The following interview took place between Dr. Alec Shuldiner of Basel Consulting and Klaas Knot, Division Director of Supervisory Policy for De Nederlandsche Bank. Mr. Knot is also Chair of the Risk Management Modeling Group of the Basel Committee on Banking Supervision and is a former member of the Committee's Risk Management Group. The two discussed Basel II and the future of banking regulation.

Klaas Knot: First of all, I think you are talking to the right person, because I have just been named the new Chair of the Risk Management Modeling Group of the Basel Committee. That is a group that has been given the task of looking beyond Basel 2, as was promised by the Committee in its midyear text. And in particular, of looking at the question of whether credit risk modeling, which goes a step beyond the internal ratings based approaches of Basel 2, whether that and other developments we see in the industry would at some stage also be suited for incorporation in regulation. That of course would be a Basel 3-type regulation because Basel 2 explicitly *excluded* full credit risk modeling because the banks at this stage aren't yet ready. But although they still have some way to go, the banks will not stop at Basel 2, that is our conviction. They will not stop at the internal ratings based approaches, which they regard as only a halfway house to full credit risk modeling. Inevitably the banks will continue on this path and at some stage the banks will come back to the regulators saying, "We now trust these models which have been developed in a much better way than was the case a couple of years ago. Would you be willing to consider incorporation of these models in our regulatory regime?" Well, in anticipation of that question the Risk Management Modeling Group has been established.

That brings me to a more general sort of background of Basel 1, Basel 2, Basel 3 argument that I would like to outline up front. Basel 1 was very much a regulatory formula which didn't have too much relationship with what was going on inside the banks, with actual credit risk management within the banks. The banks had their risk management departments, they had their risk management practices, cultures, and so on. We regulators had this formula for calculating risk-related assets and holding solvency capital. Increasingly, the banks discovered that these two worlds, so to speak, did not converge on many, many points. So the banks continued on their internal path of developing economic models, of developing their internal risk management models to quantify credit risk in the way they thought it should be quantified. And as the discrepancy between that development on the one hand and the regulatory regime on the other hand became ever more evident the Basel Committee eventually said, "We need to get rid of Basel 1 and move to Basel 2, with a closer alignment of regulatory capital with economic capital."

We have to adjust our regulatory standards so that they are more in line with internal practices within the industry. Because that enhances the efficiency, the effectiveness of supervision. Also, it minimizes the administrative burden on firms. Basel 1 became a restriction on the operation of banks which it was never intended to be. A risk sensitive regime if it works properly should not pose too many restrictions on operations that the banks would otherwise undertake. That was too much the case with Basel 1 and that's why we had to move to Basel 2. Of course Basel 2 is a halfway house in that sense. We learned from banks that they have internal rating based approaches, some of them, and elevated that practice to become the regulatory standard. But the reason that the banks had internal ratings based approaches was also in order to simplify some procedures. The even more sophisticated approaches were not sufficiently fleshed out within the banking industry itself. The more sophisticated approaches are what I would call "Credit Risk Modeling" which also takes into account correlations between asset classes and so on.. Why is that model in place in banking institutions? Well, one of the main reasons is lack of data, lack of information infrastructure. The data is often there in the institution but it's there in the wrong place. In the risk management department it's stored in individual credit files. However, it's not stored in a comprehensive way. And that is where technology and risk management really come together. The Basel Accords are sort of like Windows: you had Windows 3.1, Windows 97, Windows 2000…. You have different versions. That's the way it will also go with Basel. Of course this Basel framework will last for a while, but it will not last until eternity.

Alec Shuldiner: So was one of the purposes of Basel 2 to give the banks enough incentive, gently put, or more directly put, to force the banks to make the IT investments they needed to capitalize on the data already in their possession?

KK: Yes, I think Basel 2 clearly is much much stronger than Basel 1, and one of its main objectives is strengthening risk management practices within the institution by rewarding good risk management. My personal belief is that the capital number that comes out of a regulatory regime is one of its least interesting elements. It's the thought process that ultimately leads to this one capital number, that's the interesting part. The number in itself, yes, of course it tells us something about financial strength. But normally if you have a regime which stimulates an institution to go through this lengthy process before arriving at the number, then in that process the weaknesses will become apparent. And, it will give the institutions the opportunity to manage their risks in a much more timely fashion, to intervene sooner. That's the really interesting part. That's why we will see a continuation in the future of regulatory measures converging toward best practices within the industry.

AS: What other best practices was Basel 2 intended to encourage?

KK: One development I would also mention is a much stronger emphasis on quantification. Before Basel 1 credit risk management was by and large qualitative, it was a lot of human judgment.

AS: Red light, yellow light, green light.

KK: Yes. With Basel 1 some of these risk rates were really seen as unjustifiably harsh by the banks. Banks started collecting data to prove that Basel 1 was wrong. But in collecting this data they began to develop more sophisticated approaches themselves. Now that they had the data, they had the opportunity to start quantifying things.

AS: And was this an unintended consequence of Basel 1? Just how clever are the designers of this regulation?

KK: I think that it was unintended. The reason for Basel 1 was very simple: it was very clear that the banking systems of some economies were hugely undercapitalized. Those economies that had a properly capitalized banking system saw that as an unfair competitive advantage. In those economies where banking systems were undercapitalized there was a huge implicit state guarantee because ultimately the deposits are insured. Basel 1 was there to restore the level playing field. That was the only purpose. Improvements in credit risk management was an unintended side effect but a good one I think. And, of course it was helped by developments in IT and sales. Before 1980 you could have huge data sets but you would not have had the computer technology to process them.

AS: So the demands that were made in Basel 2 would have been unreasonable years ago even if the banks had had the data. They're now technically feasible. To what extent are you not just allowed to move further in your regulation but actually forced to do so by technical developments? E-banking is an obvious example.

KK: I wouldn't say we are forced by technical developments but more so by political developments. One political development that I would mention here is clearly the political desire to reduce administrative burdens on firms. Any discrepancy between how a firm internally manages its risk and how it is forced to quantify risk according to some outdated supervisory formula, that is a burden. It leads to huge compliance costs, to huge administrative burdens on firms. The pressure on us was to minimize these burdens. That led to our making additional efforts to more closely align regulatory capital with economic capital. But I wouldn't say that we were forced by technology. Technology is an opportunity for institutions. It allows institutions to better quantify risks and to thereby get a different perspective on risk. And, of course, as a regulator you want to be up-to-date, you want to internalize the most up-to-date perspectives on risk and on risk management.

AS: But surely technology also generates new risks?

KK: That is how operational risk, for instance, ended up in the formula. That's true. Because on the one hand technology allows better management of existing risk, but it also introduces new risks. That is also something you see reflected in Basel 2: not only the refinement of credit risk but also the introduction of operational risk.

AS: How do you see the regulation of operational risk developing in the future, in Basel 3?

KK: Already in Basel 2 the regime for operational risk is much more Basel 3-type than it is for credit risk. For credit risk the Committee has clearly stated "We do not allow full credit risk modeling in Basel 2." That's something, perhaps, for Basel 3, ten years down the road. For operational risk the regime is called "Advanced Measurement Approach," that is full modeling. So in effect in the operational risk area you could say that the Committee is making the full leap already. I wouldn't see any developments in the way operational risk is formulated in Basel III. I would see the development of, perhaps, credit risk catching up with operational risk rather than the other way around.

AS: You don't see guidelines such as the ones on e-banking, which aren't a part of the Accords, which have no official weight, you don't see these guidelines eventually being introduced into the Accords themselves?

KK: Basel 3, if there is a Basel 3, will be even more internal models-based than Basel 2. There will be even less direct regulatory restriction, direct regulatory requirements imposed upon banking operations. It will be even more incentive-based, even more based on firms' internal perspective on risk management and risk modeling.

AS: But mightn't there be a systemic tendency among banks to ignore certain forms of operational risks, and thus not include them in their modeling?

KK: Then we would not accept their model as the basis for the regulatory requirement. There will always be a two-tiered structure in the capital adequacy framework. Banks are given the opportunity to use their internal model under a set of restrictions that the model must comply with. One of these restrictions is, of course, that it needs to cover all relevant risk. If the model doesn't comply with those restrictions then we have a supervisory formula which leads to a higher capital requirement. That is an incentive to develop a good model.

AS: Let me go back to the statement you just made about how one of the major pressures on regulators is to reduce the burden of regulatory overhead to the greatest extent possible. If I were sitting on the board of a bank right now I would be thinking, "If there is so much pressure to reduce my regulatory burdens then why have my compliance costs skyrocketed over the last ten years? Why am I building these vast new systems to deal with Basel II and Sarbanes-Oxley and all the rest?"

KK: What we would say to that board member is that much of the work they are doing because of Basel 2 we sincerely believe they should be doing without Basel 2. We believe that sound risk management adds value to the firm in and of itself. One of the main things regulation does, I think, is strengthen the relative position of risk management departments within financial institutions. Normally within financial institutions risk management is the rain in the day. Without us the commercial side often prevails over risk management because the commercial guys are bringing in the money. I take your point that the costs of building compliance systems only seem to be going up within financial institutions but you should also ask yourself, "To what extent would that development have taken place without regulation? To what extent is it simply the case that the nature of risks has changed much more with cross-border transactions, with e-banking, that even without regulation managing those risks would have been more costly?" We try to add to that cost to a minimal extent by trying to lever off as much as we can from the systems that banks need to develop for internal purposes already. We try to push them every now and then because we think that without our push, maybe, the level of development of those systems would be sub-optimal from our perspective. So, we push them to do more than they would be doing without us.

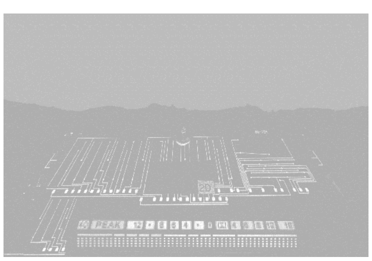
AS: Let me just address one more area of real concern to the multinational financial institutions in particular and that is, of course, the necessity of reporting to multiple regulators, not all of whom interpret Basel in the same way, or perhaps even not all of whom subscribe to Basel at all. There's been quite a bit published lately about whether or not multinational banks should be regulated solely according to their home regulator's requirements and if so what role are foreign regulators going to play? Clearly, for the banks this is a huge headache, making sure everyone is happy…

KK: That's a comment we know....

AS: …so do you see regulators cooperating to lower the differences between regimes? Is there a future in which banks might be spared having to report to multiple regulators?

KK: That last idea is clearly a step too far. We are working in that direction, visibly so. In Basel we have established the Accord Implementation Group. That's a very important sub-group of the Basel Committee. The sub-group consists of the people responsible for the frontline supervision of these institutions. For instance in the Netherlands, Rinus van der Struis is personally responsible for the supervision of the large international institutions in the Netherlands. He is on that sub-group. And so are colleagues from the US and the other Basel signatories. The goal of the Accord Implementation Group is to have convergence in supervisory practices to the greatest extent possible, convergence in reporting requirements. At least a bank dealing with multiple Basel regulators should not be faced with conflicting requirements. It should be faced with a consistent set of requirements, which should ideally be similar across countries.

It's clearly one step too far to expect this ever to go in the direction of ABN Amro or ING only reporting to us as the lead or home supervisor. That has to do with jurisdictional responsibilities. As long as deposits are insured by the U.S. government then, of course, the U.S. taxpayers will want to have an independent supervisory agency looking at ING or ABN Amro on their behalf. The U.S. is the last country in the world that is ever going to give up its sovereignty in this area. But in Europe we can make strides in that direction. Here we are increasingly transferring sovereignty from a national level to the European level. In Europe, yes, we could make progress by having a lead supervisor and having other supervisors channeling their prudential responsibilities through that supervisor. The institutions, at some stage, may only deal with the lead supervisor. Across the Atlantic? No. But within Europe, I could see that happening, not today, but, within a couple of years.



Dr. Shuldiner is founder and principal consultant at Basel Consulting, a design and management consultancy focused on risk assessment, innovation strategy, and fraud minimization.

Please direct feedback or questions on this article to alec@baselconsulting.com.