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Looking beyond implementing Basel II

Introduction

I would like to begin by thanking Eurofinas and its chairman Fernando Menezes Rodriguez for inviting me here today to join such a distinguished set of guest speakers. The implementation of Basel II is a big issue facing you as Eurofinas' members and us as supervisors right now, and I will be focusing my speech on implementation issues and looking also further beyond Basel II.

The main point that I want to stress in my presentation today is that the consistent and smooth implementation of Basel II is of key interest to CEBS and to European banking supervisors, as well as it certainly is to all finance houses and credit institutions.

CEBS – a new European Committee

But, before I go into the detail of my presentation, I would like to say a few general words about CEBS.

I realise that, for some people here I may be repeating facts or messages that they have heard before, but CEBS is a new Committee and, as its Chairman, I am bound to take every opportunity to raise awareness about it and to promote understanding of its role.

CEBS was formally established on 1 January 2004, and brings together senior representatives of the banking supervisory authorities and central banks of all 25 European Union member states. We have three main tasks, which are, to a great extent, natural tasks for a Committee of banking supervisors in Europe.

Firstly, CEBS advises the European Commission on regulatory matters in the banking field. This basically means that we can provide advice and input to the Commission on proposed new banking directives or proposed changes to banking directives. We can do this either at the request of the Commission or on our own initiative. And, under a new approach to EU banking regulation, CEBS will also have a more formal role in the future in developing what is known as the “technical detail” of such directives.

Secondly, CEBS is responsible for promoting the consistent application of the European banking directives and for supporting greater convergence of supervisory practices within the EU. European directives are legal instruments which set out the objectives to be achieved but leave it to Member States as to how to achieve these objectives, through national implementation techniques. With 25 Member States, different legal systems and different approaches to regulation and supervision, there is clearly scope for divergence in the application of directives and in day-to-day supervisory practices. In order to promote a more consistent and convergent approach within this legal context, the members of CEBS will work together to develop guidelines, standards and recommendations, which can then be implemented into our national practices and ensure a more homogeneous regulatory and supervisory framework within the Single Market. In fact, we have already published some convergence documents for public consultation – including one specifically on aspects of the new capital framework, about which I will inform you later.

Finally, one of the key tasks of CEBS is to enhance co-operation and exchanges of information between competent supervisory authorities in the EU. This is needed to ensure an effective and efficient supervision of cross-border banking groups in an increasingly integrated market, and becomes crucial in the context of the risk focused approach to supervision that is at the core of the new framework for capital adequacy, Basel II.

Those of you who are familiar with the committee structures in the EU will note that these tasks are analogous to those assigned some three years ago to the Committee of European Securities Regulators (CESR) in the securities field and, more recently, to the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) in the insurance field, under the so-called “Lamfalussy approach” to European financial services regulation. In Lamfalussy terminology, CEBS, CESR and CEIOPS are the so-called “level 3 supervisory committees”. And we have more than this description in common – in fact, we are already finding many areas of mutual interest in our collaboration with the other level 3 committees.

Some people might ask how CEBS relates to existing banking committees in Europe, or they might ask the question “who was doing CEBS’ job before CEBS?”. It probably has to be acknowledged that before CEBS was created, there was a kind of gap in the EU institutional arrangements. We had a senior committee of supervisors and finance ministries, looking at regulatory issues (the Banking Advisory Committee). And we had a senior committee of supervisors and central banks, looking at financial stability issues (the Banking Supervision Committee of the European System of Central Banks). But what we didn’t have was a senior committee of supervisors and central banks looking into regulatory and supervisory issues, co-operation and convergence. And I think that you will all agree that this is absolutely essential as we enter into this crucial phase of implementing Basel II in the European Union.

CEBS work streams on Basel II

We all know that Basel II will be a challenge, and that both the industry and supervisors will need to upgrade their policies, systems and procedures, and to step-up their staff training efforts, in order to prepare for the new framework. And there is not, in fact, much time to do this. Parallel running for the IRB approaches to credit risk and for the advanced approach to operational risk starts in less than 15 months time.

It is indisputable that Basel II increases the importance of improving and enhancing co-operation and coordination between the supervisors of cross-border banking groups. As supervisors we should, of course, avoid unnecessary duplication of efforts, particularly in the context of evaluating such groups' applications to use the advanced approaches to credit risk and operational risk.

The industry has repeatedly highlighted that in an increasingly integrated market the compliance costs for banking groups with significant cross-border establishments would become excessively high, if practices and requirements differ significantly across countries. Understandably enough, from the industry perspective differences in approaches and multiplicity of reporting lines should be reduced as much as possible. The move to a supervisory regime more aligned with the market practices for the measurement and the internal control on risks is a great opportunity to achieve both a lighter supervisory approach and a simplified supervisory process. Hence the proposal raised from several industry fora to introduce in the regulatory framework the notion of the "lead supervisor", that is a single authority responsible for the supervision of a banking groups, including all its branches and subsidiaries, throughout the EU. This would allow a group to have a single interface with the supervisory authorities, a single approach to supervision and a single reporting framework.

However, a move in this direction raises complex issues that cannot be disregarded in the present institutional framework. For instance, it would impact on the framework for crisis management and liquidation and winding-up procedures; on the statutory obligations of supervisors and their accountability to national parliaments and depositors; on the treatment of subsidiaries which are significant to the banking system in the country in which they are located but less significant to the group as a whole; on deposit insurance and consumer redress arrangements.

At the same time CEBS considers it as important to provide pragmatic responses to the concerns raised by the industry and to the more general need to ensure a safe and prudent management of banking organisations with extensive ramification throughout the Single Market. Our response aims at (i) improving the process for supervisory co-operation, relying on the well-established notion of consolidated supervision; (ii) pursuing convergence in supervisory practices in key areas of the new capital adequacy framework, from validation, to the supervisory review process, to the reporting framework.

Consolidated supervision. We are aware that the internal reorganisation of banking groups and the increased reliance on functions centralised at group-wide level requires a strengthening of co-operation practices between the authorities. The strengthening of co-operation should be based on robust procedures for the exchange of information and an enhanced role – with clarified responsibilities - for the authority responsible for consolidated supervision. We need to carefully understand the needs arising from the specific organisational structures of major EU banking groups, in order to check whether there are any shortcomings to be amended, duplications of tasks to be streamlined, dead-weight costs to be cut. At the same time, the interests of depositors and the potential impact on financial stability have to be considered; also taking into account the fact that in some countries, especially in the new Member States, the share of foreign-owned banks is very high.

The development of a strengthened co-operation between all the authorities involved in the supervision of a group, with a clear role for the authority responsible for consolidated supervision, has the advantage of comprising all European supervisors, thus providing the possibility for creating harmonised practices from an EU-wide – and not only group-wide – perspective. This approach should have a positive impact on the compliance costs for the industry, while achieving superior results in terms of level playing field.

CEBS has already launched a specific work stream in order to address the concerns of industry with cross-border activities, in particular in the context of Basel II. The objective of the work in hand is to issue supervisory guidelines specifying practices and cross-border operational networks to be set up to ensure the smooth and expedient processing of relevant applications of cross-border banking operations by all supervisory authorities involved, taking into account and reflecting their individual roles. This line of action is coherent with the Commission's Proposal for a Capital Requirement Directive, which stresses the need to reinforce bi-directional flows of information between home and host authorities and shapes the co-operation framework around the well-established concept of consolidated supervision.

Convergence in supervisory practices. CEBS has already started to wok in several direction, with a view to provide for concrete progress in the convergence of supervisory practices in key areas of the new capital adequacy framework. The work under way encompasses the validation of internal ratings systems and advanced measurement approaches for operational risk, the efforts to reduce the number and scope of national discretions in the Commission's proposal for a Capital Adequacy Directive, the development of common principles for the implementation of the supervisory review process (Pillar II) and the creation of a common framework for the reporting on the capital ratio to supervisory authorities throughout the EU. I'll try to provide you with more details on our work in these areas.

Validation

Reaching a satisfactory level of convergence with regard to Internal Ratings Based (IRB) systems and Advanced Measurement Approaches (AMA) for operational risk has been identified as key priorities for 2004 and beyond, predominantly focussing on both quantitative and qualitative aspects of validation.

According to the Capital Requirements Directive (CRD) credit institutions using the IRB approach shall have robust systems in place to validate the accuracy and consistency of rating systems, processes, and the estimation of all relevant risk parameters, like probability of default (PDs), loss given default (LGDs) and exposure at default (EADs, or conversion factors in the terminology of the CRD). Although not explicitly mentioned in that detail in the CRD, it is implicitly clear that robust systems must be in place, too, to validate the calculation of expected and unexpected loss determining regulatory capital for operational risk under the AMA framework.

Since the risk parameters determine the risk weight that is attributed to a certain exposure or a certain class of exposures and by that also the total capital requirements for credit risk, it is crucial that the statistical and mathematical methods used to estimate these input parameters have a satisfying goodness of prediction.

Since back testing of an IRB or AMA model bears more methodological and data challenges as back testing of an established market risk model, it is necessary to discuss the arising problems also on a technical level.

From a quantitative perspective, the technical work has to concentrate on possible ways for promoting the convergence of the requirements defined by national authorities. This implies work on the validation of the internal estimates of key risk components and the assessment of the quality of discrimination (i.e., assignment of a quantitative indicator of credit quality to a particular borrower and distribution of the borrowers among classes or grades) and calibration (i.e., quantification of the probability of default in any given class or grade) of the rating system in use under the IRB framework.

But 'validation' does not mean only talking about technical aspects. From a qualitative perspective areas concerning the use of data, governance aspects, stress testing but also – and this is why IRB and AMA approaches are closely related to Home/Host problems - the review process of supervisory authorities have to be covered by the work on validation. According to the current Directive text, when the IRB or the AMA approach is intended to be used by the EU parent credit institution and its subsidiaries, or by the EU parent financial holding company and its subsidiaries, the competent authorities of the different legal entities shall co-operate closely to determine, whether or not to grant the permission sought by the credit institution and to determine the terms and conditions to which such permission should be subject.

Pillar two

One of the main working areas for CEBS is the development of common principles for the implementation of the supervisory review process. The committee is aware of the industry concerns regarding the EU-wide implementation of this important piece of the supervisory framework.

The importance that the committee is attaching to this particular issue was showed by the release last May of CEBS' Consultation Paper on "The application of the supervisory review process under pillar 2" (CP03).

This paper sets out principles for the overall Supervisory review Process and its two elements, the Internal Capital Adequacy Assessment Process (ICCAP) and the Supervisory Review and Evaluation Process (SREP). The paper describes what supervisors will expect from institutions in their assessment of the adequacy of their financial resources and also contains principles regarding the supervisory authority's obligations under the Supervisory Review and how these might be performed.

Although the Directive text is still under Discussion, CEBS has decided to release this consultative Paper because it considered it important to consult interested parties at this early stage in order to encourage a dialogue and to promote transparency in the debate between supervisors and institutions on this decisive issue.

The paper, while recognising that the ICAAP and SREP area separate process takes also into account that in practice they are closely intertwined and it is intended that there will be a close interaction between them. This interaction will generate an important and necessary dialogue, and feedback mechanism that will be very appreciated by both supervisors and institutions.

The principles are also intended to enhance the level playing field in the EU under the new capital regime. In this regard it should be stressed the concept of proportionality should play a key role in both the ICAAP and the SREP.

It is also made clear that it is the responsibility of the institution to define and develop its ICAAP, and that this assessment should be risk based. The new framework emphasised the importance of capital planning but also the importance of management responsibility and other qualitative aspects of risk management.

The supervisor's role, includes the review and evaluation of the institution's ICAAP, the performance of an independent assessment of the institution's risk profile, and if necessary taking prudential measures and other supervisory actions.

The pillar 1 capital requirements will continue to be seen as a minimum for regulatory capital requirement based on uniform rules, bearing in mind that no set of rules for capital requirements may capture all aspects of an individual institution's overall risk profile. As part of the supervisory review process, regulatory capital over and above pillar 1 is seen as one of several regulatory and supervisory tools to be potentially used by the supervisors to mitigate identified risks, having carefully considered controls and other mitigating factors.

The paper received many positive responses from the industry. Once these responses have been analysed, CEBS will respond in due course. In the meantime, CEBS is carrying on a more detailed work on how ICCAP and SREP will interact to achieve an effective functioning of the Supervisory Review Process. It is also working on the definition of principles on internal governance and on the main implications that the of the new CRD directive will have on home/host issues,

Common EU reporting

The issue of achieving a streamlined way of reporting by institutions is a traditional claim by banking industry, especially from institutions with a broader international presence. Institutions have always complaining about the multiplicity of reporting and presented the necessity to draft as many reports as the number of authorities involved in the supervision of their group as a very burdensome and time consuming task.

Supervisors, on their part, even having been aware of the amount of work that can represent the compliance with many and very different reporting requirements from several competent authorities, have always emphasised the technical and legal difficulties of moving towards a more common reporting framework. In fact, they were concerned that this could reduce their ability of been adequately informed about institutions on which they have supervisory responsibilities, fully exploiting information available at local level and useful within the specific features of local markets.

The entry into force of the CRD and the subsequent necessity of a new reporting framework has been seen as an occasion of trying to cope with industry's long expressed claims while, at the same time, trying to reach a framework suitable for supervisors' information necessary to perform their statutory duties. It should be noted that the task of striking a right balance between institution's claims and supervisors' genuine right of being properly informed cannot, by any means, be considered as an easy task. But the good news is that this work has been undertaken by CEBS and good progress is expected within a very tight time frame.

The first step in this direction are the efforts to reach a "common way" of reporting the Solvency Ratio, that while providing for a high degree of commonality, allows for some kind of flexibility, giving to each supervisor the (limited) possibility of requiring some specific information outside the common reporting.

We are now embarked in this challenging task and I hope that I will be able to give you some news in this respect in the near future.

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Allow me to take this opportunity to stress once more the importance of transparency and dialogue as we enter into the new phase of Basel II. CEBS has a vocation to be as transparent as possible and the whole thrust of the Lamfalussy framework is based on the belief that close technical dialogue between competent authorities and open consultation with interested parties will lead to better quality regulation, "going with the grain" of the market and supporting increasing integration within the EU. We have a website (www.c-ebs.org), and we have already published three papers for open consultation. We have also established a consultative panel to act as a sounding board and to provide us with high level advice on strategy issues. And we want to hear your views. Your active participation in the debate is key for the success of our endeavour.

I look forward to a rich and fruitful discussion with you, today as well as in the coming months leading to the implementation of Basel II in all Member States. Thank you for your attention.