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Yoon Jeung-Hyun
Chairman, Financial Supervisory Commission
Governor, Financial Supervisory Service

Keynote Speech: Basel II and Policy Response
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Adopting the New Basel Accord: Impact and Policy Response of Asian-Pacific Developing Countries

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Distinguished Guests, and Ladies and Gentlemen,

I am pleased to join you this morning for the 2006 KDI Conference on the New Capital Accord. We have with us many distinguished scholars and experts on Basel II from home and abroad. We welcome you, and we are very glad that you could join us. I would like to thank President Hyun Jung Taik and KDI for organizing this conference and inviting me to speak.

Without question, the implementation of Basel II is a matter of utmost importance to financial regulators. Indeed, the new capital framework in many ways represents a milestone in banking supervision with far-reaching implications for the banking industry. So, more than ever before, banking supervisors and the industry must work together to ensure a successful implementation. This is the very goal for which we have gathered here today. I have always put much emphasis on the benefits of open and frank debates. This conference is just that, and I am impressed by the list of people who are here with us.

Over the years, the Basel Committee on Banking Supervision has provided useful guidance on banking supervision. In particular, the Committee's work on risk-based capital since 1988 has been instrumental in improving bank capital soundness. As you know, the Basel II framework takes the original accord a step further and proposes more risk-sensitive regulatory capital. Because of its wide-ranging impact, Basel II may well prove to be a major turning point for both banking organizations and supervisors.

To date, most bank supervisors have practiced what can be essentially characterized as "rule-based" supervision. But, under Basel II, banking supervision becomes much more "principle-based" with respect to capital soundness. As such, it leaves much of day-to-day operations and compliance work to the individual banks.

There is a general expectation that the safety and soundness of the financial system as a whole will improve with Basel II. In part, this is because the new capital framework encourages banks to maintain, at all times, sufficient level of risk-based capital for economic downturn and to avoid risk concentration.

Similarly, under Basel II, bank supervisors are expected to ensure consistency between a bank's capital position and its risk profile. Expanded public disclosures are also to be enforced to facilitate market discipline. It may also be said that Basel II is an international agreement on risk management and supervision based on the best practices we have learned over the years.

So the new capital framework is in essence a collection of advanced risk management practices and standards. In short, Basel II will give financial institutions a unique opportunity to imbed risk management into every part of their business and thereby help raise the overall safety and soundness of the financial system.

The members of the Basel Committee are getting ready to implement the new capital regime under Basel II by the end of this year. And the general expectation among bank supervisors is that it will prove to be a positive change. But, as President Hyun Jung Taik noted, we know that Basel II was not proposed with developing countries in mind. And because the risk profile of banking organizations in developing countries is less certain than that of the developed countries, the impact on the banking sector will vary from country to country. So some adjustment and fine-tuning by Asia's banking supervisors will be inevitable.

In fact, the Basel Committee understands this and gives bank supervisors multiple options for national discretion in implementing Basel II rules. Adjustments can also be made with a regulatory system that provides for different approaches to measuring the same type of risk. So the challenge is to accommodate country-specific needs while maintaining comparability and consistency across the board with risk measurement.

Ladies and gentlemen, Korea is on track with its preparations for Basel II. Under the timetable we set, the new capital regime is expected to take effect for domestic banks beginning in January 2008.

But I think it's wise to leave some room on the implementation and not be excessively constrained by the target date we set for the implementation. We see bank supervisors in countries such as the U.S. and Singapore taking a cautious stance with their implementation date. This is understandable. After all, it is not difficult to appreciate what a major undertaking Basel II has been for both banks and bank supervisors. This is true for Korea as well.

So, to minimize any adverse impact the new capital regime may have on Korea's banking sector and beyond, we are looking at wide-ranging scenarios and hope to come up with the most sensible and practical approach.

Let me say a few words about how we intend to proceed with our implementation. First, we intend to come up with follow-up measures for the shortcomings we have identified so far. For example, we see instances where banks applying for internal ratings-based approach or advanced measurement approach are having problems with insufficient data or unreliable risk-rating models. And we still see weaknesses in internal controls for risk management at some banks. So we expect to work closely with the banks to address weaknesses and shortcomings we identify.

Like other bank supervisors, we also have some reservations about possible downsides to the new capital regime. One is that the new approach will amplify procyclicality when banks tighten credit in response to higher capital requirement prompted by adverse credit conditions. So we are looking at this issue closely and have conducted quantitative impact studies on several occasions.

To date, what we find is that the effect of procyclicality and other downside risks from Basel II will be limited. But we will continue to look at this issue from various angles and see if our approach needs to be adjusted.

I would also stress that, with today's large banking organizations operating across many borders, the success of Basel II will depend, to a significant degree, on effective information exchange and cooperation between the home and the host supervisors. We recognize this and have maintained close working relations with foreign bank supervisors for internationally active banks that are operating in Korea. And we will certainly continue to do so with other home-host issues.

There is much to be gained from taking an active part in the work of the Basel Committee and other international efforts as we strive to adopt the best global standards into our supervisory system. So this is an area of priority for us as well.

I would also argue that continued dialogue between the banking industry and banking supervisors will be crucial to the successful implementation of Basel II. So we have stayed closely engaged with the industry through task forces, public hearings and workshops. We have also had many valuable inputs from you and many other experts. There is no question about how much we can gain from your expertise, your insight, and your wisdom. So I can assure you we will continue to stay engaged and maintain our dialogue with you. This conference is of course one good example of what we are trying to achieve.

What we would like to see from financial institutions is not to avoid risk, but to engage in controlled and disciplined risk-taking to innovate, compete, and create value. The key prerequisite for sound risk management is effective management of capital, the first line of defense and buffer from potential risks. Because Basel II proposes a more fine-tuned minimum risk-based capital than before, our hope is that it will contribute to greater stability and confidence in the financial system.

Today's conference is a continuation of the open debates and dialogue we have had with outside experts like you to help us come up with a sensible approach to the new capital regime. Clearly, much work lies ahead for the supervisors and the banks before Basel II can become a routine part of supervisory process for us and a routine part of the business process for the banks.

All of us share the common goal of improving the safety and soundness of the financial system. The new capital framework we are discussing today and tomorrow is a key step to this end. We are certainly ready to do our part, and you have much to contribute to this process.

Thank you very much.