Check Against Delivery

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Current Directions in Financial Regulation
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I want to talk today about the role of capital in our regulatory framework and current developments, particularly the Basel II capital accord. Capital matters a lot because it is real money and because it has such a crucial link to an institution's strategies and operations. Institutions that are capital constrained have less room for acquisitions. The capital allocated to a particular business has a lot to do with whether that business grows or declines and the ROE associated with it. First, some general points of principle:

- Having at least adequate capital is essential to running a safe and sound financial institution. It is necessary but not sufficient—for example, sustainable profitability is key as an unsuccessful institution can't be a safe and sound one for long. Nor is capital ever a substitute for appropriate risk management and controls. That is why capital is only one factor of OSFI's supervisory assessment of institutions.
- Institutions have to have a buffer over minimum requirements to deal with unexpected events and that buffer has to be enough relative to risks, for the institution to be considered well capitalized. But no regime can or should guard against all failures. This is explicitly recognized in OSFI's legislated mandate.
- Our capital rules and policies have to be consistent with international norms
- Our capital rules and policies have to be reasonable relative to those in the main competing markets. Where there are differences, they have to be justifiable.
- We have to have a reasonable degree of consistency in our rules between types of products and types of institutions.
- Disclosure of the capital position of institutions is an important part of market discipline. I recall a few years ago when life insurers were diametrically opposed to OSFI requiring publication of institutions' capital ratios. Well, we went ahead and the sky didn't fall.

So, what is the Basel capital accord and where does it fit into all of this?

I just came from the Basel Committee meeting two days ago. The press release following the meeting announced that the Committee has achieved consensus on all key remaining issues in the New Accord regarding the proposals for a new capital standard for internationally active banks.

This New Accord is truly and absolutely one of the most amazing examples of international rule making that came as a result of significant worldwide effort and industry consultation. It is also the most important regulatory development affecting these banks in my view.

I want to share with you my views on the New Accord and how it differs from the current Accord, what the impact Basel II will have for both banks and supervisors alike in all jurisdictions, and lastly, I will discuss what impact the New Accord will have on Canadian domestic banks and OSFI's approach to implementation.

Why go to all this trouble? What's wrong with the current Accord?

It is commonly known that the existing Accord, which dates from 1988, does not adequately differentiate capital requirements based on risks. All large corporate credits are charged the same capital regardless of risk. Loans to a lower rated sovereign OECD government attract less capital than loans to an AAA corporate client. Capital required for some transactions is more than the market would price for.

So, naturally, the current rules lead to counter-productive behaviours, such as the undue use of off-balance sheet entities and the underlying pressure to dispose of good quality assets in order to economize on capital.

The new rules bring regulatory capital more in line with actual risk. In addition, for the most sophisticated banks, the new rules are much more based on bank practices with supervisors adopting a trust but verify attitude. So, the rules will be inherently more flexible and responsive over time to changes in the market place.

Let us recall some of the basic principles of the New Accord. Basel II will also reinforce the foundation of a sound banking sector by the very fact that it explicitly addresses risks that have not been part of the old Accord, such as operational risk and interest rate risk.

The new, modernized Accord will lead to a better allocation of capital that will support sound risk management practices in banks. These practices will lead to a more refined risk allocation in the pricing of banks' products. It will promote more disciplined supervisory risk-assessment processes and it will promote more and better governance in banks around risk assessment practices.

The old accord became a de facto international standard. I expect that many countries outside those represented on the Basel Committee will adopt the new Accord over time. Although the Committee hopes that the new framework will be applied as uniformly as possible at the national level, there are a range of options for determining capital requirements for credit risk and operational risk that allow banks and supervisors to select approaches that are most appropriate for their operations and their financial market frameworks.

Pillar 2 of the new Accord is also key. It states that the bank's responsibility is to assess its target capital related to its risks and it is the responsibility of each supervisor to assess that process. It also states the Committee's expectations that internationally active banks will operate above the minimum. Most importantly, it provides that banks should explicitly consider other risks in setting their target capital such as interest rate risk and concentration risk. It also mandates stress testing by banks.

Lastly, under the third part of the rules (Pillar 3), this new Accord will promote transparency in that it will allow market participants to assess an enhanced level of key information about a bank's risk profile and level of capitalization. Disclosure of these matters is generally pretty good in North America but that is not true universally elsewhere and even in Canada some improvements are possible.

All of these elements of the new Accord will further strengthen the soundness and stability of the international banking system.

Depending on the bank's level of sophistication, there is a menu of options built into Pillar 1 for computing a bank's minimum capital requirements. Banks can choose to take a simplified or standardized approach that draws on a number of distinctions that improve the risk sensitivity of the resulting capital ratios compared to the current Accord. Similarly, with the introduction of the Advanced Measurement Approaches to operational risk, banks may use their own method for assessing their exposure to operational risk. But there are also simpler approaches as part of the package.

Operational risk is a good example of where regulatory rules are pushing banks to be better at risk measurement and risk management. Many of the major losses in international banks in the past few years have been due to operational risk events. For some banks, such as those involved in large amounts of processing, operational risk is much larger than credit or market risk. The work to develop a capital charge for operational risk by regulators in conjunction with industry is helping move the yardsticks forward on better practices. But, even though more analytic techniques will be brought to bear, there is a significant role for judgement. Banking is about judgement and, healthy skeptisicisms about models is appropriate.

What is the impact of this new system? Will this result in material changes to the level of overall capital in the financial system?

Overall capital in the system is not expected to shift materially. But there will be material changes bank-to-bank and asset-to-asset. For example, higher risk corporate loans will attract more capital and lower risk portfolios less. Retail portfolios will generally have lower requirements unless a bank is in sub-prime lending. The Accord has a special set of rules for small- and medium-sized business, recognizing their distinct characteristics.

The Accord should also improve the allocation of capital to businesses inside a bank and thus provide better information on the true profitability of certain products and have a beneficial affect on better pricing risk.

Implementing the Accord will be a major challenge for banks and supervisors. Work is well underway but more is necessary, particularly for the advanced approaches.

The Committee put in place the Accord Implementation Group, which I chair, with the mandate to "exchange views on approaches to implementation and thereby to promote consistency in the application of the Accord." We are focussing on promoting:

- More cooperation and coordination among home and host supervisors in implementing the Accord. This additional cooperation will, I think, have other benefits outside of the capital area.

- Sharing of information on the use of national discretion

- Sharing of information on supervisory practices. A number of jurisdictions are using the new Accord as an impetus to enhance their supervisory processes.

- We also have a significant outreach to non G-10 countries.

Canadian banks and OSFI are well positioned to adopt the new Accord. Canadian banks generally have well developed risk management systems though some enhancements will be required and are occurring. Implementation costs are not trivial, but a good deal of these costs provide improvements in risk management and measurement that will be beneficial for banks in any event. OSFI already has in place a leading edge supervisory process and the enhancements involved for us are eminently doable.

There have been criticisms of the Accord. I would like to address two. The first is complexity. Yes, parts of it are complex, but that reflects the complexity in

banking. And simpler institutions do not have to deal with this complexity. The simplest version of the rules is about 12 pages long.

Secondly, pro-cyclicality. The worry of critics here is that the new rules will result in minimum capital requirements changing over an economic cycle much more than under the current rules. There is some truth to that, but I think that concern is overblown. Most importantly, we expect banks to maintain a healthy cushion of actual capital above the minimum. This target need not change (and indeed there are market incentives for banks not to change this much over a cycle). In addition, as the time horizon lengthens for banks looking forward to estimate potential losses, the Accord could actually reduce cyclicality.

If the gap between minimum capital and banks' actual capital narrows as credit condition worsens, that is a true reflection of what is occurring in the banking system. As well, I find it hard to argue that banks and supervisors ought not to better recognize risk in order to smooth economic cycles. Rather, I think it is better to do an improved job of recognizing risk and thus reduce the chance of serious financial instability.

Overall, this is a much improved, more market-compatible set of rules. I welcome these developments, which will help promote global financial stability.