

Is Banking Regulation Under Basel II Getting Ahead of Other Areas of Financial Regulation?

WB/IMF/FED Seminar

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Aims of Basel II

- **Encourage better risk management**
- **Bring regulatory requirements more in line with banks own internal calculations**
- **Be more risk sensitive**
- **Maintain overall level of capital in the system**

What Basel II has to say to regulators about corporate governance, risk management and controls



Outline

- **what Basel II has to say on banks**
- **how this affects the UK FSA**
- **the other sectors – investment firms, insurance**
- **relevance outside G10**

Where do these issues arise in Basel II



- **P1 – operational standards**
- **P2 – banks' own capabilities**
- **P3 – what the markets need**

P1 – governance and controls - IRB



- **IRB must play an essential role in credit approval, risk management, internal capital allocation and corporate governance**
- **Material aspects to be approved by Board**
- **Senior management to have a good understanding and ensure operating properly**
- **Internal ratings to be essential part of reporting**
- **Independent credit risk control units**
- **Independent internal audit**

P1 – governance and controls – OP Risk



- **Board/senior management active oversight**
- **System closely integrated into day-to-day risk management**
- **Regular reporting up to Board**
- **Sufficient resources in business lines, control and audit areas**
- **Independent operational risk management function**
- **Independent internal audit**

P2 – “Supervisory Review”



- **Recognises responsibility of bank management**
 - To develop internal capital assessment process
 - To set capital targets to match risk profile and controls

Principle 1



Banks should have a process for assessing their overall capital adequacy in relation to their risk profile and a strategy for maintaining their capital level

Five main features

- **Board and senior management oversight**
- **Sound capital assessment**
- **Comprehensive assessment of risks**
- **Monitoring and reporting**
- **Internal control review**

Other Principles



- 2. Supervisors to review banks' ICAAs and take appropriate action**
- 3. Supervisors should expect, and be able to require, banks to operate above the minimum**
- 4. Supervisors should intervene to prevent capital falling below minimum**

P3 – market discipline



By ensuring adequate transparency and disclosure seeks to ensure that market discipline will reinforce the messages in P1 & P2 towards good governance and effective risk management

Summary so far



- **Basel II has a lot to say to banks and supervisors on governance, risk management and controls**
- **Not new, rather a codification of what is already good practice in well managed banks**



How Basel affects FSA

P1 – FSA approach



- **Senior management responsibility at the core of FSA's current approach**
- **We propose to take the same approach to Basel II**
- **We will require banks to develop clear documented policies on responsibility of Board, senior management and relevant controls**

P2 – FSA approach



- **We currently undertake supervisory review**
 - **We set individual capital requirements for each bank**
- But**
- **We largely currently only apply Principles 3 and 4 and part of 2**
 - **Key change will be Principle 1**

P3 – FSA approach



- **The current role will increase significantly**

What's happening elsewhere?



- **a lot**

Sarbanes–Oxley Act



- **Section 302 requires both the chief executive and the chief financial officer of a public company to personally certify the accuracy and fairness of their company’s financial statements and the adequacy of internal accounting controls**

Combined Code



- **Internal Control Principle**
“The board should maintain a sound system of internal control to safeguard shareholders’ investment and the company’s assets.”

IAS 39



- **Much wider than just accounting**
- **Provides, amongst others, guidance on fair value of derivatives, asset and liability classification, effective interest rates**
- **Requires rigorous documentation and**
- **Effective testing procedures**

Investment Firms



- **Basel I applies to investment firms as well as banks in EU**
 - **Similarly for Basel II**
 - **SEC has announced that Basel will also apply to investment firms in US**
 - **Plus joint Basel/IOSCO Trading Book review**
- So standards/expectations for investment firms moving quickly into line across G10.**

Insurance



FSA experience – firms

- **Risk management standards not as advanced**
- **Control functions not strong enough**
- **Senior management/boards take less responsibility**

Insurance



FSA experience – regime

- **P1 – not risk sensitive**
- **P2 – neither firms' nor regulator's roles developed**
- **P3 – lot of it , but**
 - Could not see wood for trees
 - Did not help o/a P1 and P2

Implications for non-G10 supervisors



For banks

P1

- Don't push banks too early to advanced approaches for regulatory capital
- Do push banks to adopt improved governance and controls as in Basel II
- Do push banks to develop advanced risk methods of Basel II for their own internal use

P2

- Apply this whatever approaches are adopted under P1
- Essential that banks develop capability to assess own risks and adequacy of capital
- Essential that supervisors develop and apply supervisory review

P3

- In many markets less usable but worth considering what it can do

For investment and insurance firms

- Aim to apply the same principles

Conclusions



Basel II

- **Represents a codification of best practice for governance, controls and risk management**
- **Is not ahead of the game in terms of theory**
- **But is a long way ahead of where many banks and others and supervisors are in practice**

The main goal of Basel II is to bring the many up to the standards of what good banks and others do now

And then use this as a base for further progress

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QUESTIONS