It is a great pleasure for me to participate in this conference on such an important subject as credit risk management. Both the agenda and the speakers' expertise are really impressive.

Basel I has been a major step forward for both national capital rules and international cooperation among national supervisory authorities. Since its inception the 1988 Accord became the subject of intense criticism: A principal argument was that it established capital requirements that were only remotely related to actual risks, while also being susceptible to significant arbitrage.

In response to these criticisms, the Basel Committee on Banking Supervision decided to replace the 1988 Accord with a more risk-sensitive framework taking into account the fact that the business of banking, risk management practices, supervisory approaches and financial markets have all undergone significant transformation.

The impact of the New Basel Capital Accord to the banking system

As you know, the Basel Committee is quite close to finalizing the new capital framework after a long period of deliberations. I have been asked to offer some thoughts on the impact of the New Basel Capital Accord to the banking system. Implementing the Accord will affect the way in which banks do business as well as the markets in which they operate. The crucial question is the following: do costs outbalance benefits?

I will focus my speech on the following subjects:

- Effects on lending and loan pricing
- Implementation of the IRB approach
- Operational risk
- Pillars II and III

Effects on lending and loan pricing

The revision of the capital adequacy regime is of great significance to the banks, regardless of whether they will implement Basel II right away or not, as it affects banks' counterparties and competitors.

Banks adopting the Standardized Approach are likely to find themselves at a significant capital disadvantage compared to those adopting one of the IRB approaches.

Generally speaking, banks specializing in the areas of asset management and custodial services will be among the main losers of the New Accord, whereas banks focusing on retail and lending to SMEs are likely to benefit the most. Therefore banks are expected to put more capital into retail activities.

The new framework will also profoundly alter the corporate lending business. Loans to borrowers with a higher credit rating will require less capital, resulting in lower capital costs. This will end-up in strongly differentiated conditions for corporate clients. Low risk firms will achieve reductions in their loan rates by borrowing from banks adopting the IRB approach, while high risk firms will avoid increases in their loan rates by borrowing from banks that adopt the less risk-sensitive standardized approach of Basel.

Risk sensitivity brought about by Basel II should promote the use of risk adjusted pricing, thus putting an end to the practice of cross-subsidizing across different debtor classes and promoting the allocation of capital to the processes, segments and markets that demonstrate a strong risk/return ratio. Hence, loan pricing should be increasingly based on credit risk rather than relationships. It is likely that the New Basel Capital Accord will affect banks' strategic decision-making regarding which business lines to pursue.

Among the losers of the new Accord will be the higher credit risk counterparties, non-OECD sovereign exposure, any uncollateralized exposure and the so-called specialized lending exposures. In addition to the already mentioned retail banking activities, main winners include low credit risk counterparties, mortgage customers, small and medium-sized businesses, and collateralized and hedged exposures.

An overarching issue refers to the new role of banks as information intermediaries (collecting and analyzing customer-related data). Customers who can supply such information may choose to bypass banks and go straight to the capital markets to obtain capital.

Implementation of the IRB approach

According to the IRB approach banks are allowed to use internal assessments of key risk drivers as primary inputs to capital calculation. Basel II compliance requires major investments in strategies, resources, processes and systems, which some institutions may not be able to afford.

Needless to say, banks operate on systems that were designed many years ago to process transactions, not to collect the kind of data that Basel II requires. As a consequence these systems would not be adequate for the demands of the risk modeling and analysis required by Basel II. Adapting and/or replacing core banking systems is a difficult, time-consuming and very expensive task. Key challenges include:

- the design and structure of rating systems;
- the availability and quality of credit data;
- the corporate governance framework to ensure that ratings are accurate and up to date; and
- the cost of implementation.

The first challenge is for banks to define the criteria for the ratings of their internal risk categories in order to provide accurate and meaningful assessments of individual credit exposures. The clarity and transparency of rating criteria will be fundamental in ensuring that ratings are assigned in a disciplined and reliable manner.

It goes without saying that a system is only as good as the data that go into it. Using quantitative methods to manage risk – and to deploy capital based on risks – requires high-quality and high-frequency data. High quality data are critical for formulating accurate internal risk assessments. In practical terms, banks will be expected to develop a process enabling them to collect, store and draw upon loss statistics in an efficient manner over time.

The design, controls and data that figure into a risk rating system must all be developed and function within a robust corporate governance framework. The persons assigning ratings should be independent of the marketing department and revenue producers. Moreover the rating system and individual ratings should be subject to review by the internal and external auditors. Additionally senior management and, to a lesser extent, the board of directors, will need to have a deeper understanding of the conceptual underpinnings and even operational mechanics of a bank's internal rating systems. Senior management will have to develop and embed a 'risk culture' across their organisation, which will provide employees with incentives to target appropriate customers, and ensure that business processes are reliable and that risk-related information is gathered and disclosed appropriately.

Finally, the implementation of the new rules will be of high cost, but not necessarily highly cost-effective. Implementing the more advanced approaches is going to be expensive for the majority of banks. Some of these costs may drive banks out of certain activities leaving these markets to unregulated entities.

Many commentators argue that the work required to comply with Basel II is not worth the "savings" in capital.

Operational risk

The operational risk capital charge proposed by the Basel Committee remains highly controversial. Operational risk capital is primarily intended to insure against the risk of being fundamentally surprised by a major event, but it is difficult to predict and measure what you don't expect!

Some commentators are concerned about the attempt to model operational risk in the quantitative way proposed under the Basel II rules, and believe operational risk should only be addressed through Pillar II. (As it is said, "you cannot manage what you cannot measure").

Increased supervisory scrutiny under Pillar II

Pillar II is an integral part of the Basel II framework. It aims to encourage banks to develop and use better risk management techniques in monitoring and managing the risks to which they are exposed and to ensure they hold appropriate capital against:

- risks not fully captured by the Pillar I process, such as business concentration risk,
- risks not taken into account by the Pillar I process, such as interest rate risk on the banking book, business and strategic risk, and

- factors external to the bank, such as business cycle effects.

Given that the regulatory capital should be closer to economic capital, as a function of this risk sensitivity, banks' capital could become more volatile. This volatility will induce increased supervisory scrutiny under Pillar II.

Banks are concerned that Pillar II is moving toward a system of automatic capital add-ons, driven less by the specific circumstances of each individual bank and more by a general regulatory requirement. In addition industry concerns (arising mainly from large international active banks) focus on the potential for divergence in the application of the supervisory review process by different national supervisors.

Third pillar requirements

Basel II purports to ensure that "market discipline" will force banks into greater concern for their capital adequacy by requiring that they make publicly available more information about their level of capitalization, and any capital charges, particularly since many of the new regulatory measures are based on internal discretionary decisions by the banks.

Banks will also have to adapt to the third pillar requirements of more extensive disclosure and greater transparency. For many banks, this undoubtedly means that they will have to make public considerably more information than they currently do. The disclosures required under Pillar III of the New Accord are likely to add several pages of highly technical data to bank reporting requirements, raising costs and adding little information of value to the reader. While the Pillar II disclosure requirements have been undoubtedly reduced, they continue to be burdensome and potentially confusing.

Final remark

The New Accord will have a lasting effect on the financial services industry, implying significant economic and structural consequences, which should not be underestimated, as I already showed.

The New Accord's risk management requirements are likely to prompt significant changes in the core business of individual banks as well as in their organizational structure.

It should be emphasized that the new capital requirements regulation is not only about IT. It will also affect the marketing strategy of banks, thus setting a great strategic challenge.