The Future of Banking Regulation

Basel II, Quantitative Models, and Risk Management in the Aftermath of the Current Financial Crisis

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Challenging times

- Importance of good risk management
- Importance of attention to detail
- Importance of timely information
- Importance of assumptions
- Importance of good governance/controls

Lessons – Relevance/Focus

- Most structured instruments relatively new
  - Data used in estimation was constrained to most recent (benign) periods
  - Difficulty in identification of risk
  - Difficulty in recognizing time-varying features (e.g. correlations)
- Excessive focus on default risk
  - Ratings transitions matter
  - Shifts in distribution of spreads matter
  - Point-in-time vs. ability to pay over life of the loan

Lessons – Information Content

- Over-Reliance on Rating Agencies
  - Internal assessment of third party valuations related to structured products important
  - Understanding third party models and assumptions in relation to own portfolio
- Full Information vs. Proxies
  - Structured different from corporate/municipal
  - Specific instruments different from indexes
- Importance of Information Availability prior to event

Basel II

- Key component of financial stability going forward
- Enhanced risk sensitivity / incentive compatibility
- Greater alignment of regulatory capital with actual capital – narrows gap
- Improved comparability – counterintuitive that greater flexibility may help
- Three pillars: capital requirements, supervisory oversight, market discipline
- Adaptable to evolution of markets and products

Lessons learned

Recent comments by Wellink

- Importance of better coordination among public authorities
- Enhancements to strengthen Basel II
  - Procyclicality
  - Leverage ratios
  - Liquidity risk
  - Banking/trading book boundaries
- Real live stress test
  - Need for cooperation between central bankers and prudential supervisors
  - Need for international coordination among supervisory community
- Strengthen macroprudential supervision
- Goal of creating resilient system, reducing frequency and severity of crises

Basel Committee Developments

- Economic capital (29 Aug 2008)
- Liquidity risk management (25 Sep 2008)
- Fair value practices (28 Nov 2008)
- External audit quality (2 Dec 2008)

2009:

- Stress testing principles (6 Jan)
- Strengthen standards and guidance (8 Jan)
- Enhancements to Basel II framework (16 Jan)

Recommendations - Future

- Addressing situation requires prioritization
- Reality vs. perception/confidence
- Ex-ante vs. ex-post decision-making
- Return to fundamentals of risk management
- Proactive information/data collection
- Importance of infrastructure

Risk Management and Modelling

- Risk Management Principles ⇔ Modelling Principles
  - Proper identification/measurement
  - Robust and objective methods, resilience to shocks
  - Importance of preparing for disruptions
  - Critical role of strong oversight
  - Importance of time series element
- Variable:Model :: Exposure:Portfolio
  - Is it available?
  - How much do you know about it?
  - Does it help to diversify?
  - Does it address your objectives?
  - What form is most appropriate?
  - What are upside and downside risks?

Avoid common pitfalls

- Poor decision-making, not enough thought upfront
- Overconfidence
- Failure to anticipate disasters
- Lack of appropriate controls/governance
- Failure to understand upside/downside risks
- Taking comfort in what is known
- Excessive reliance on past performance
- Failure to recognize and react to a changing environment

Questions?