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BANK FOR INTERNATIONAL SETTLEMENTS

The Changing role of Non-Financial risk

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Danièle Nouy, Secretary General of the Basel Committee

Introduction

- 1st of all, thank you for inviting me and for the honor of opening the session;
- It is a challenging task, with the focus of the day being ***Non-financial risks and recommendations for the future development of ratings***;
- In a Basel Committee's/ Banks supervisors' perspective -which is the only one I feel entitled to provide at this stage- I will focus on the Basel Committee's proposals about banks' regulatory capital (what is called Basel 2) as an example of what regulation can achieve. I will not describe Basel 2 to you, but spend time on the issues related to today's concerns, namely:
  - The eligibility criteria for using **external ratings** in our new SA;
  - The **internal ratings-based approach for credit risk** (to be compared with external ratings by rating agencies, or other institutions such as export credit agencies for example);
  - Requirements regarding **legal certainty and robust risk management processes for taking risk mitigants** into account , As well as **operational risk** in general, which are part of the non-financial risks to be addressed;
  - Pillar 3 **disclosure requirements;**
  - **…And as a conclusion, what it means in terms of corporate governance.**

A. Basel 2

What is called Basel 2, the new framework for banks' regulatory capital is about *better measuring and managing risks*, all risks.

•It comprises three mutually reinforcing Pillars:

- **Pillar 1**, the most classical part, Minimum Capital Requirements,
- **Pillar 2**, the supervisory review, is about the quality of the dialogue between banks and supervisors; it is meant to assess each bank's risk profile and draw the relevant supervisory consequences, including in terms of supplementary capital requirements.
- **Pillar 3**, is about the disclosure requirements.

•Basel 2 is a more risk sensitive capital rule, but not so sensitive that it becomes excessively pro-cyclical.

•…A more comprehensive framework for addressing risk: credit risk, but also operational risk, interest rate risk in the banking book, market risk, as well as other risks in Pillar 2.

•…And it provides several options to fit banks", (and banking systems) with different sizes and different levels of sophistication.

A. Basel 2

The overall level of capital

The general principles:

- The new rule should, on average, neither raise nor lower total regulatory capital for the banking systems;
- But, capital requirements may increase, or decrease, for individual banks depending on their risk profiles;
- The Basel Committee will build in some incentives for banks to move to the more advanced approaches, where it makes sense.

…But the ultimate target of the exercice is not a magic formula to calculate what is the adequate amount of regulatory capital; *it is to provide incentives to better measure and manage risks in order to enhance banking systems' resilience, in particular during difficult economic situations and, as a result, increase financial stability*.

A. Basel 2

A menu of approaches to calculate capital requirements

- For measuring **credit risk:**
  - –Standardised approach, making some use of external ratings,
  - –Foundation internal ratings-based approach,
  - –Advanced internal ratings-based approach.
- For measuring **market risk:**
  - –Standardised approach,
  - –Internal models approach.
- For measuring **operational risk:**
  - –Basic indicator approach,
  - –Standardised approach,
  - –Advanced measurement approaches .

…And **other risks:** for example legal risk, or reputation risk arising from abuse of banks' systems for money laundering, …etc. are addressed in Pillar 2.

A. Basel 2

Regarding credit risk- which is the core risk of commercial banks-, the simplest option, the standardised approach relies a lot on the use of external ratings (from rating agencies):

•We do not think that it is a perfect solution; banks should know their borrowers better than rating agencies; but when external ratings exist, and when banks are not able to develop internal ratings, external ratings permit a more accurate differentiation of risks,

•For ECAIs, it implies certain constraints, as their recognition by national supervisors, is based on eligibility criteria provided by the BCBS.

As a contribution to the targeted outcome of our discussions: ***recommendations for the future development of ratings***, let me mention the BCBS 6 eligibility criteria: ***objectivity, independence, Transparency (International Access), Disclosure, adequate/sufficient resources, and credibility***.

A. Basel 2

The 2nd main option is the Internal Ratings-Based Approach- IRB, that will be used by most banks in developed countries and by the biggest banks of some emerging market economies

•It relies on banks' internal assessment of their counterparties and exposures;

•It is based on three main elements:

- Credit risk parameters (e.g. probability of default, loss-given-default, exposure at default),
- A risk-weight function,
- Minimum requirements;

•It is subject to supervisory validation and approval,

•It is an evolutionary approach. Based on their expertise, banks may use their own estimates for all parameters, or for some of them. (The Basel Committee provides regulatory parameters –based on conservative averages of loss history- for the parameters not calculated by banks).

A. Basel 2

Let me mention that , of course, we need/we have specific treatment for specific portfolios, when they have different credit characteristics and loss history:

- Corporates/Commercial and industrial loans (C and I),
- Specialized lending,
- Retail (including residential mortgages and loans to small firms),
- Equity in the banking book,
- Securitisation.

A. Basel 2

In order to be authorized to make use of their internal systems, (to have their systems validated by supervisors) banks have to comply with quantitative and, more importantly, qualitative standards.

These qualitative standards can also be a contribution to our discussions about recommendations for the future development of rating.

They can be summarized in 4 strong principles:

•Banks' rating systems should provide for a meaningful differentiation of risk,

•Data sources used by banks should be suitably rich and robust,

•Ratings should be subject to some independent review, and the most important element,

•**Ratings should be an integral part of the culture and management of the banks: "The use test".** "If they are not good enough for banks' management, they are not good enough for banks supervisors either".

A. Basel 2

Concerning risk mitigants…

…The New Accord recognizes a wider range of risk mitigants, subject to meeting minimum requirements regarding legal certainty and robust risk management process.

This is about non-financial risk, but of course it has important financial consequences.

A. Basel 2

Even more related to Non-Financial risk: Operational risk

- The Basel Committee is of the view that due to the development of banks' practices such as securitisation or outsourcing, the reliance on rapidly evolving technology and complex financial products, etc. Operational risk is increasingly important.
- Therefore it needs to be reflected in credible capital assessments by both banks and supervisors.

But it has proved to be a challenging issue.

A. Basel 2

Operational risk

- The Basel Committee's definition of Operational Risk is the following one:

- The risk of direct loss resulting from inadequate or failed internal processes, people, systems, or from external events.
- It includes legal risk, but excludes, at least at the pillar 1 level, strategic or reputation risk as well as indirect losses, because they are very difficult to assess and quantify on a general, internationally harmonized basis. (Therefore it is treated under pillar 2.)

-… and we offer different methodologies to measure and address this risk:

- The basic indicator approach (BIA),
- The standardised approach (SA),
- The advanced measurement approaches (AMA).

A. Basel 2

Pillar 2, the supervisory review of banks’ capital adequacy, is the next big challenge ahead of banks’ supervisors, once they have finalized pillar 1 and pure quantitative requirements:

- **This supervisory Review is based on four key principles:**
  - Banks must undertake their own assessment of their capital adequacy,
  - …And supervisors should review the whole capital adequacy process,
  - Banks’ capital should be above regulatory minima,
  - …and provide room for supervisory intervention (prompt corrective action) when need be.
- **The main challenges are:**
  - Adequate human resources in supervisory bodies,
  - Consistency in the implementation process.

A. Basel 2

Pillar 3 is about disclosure requirements and market discipline.

-Good regulation and supervision are not enough to ensure a robust and efficient banking/financial environment. Regulators and supervisors’ efforts need to be supplemented by market discipline.

-In order to get this market discipline, Basel 2 is providing a framework for banks’ disclosure.

Conclusion

The package/framework that I have just described is a **comprehensive and challenging one**. **In order to achieve its final goal of enhancing financial stability, it requests support and adequate involvement of many different actors,** namely:

-***Banks*** to design, calibrate and use properly internal systems,

-***Auditors*** to validate the inputs and review the systems,

-***Supervisors*** to validate them and supervise their use on an on-going basis,

-Well informed and educated Financial institutions to enforce ***market discipline***,

etc.

This globally means ***high quality Corporate Governance***, which is another possible item for today's discussion.

Conclusion

I do not want to enter too much into details at this stage, but we all know that ***weak corporate governance in banks, but also in corporates***, has been one of the key factors in the past crisis.
… And it will probably still be the case in the future.

As far as banks are concerned the range of control/surveillance implies:,
- -Internal control, by specialized staff,
- -Control of the Board of Directors,
- -External control by auditors and supervisors, and
- -Market discipline.

Past experiences have taught us that if one of these elements is missing, prompt corrective action by supervisors is more difficult: It takes much more time to assess the problem, and more time to find an adequate solution and implement it.

Conclusion

There is no single good response to this issue: various corporate governance structures exist in different countries, but they all must meet high standard principles. For banks such principles have been defined in a September 1999 Basel Committee Paper, supplementing the OECD standards.