



# **BASEL 2: RAISING THE GLOBAL RISK BAR**

**ADDRESS BY OTBERT DE JONG, EVP  
HEAD OF RISK ADVISORY SERVICES, ABN AMRO**

**FOR**

**IADI THIRD ANNUAL CONFERENCE  
BRUNNEN, OCTOBER 26, 2004**

## **1. RISK MANAGEMENT: A MODERN ART**

In today's financial markets, the challenge for risk professionals is becoming ever more exciting.

The "Pace of the Place" nowadays demands faster decision-making on transactions with increasing leverage and complexity.

Technical aids to assess risk have improved. This can create however create a false sense of security.

The risk professional's tool-kit requires an increasingly well-developed ability to read between the lines, look behind the presented truth, through the cycle, and beyond the numbers.

The proper approach includes preparedness to take a clear, yet balanced stand on high risk/high reward issues in an environment full of volatility and uncertainty.

In other words, success takes a combination of independence, authority, expertise, prudent ambition, and most definitely imagination.

All of this must be backed by an ever stronger risk framework, which has effective proximity to where the risk actually resides.

Nowadays we are also supported by technology. It is a new order of things. Is risk management an art or has it become a science? Perhaps we can consider it Modern Art.

## **2. NEED BETTER TOOLS**

A risk manager is only able to take the right decisions if he can rely on a professional, values-based, disciplined business organisation, combined with structured and immediate access to all relevant internal and external data.

Risk management and its processes are core to a bank's strategy and operating efficiency, as well as its sustained "license to operate."

When risk management is brought in close alignment with the business, it is a major contributor to value creation for all stakeholders.

Excellent enterprise wide risk management (ERM) is a core differentiator in our highly competitive business environment.

It is much more than playing defense. It is creating value.

### **3. MORE EXTERNAL PRESSURES**

The “Pace of the Place” in our business environment is increasingly vulnerable to operational risks like fraud and money-laundering, which have necessitated strengthened discipline on KYC and disclosure requirements.

Today we also have a better understanding of our vulnerability to more general external “events” with many different causes.

These often unexpected, uncontrollable situations are putting additional pressure on financial stability in markets and are therefore affecting not only individual players but also much needed sustainable economic growth.

This has made us pay much more attention to concepts such as stress-testing and business continuity management.

Moreover, worldwide business-interdependencies may be causing wider, undesired ripple effects throughout the system. We have seen enough crises of many different sorts during the last decade to recognise this as a structural issue for all of us.

The world has become smaller and riskier. Clearly these issues are not just a concern for us as practitioners, but also for regulators and supervisors.

However, their response by way of a myriad of (sometimes conflicting) rules and regulations are becoming a major concern - not to mention cost-burden - particularly for internationally operating banks.

#### **4. BASEL2: RAISING THE GLOBAL RISK BAR**

Against this reality it is encouraging to BC-supervisors and practitioners (like us) that so many of our colleagues in *non-BC countries* are taking a stepped-up interest in the New Capital Adequacy Framework, or Basel 2, published in June 2004.

The New Framework recognises the fact that markets require enhanced stability, and that the soundness and the safety of the banking system worldwide is key therein.

It also recognises that to enhance the financial stability of an individual bank and the system at large, there is a need to focus not only on the traditional Review and Compliance functions. But also on portfolio behaviour modeling and the quality of control processes, as well as transparency and disclosure.

In many non BC-countries, regulators and supervisors have engaged in a constructive, consultative process with bank-practitioners, similar to that which international banks had (and still have) with the Basel Committee, to define a roadmap towards adoption of the principles of Basel 2.

#### **5. COUNTRY-SPECIFIC, BUT COORDINATION PLEASE**

Clearly, migration of the Basel 2 Framework into national legislation must be country-specific in terms of conditions, scope, and time-schedule.

Some countries are already in an advanced stage.

For international banks, such development is quite desirable, as the many financial markets in which we operate will become more professional,

disciplined and transparent, while home/host supervisory issues for us can be dealt with better by a *well-informed* host-supervisor.

## **6. NOT A QUICK FIX**

Such country-specific roadmaps must be agreed upon among all stakeholders with ambition.

However, Basel 2 itself should not be considered a “quick fix” for sounder and safer bank practices and market-based supervision.

It is definitely an essential attribution thereto and must be initiated now, but more factors need to be considered and simultaneously effected.

Such factors include:

- a transparent and effective regulatory and judicial environment (e.g. Banking Law, Civil Code, Bankruptcy Law);
- adequate governance structures within the banks;
- an embedded, values-based, professional business and risk culture;
- and
- effective, independent supervision.

All of this requires vision, execution ability, capacity- and competence-building by regulators, supervisors and bank-practitioners.

## **7. ON-GOING JOURNEY**

It should be recognised that next to an improved skills-set in ERM the right mindset particularly from the Governor and boards of the banks is essential.

Basel 2 is still very much “work-in-progress” as a number of important technical and efficiency issues still need to be resolved under the leadership of the Accord Implementation Group (AIG), and are even selectively the object of a further (4<sup>th</sup>) Quantitative Impact Study. Also, the Basel 2 framework itself will be subject to further evolutionary improvement.

## **8. ON-GOING TOP LEVEL LEADERSHIP**

These dynamics will also play a role in each country individually, requiring continued, active, top-level involvement among supervisor and locally operating banks, including subsidiaries of foreign banks.

For some countries the journey to Basel 2 may lead initially through “Basel 1.x”, or within Basel 2 through a “Simplified Standardised Approach”, ideally eventually reaching the IRB approach.

A particularly interesting issue will be the future role and status of State-owned Banks and their role in emerging local capital markets. The latter being essential to the local agenda to “de-bottleneck” obstacles for sustained economic growth.

## **9. BEST PRACTICE CONTINUES TO EVOLVE**

By 2007 it will have taken nearly a decade to bring the New Capital Adequacy Framework into practice after an extensive, very productive, multi-stakeholder consultation process, improving the understanding of a new risk paradigm by all participants.

During this period, markets have clearly moved to new “best practices.”  
Basel 2 is not a handbook for best practices, neither is it an inter-governmental treaty.

But it definitely will provide an important impetus to more widely understood ERM practices in BC and non-BC countries alike, each within their own authority, domestic agenda and standards.

Basel 2 is a journey, an evolution, not an end.

## **10.BROAD SCALE CONVERGENCE**

Basel 2 has offered, and will continue to offer, a platform for much needed convergence of concepts and practices in the financial system at large.

And yes, many issues still need to be resolved. Just to mention a few:

- data-reliability and availability;
- the integration of Basel II and IAS;
- improved home/host coordination;
- in-efficiency and cost of multiple supervision for international banks;
- downturn-LGD/stress testing;
- the portfolio effects of diversification;
- model-validation
- “migration/leakage” of traditional banking business to unregulated entities outside the regulated bank sector,
- and how to preserve diversity of the banking system (small banks),

Many papers, circulars and guidelines will continue to follow.

Hopefully these will not add to the complexity, since the “Pace of the Place” will itself continue to increase.

Both in terms of complexity and volatility.

And we, the international banks, will, out of self-interest, play an active role to contribute towards a safer and sounder banking and business environment also in your countries.

Like you and our (many) supervisors we are all part of it.

So we must make it work.

Amsterdam/Brunnen 26<sup>th</sup> October 2004