Ladies and Gentlemen,

I am pleased to join you this night as you are about to finish your timely conference about credit risk management and regulation. These are two widely discussed issues in the banking agenda during the last five years, in particular due to the deliberations/negotiations on the New Basel Capital Accord. Advances in risk management practices, technology and banking markets have made the 1988 Accord's simplistic approach to measuring capital requirements against exposure to credit risk less meaningful for banking institutions as well for their supervisors. Thus, the need for revision was imperative.

As you know, the new international capital adequacy framework, commonly known as "Basel II", is a reality. Central bank Governors and the heads of bank supervisory authorities represented in the Basel Committee on Banking Supervision issued the final document on the New

# *The New Basel Accord: Challenges for Banks and their Supervisors*

Capital Accord last Saturday. It has been a long process, but I am confident that the result will be a more robust and risk-sensitive Accord than the one it will replace.

It is not the time today to go into the details of the new proposals. Hence I would like to restrict myself to some general comments regarding the implications of Basel II for banks and the banking sector.

First of all, I strongly believe that the New Basel Capital Accord will profoundly affect our working environment. It offers the clear advantage that banking supervisors will be required to acknowledge for supervisory purposes the credit risk measurement methods used by banks themselves, provided that certain quantitative and qualitative conditions are met (as it is the case, since 1996, for market risk models). This will in turn lead to a reduction in the gap between capital requirements required by supervisory authorities, and the economic capital allocated by banks themselves.

Notwithstanding the above mentioned, Basel II also represents a great challenge for banks, bank customers, rating agencies and supervisors.

(a) First and foremost, complying with the complex Basel II rules will be costly and will constitute a considerable additional burden for banks, even though the expenses for specialized risk management techniques are already very significant – at least for some large banks. Cost/benefit analysis will determine the amount of funds that banks will decide to spend on the adoption of the advanced techniques subject to regulatory recognition under Basel II.

Depending on its current risk management processes, its size and its portfolio composition, every single bank is likely to experience varying effects from the implementation of Basel II. Once banks can attribute risk to a potential transaction, product or process, they can ascribe a portion of economic capital to it, define an expected return on it, consider risk mitigating techniques, and thereby decide whether to enter (and at what price) a transaction, engage in a business or pursue an activity or process.

(b) Turning to the impact on bank customers, both advantages and disadvantages will emerge. On average potential winners are mortgage customers, well-rated entities, high-quality liquidity portfolios, collateralized and hedged exposures, and small and medium-sized businesses. In contrast, those with a possible disadvantage include higher credit risk individuals, as well as uncollateralized credit and specialized lending (in some cases).

(c) As far as the rating agencies are concerned, the standardized approach requires external rating of most borrowers to be taken into account. Thus, external rating agencies acquire new importance under the New Accord. Certain markets will remain accessible to unrated borrowers, but they are likely to face premium pricing, as banking institutions will have to set aside additional capital to cover the risks they pose.

(d) Finally, it must be highlighted that the New Accord constitutes a challenge for the supervisory authorities as well. A specific issue refers to "regulatory captivity", a situation that, according to some observers, is being intensified by Basel II. Supervisors will become deeply involved in the micro-decisions of risk management. This involvement might imply that any bank failure may be viewed as the failure of the supervisor, which, in turn, may increase the reluctance to allow banks to fail.

In addition to the previous general remarks, let me now comment on some specific aspects of the New Accord.

## *Level playing field*

Being essentially "soft law", Basel II is not a self-executing international treaty. Hence, level playing field issues may arise from the potential for differential application of Basel II in the United States and in the EU (as well as other jurisdictions), and from the extensive discretion provided to the national supervisory authorities under Pillars I and II of the New Basel Accord. This potential of disparity in the application of the new framework is one of the major weaknesses of the New Accord.

## *Operational risk*

The (new) capital charge imposed against banks' exposure to operational risk is without doubt the most controversial element of the New Accord. The use of capital adequacy rules as a means to reduce operational risk is questionable. Apart from the fact that operational risk is difficult to evaluate and quantify, I believe it is best dealt with not with capital regulations, but with adequate corporate governance, internal structures, business continuity planning, audit and compliance, as well as with insurance. It goes without saying that banks will comply with the new rules.

## *“Pro-Cyclicality”*

The linking of capital adequacy to credit ratings, as envisaged by Basel II, is not without problems. Capital requirements tied to credit risk may cause banks to accelerate the historic pattern of loosening credit in good times and restricting it in bad times.

Among the Basel II proposals for dealing with the pro-cyclicality issue, the most important is the use of stress tests, which are an effective instrument for comprehending how much capital might be needed under adverse market conditions. However, these tests will not eliminate the potential for pro-cyclicality under Basel II since all scenarios tend, like minimum capital requirements, to vary over the business cycle. In addition it has been argued that dynamic provisioning could mitigate pro-cyclicality, with provisions being built up in good times in order to enhance the resources to cater for default in bad times.

## *Pillar II*

Pillar II is based on four key principles addressing two central issues:

- the need for banks to assess capital adequacy in accordance to their overall risk profile,
- the need for supervisors to review banks’ assessments and, consequently, to determine whether to require banks to hold additional capital beyond that required under Pillar I.

There are three main areas that might be particularly suited to treatment under Pillar II: risks considered under Pillar I that are not fully captured by the Pillar I process (e.g. credit concentration risk); the factors not taken into account by the Pillar I process (e.g. interest rate risk in the banking book, business and strategic risk); and factors external to the bank (e.g. business cycle effects).

## *Pillar III*

Finally, I would also like to say a few words about Pillar III, the one on market discipline. The third pillar sets out that banks should satisfy particularly stringent criteria for disclosure, which would essentially improve information to the public, and thus allow a better assessment of their actual risk profile. Obviously, Basle II proposals are addressing only the issue of transparency.

By choosing to depend on opinions of market participants rather than observing market prices and quantities, Basle II is not dealing with the much debated approach to implementing enhanced discipline through the issue of subordinated debt.

Subordinated investors are junior with respect to senior creditors in case of default of the issuing bank, and thus would not get paid out until after the senior debt holders were paid in

full. So, the use of market risk measures has the potential to provide substantially more accurate risk measurement results than any supervisory formula would.

## *Concluding remarks*

An initiative as important as Basel II is inevitably bound to change significantly over time. Basel II as a framework has been completed, but its application will be in a constant state of flux. The New Accord will have to keep pace with and adapt to market developments, the evolution of products and advances in risk management practices.

Let me, in conclusion, use the words of Mr Jaime Caruana, Chairman of the Basel Committee on Banking Supervision: *"[...] by motivating banks to up-grade and improve their risk management systems, business models, capital strategies and disclosure standards, the Basel II Framework should improve their overall efficiency and resilience."*

Hoping that we, the Hellenic Bank Association, have achieved to organise a comprehensive seminar about the most recent regulatory and market developments in the field of credit risk, I thank you very much for your attention and wish you a wonderful night.