the objectives we are seeking cannot be achieved overnight and that they are dependent on building good relations and trust between supervisors. As part of this effort, the AIG will be meeting again with the Core Principles Liaison Group's working group on capital in the middle of this month. Among other things, the two groups will discuss cross-border issues and case studies and will exchange current thinking on implementation strategies. I believe that each and every

effort and initiative to improve communications between supervisors around the world should be strongly encouraged.

#### **4. *Moving to the new framework***

These are just a few examples of how Basel II has been improved to make it more suitable for national circumstances and domestic banking systems in many countries.

The members of the Committee and I recognise, and we have consistently stressed, that only national authorities can decide when to adopt Basel II. Adopting Basel II on the same timetable as the member countries of the Basel Committee is not feasible for all countries. In fact, Basel II may be a lesser priority compared to other ongoing efforts to promote the fundamentals of safety and soundness in each country's banking system.

All of us must think long and hard about the state of our markets, our banking systems, and our supervisory structures to determine when we are ready to adopt the new approach to banking supervision that Basel II implies. Of course, the Committee hopes that, over time, more and more countries will adopt the framework. We do not want them to do so before they are ready. And, when they are ready, we want them to adopt the options and approaches that are most appropriate for their circumstances.

For a country that wishes to adopt Basel II but may not yet be ready, I would suggest a three-stage approach to the transition to Basel II. These stages could be categorised as (1) strengthening the supervisory infrastructure; (2) introducing or reinforcing the three pillars; and then (3) making the transition from the 1988 Accord to Basel II.

This three-stage process recognises that Basel II is not intended simply to ensure compliance with a new set of capital rules. Rather, Basel II is intended to enhance the quality of risk management. To achieve this goal, Basel II must be built on the foundation of a sound supervisory system. Such a foundation includes having successfully implemented the Basel Committee's "Core Principles for Effective Banking Supervision," including the provisions on operational autonomy of the supervisory authority, adequate supervisory resources, regulatory and remedial powers, and a sufficient legal framework. Likewise, sound accounting and provisioning standards are critical to ensuring that the capital ratios - however calculated - reflect meaningfully the bank's ability to absorb losses. Establishing a solid foundation of sound supervisory, legal, and accounting systems constitute the essential first stage of the process of moving to the new supervisory framework.

Secondly, I would encourage supervisors to consider how the three pillars of Basel II could already be enhanced in their jurisdiction. Supervisors do not need to await their formal adoption of Basel II to start introducing or using the principles of the three pillars. On the contrary, incorporating those principles is excellent preparation for adopting Basel II in the future. For example, supervisors might be encouraged to move towards a system of risk-based supervision, developing skills in assessing the quality of a bank's risk management and its ability to assess risk exposures. At the same time, banks could be reminded of their responsibility to develop their own processes for evaluating their capital needs and a strategy for maintaining their capital levels, in line with the principles of Pillar 2. With regard to the principles of market discipline in Pillar 3, supervisors in some countries may wish to focus initially on ensuring a baseline level of disclosures across all banks. This might include discussing with banks, investors and other users of financial information their information needs and the tools available so that supervisors can tailor requirements accordingly.

In my view, these two preliminary stages will provide an excellent preparation for the "final" stage to move to Basel II.

The Basel Committee welcomes the efforts that so many countries have already undertaken to enhance the quality of bank supervision and to encourage prudent management in the banking sector. We support your work and would like to contribute to your efforts. The Basel Committee, its member agencies, and the Financial Stability Institute of the Bank for International Settlements have long participated in regional training initiatives that are intended to help promote supervisors' understanding of international banking standards such as the new capital framework. The Committee's Accord Implementation Group likewise engages in outreach to supervisors in non-member countries, including through the Core Principles Liaison Group. I chaired a special session of such a discussion earlier this year because I am personally committed to improving that dialogue.

We look forward to working with other institutions, including the World Bank and the International Monetary Fund, to assist other supervisors in their journeys as they come to their own crossroads for banking supervision.

## **Conclusion**

In my remarks this morning, my intention was to offer more insight into why the Basel Committee believes that Basel II is such an important step in embracing a new, incentives-based approach to supervision. I also wanted to discuss how it will keep our supervisory framework up-to-date with the latest advances in risk measurement techniques and risk management practices.

In my answers to the sensitive questions that I have heard from bankers and policymakers in other countries, I have sought to emphasise that the Basel Committee seeks the appropriate balance for Basel II between developing simple rules while maintaining their sensitivity to a bank's actual underlying risks. We intend to align Basel II's capital requirements more closely to banks' actual economic capital needs. Consequently, we do not think that aligning the regulatory framework to banks' contemporary risk measurement techniques will make lending patterns more volatile. Nor do we think that it will harm competition or dry up capital flows into emerging market countries.

The Committee has worked to ensure that the new framework contains sufficient options and simpler forms of rules so that its basic principles can be applied to many kinds of banking organisations in many countries. Basel II presents an excellent opportunity for emerging and developing markets. By stimulating banks to upgrade and improve their systems, business models, capital strategies, risk management systems and disclosure standards, Basel II should improve their overall efficiency and ability to compete globally. It will help to reduce the risk premiums of emerging and developing markets and will help to ensure the stability of the financial system.

Still, it is clear that, to accomplish all of these intentions, the new capital framework will be a very different approach to supervision than what we have known so far. It will require hard work on all of our parts. Bankers must work to ensure that their risk management systems meet the standards to qualify to use the more sophisticated measures of risk.

For our part, supervisors must ensure that we are comfortable with banks' progress. But we must also be ready to supervise a more comprehensive capital framework. We will need to share information on the issues we encounter in moving from the 1988 Accord to the three pillars of the new framework. We will need to compare notes on the advances our banks are achieving in measuring and managing risk and on what implications those advances may have, not just for the capital framework, but also for the safety and soundness of the banking system, and for the future health of our economies.

Thanks to the cooperation of the Federal Reserve, the World Bank, and the IMF, we are all privileged to enjoy the rare opportunity to engage in a multilateral dialogue with fellow supervisors from 50 or more countries in the same room. I encourage you to make the best use of this unusual occasion to ask questions, to share views, and to pledge your cooperation - across agencies, across jurisdictions, and across markets. Together, we can better encourage our banking organisations to improve their risk management. Together, we can better secure the benefits of greater financial stability and more sustainable economic growth for all.