



BASEL COMMITTEE ON BANKING SUPERVISION
BANK FOR INTERNATIONAL SETTLEMENTS

Implementation of Basel II

**Presentation to the IIF Asian CEO Summit
Singapore, 14 September 2007**

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1. Why Basel II?

- Innovation in financial markets
 - Significant advances in technology, financial product innovation and risk management, examples:
 - Derivatives products (from plain vanilla to exotic);
 - Securitisation (from simple risk transfer to increasing sophistication in the slicing and dicing of risk)
 - Innovation continues to occur at a rapid pace



1. Why Basel II?

- Shift in many banks' business models, from buy-and-hold to originate-to-distribute
 - Greater reliance on markets for risk transfer and liquidity
 - Models have generally focused on behaviour under “normal” circumstances
 - Supervisory focus is on what happens under “stressed” conditions
 - New challenges for banks (and supervisors)



1. Why Basel II?

- Given rapid financial innovation, Basel I capital ratios are no longer very accurate measures of bank risk
 - Basel II more closely aligns bank capital to the actual level of risk
 - Basel II is more capable of evolving with financial innovation
 - Basel II is more closely aligned with bank's internal risk management practices
 - Basel II is a necessary response to a complex and changing environment



2. Basel II implementation challenges: Home-host issues

- Home-host issues are at the core of many implementation challenges
 - Home-host issues are longstanding
 - The 1975 Concordat set out the basic guidelines for home-host cooperation in the supervision of international banks
 - The implementation of Basel II hasnt altered the structure of incentives and/or the legal responsibilities of supervisors
 - However, home-host issues are more relevant under Basel II



2. Basel II implementation challenges: Home-host issues

- The AIG is not Basel II control central
- Supervisors share experiences and communicate range of practices and sound practices, and learn from each other
- Information exchanges and outreach to the global supervisory community (ILGC) and industry.
- Home-host issues (significant progress has been made):
 - Validation/approval of Pillar I models – who does what?
 - Assessment of group-wide Pillar II internal models
 - Different approaches/timing in different jurisdictions
 - Home and host information needs
 - Systemically important subsidiaries
 - Pillar III disclosures



2. Basel II implementation challenges: Home-host issues

- Challenge: to strike the appropriate balance between legitimate home/host supervisory needs and the goal of minimising burden on banks and supervisors
- This is true for all three Pillars.
 - There is no simple solution



3. Basel II implementation challenges: Pillar I

- Significant progress has been made in implementing Pillar 1 of the Basel II Framework.
- Supervisory colleges have been a significant factor in the success banks and supervisors have achieved around the Pillar 1 approval process.



3. Basel II implementation challenges: Pillar I

- Trading Book - Incremental Default Risk Charge
 - Part of the “July 2005” package (together with the use of EPE for measuring counterparty risk and the recognition of double default)
 - Complex and systemically important issue
 - Addressing potential regulatory arbitrage between trading and banking books
 - Industry views on appropriate modelling methods vary
 - Significant assumptions around correlations, liquidity horizon, and capital horizon



4. Basel II implementation challenges: Pillar II

- Varying Pillar II approaches across supervisors, but similar supervisory objectives
- Need to better understand the impact of internal supervisory differences on cross-border banks
- It is important to distinguish between economic capital models and the internal capital adequacy assessment process (ICAAP) more broadly.
- Host supervisors expect local bank management to be adequately informed and empowered. However, global banks should not be required to develop stand-alone economic capital models for each subsidiary.



4. Basel II implementation challenges: Pillar II

- Assumptions for capital allocations have to consider the transferability of capital across countries, particularly under stress conditions.
- Assumptions regarding diversification benefits have to be assessed at various levels
 - capital transferability
 - uncertainty around diversification estimates – correlations change over time (particularly during stress periods); reliability of models
 - types of diversification (eg intra-risk and inter risk)



5. Basel II implementation challenges: Pillar III

- So far, Pillar III hasn't received the attention it deserves.
- To maximise the benefits of Basel II, banks, market analysts and supervisors need to devote greater attention to Pillar 3.
- Timely and relevant information is key for the functioning of markets.
 - Need for bankers and supervisors to reflect upon this in the light of recent market developments.



6. Conclusions

- The AIG will continue to address Basel II implementation challenges. Effective supervisory coordination and cooperation, and dialogue with the industry are key to maximising the benefits of the Basel II Framework.
- Need to focus less on short-term issues and understand the long-term benefits of implementation
- Need to be realistic about where industry and supervisory perspectives are aligned and where they differ (eg assumptions around transferability of capital)