The Future Regulation of the Financial Market

Basel II as a tool supporting the convergence of methods and procedures in EU member countries and globally

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Outline

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2 • Convergence at the international level

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1 • The need for a consistent Basel II implementation

Contrary to Basel I, Basel II is based both on quantitative and qualitative requirements.

The Basel II capital framework is not a «one-size-fits-all» approach:

- It is a risk sensitive framework,
- It allows diversity of approaches: several options and substantial flexibility for banks,
- It is based on larger recognition of banks' internal systems and models: methodologies, data, parameters, … may vary/will vary from one firm to another...

As a result, Basel II implementation will be unique for each bank and will request a supervision suited to the risk profile of each bank.

1 • The need for a consistent Basel II implementation

Comprehensive, rational and consistent consolidated supervision is crucial.

More precise principles have been defined to clarify the relationship and the split of responsibilities between the home country and the host countries supervisors (they are mostly similar in EU and in Basel):

- The legal responsibilities are unchanged,
- The home country supervisor is responsible for the consolidated supervision and plays a special role in validating internal systems,
- The host countries have legitimate rights that must recognized and legitimate concerns that must be addressed,
- The result being enhanced mutual recognition and cooperation between home and host.

  … And of course this should be obtained without unnecessary administrative burden for banks.

1 • The need for a consistent Basel II implementation

Basel II has structuring effects for banks (and supervisors), since it will impact:

- The information systems (need for data bases/data warehouses, integration of systems…);
- The organization of the business, from the front activities to the senior management and internal audit.

Thus there is a need for improved dialogues between each bank and its supervisor.

Moreover, Basel II will affect each bank on a group basis, from the parent to the subsidiaries, therefore, cooperation, coordination, exchange of information, … among home and host supervisors will be key.

1 • The need for a consistent Basel II implementation

One of the main changes in Basel II is the larger role it implies for supervisors.

For example in Pillar 1:

- Recognition of External Credit Assessment Institutions (ECAI) that can be used for the standardized approach for credit risk;
- National discretion options;
- IRB approaches and AMA: assessment of the minimum requirements and validation of the approaches selected methods, criteria may differ from one supervisor to the other…

1 • The need for a consistent Basel II implementation

In Pillar 2, the «Supervisory Review Process» (SRP), three (out of four) principles are defining the role of supervisors:

- Supervisory review of banks' capital adequacy assessment process,
- Supervisors' expectations for banks to operate above regulatory minimum capital requirements (… And possibility to ask banks to hold capital in excess of the minimum),
- Supervisors' preventive and remedial action; (Early, preventive intervention to prevent capital from falling below the minimum requirements).

1 • The need for a consistent Basel II implementation

As a consequence of this larger flexibility, supervisors must act in a transparent and accountable manner. This supervisory disclosure will speed up convergence.

The EU CAD III Directive requires supervisors to disclose four kinds of elements:

- The texts of laws, regulations, administrative rules and general guidance adopted in member states,
- The manner of exercise of the options and discretions available in community legislation,
- The general criteria and methodologies they use in the review of and evaluation of banks' capital adequacy (for example for Pillar 2 requirements),
- Aggregate statistical data on key aspects of the implementation of the prudential framework in member states.

1 • The need for a consistent Basel II implementation

… In a nutshell, supervisory convergence in Basel II implementation is desirable to:

- promote an efficient implementation of Basel II in member states (as flexibility may result in different or inconsistent Basel II implementation);
- Disseminate banks’ and supervisors’ best practices;
- promote a level playing field;
- avoid supervisory arbitrage, and
- limit undue administrative burden for banks.

2 • Convergence at the international level

Convergence in prudential regulation and supervision is the core business of the Basel Committee:

- The **1983 Concordat** (“Principles for the Supervision of Bank’s Foreign Establishments”), is based on the principle of consolidated supervision, adopted soon after the BCBS was established (1978). Two main principles: every bank, domestic or foreign, must be supervised; supervision must be adequate. (Possibly, if need be, MoUs are signed.)
- The **CPLG** (Core Principle Liaison Group), is aimed at cooperating in preparing international standards and exchanging information among G10 and non-G10 countries about its implementation and banking supervision in general.
- Since its creation, many **supervisory standards, guidelines,** best practices... have been delivered.

2 • Convergence at the international level

To address the challenges and meet the expectations raised by Basel II the BCBS has created the AIG (Accord Implementation Group)

This global dimension/perspective is needed as groups (EU or not EU ones) are established on a worldwide basis.

This group is closely involved in:

- The validation process of the IRB approaches (credit risk) and AMA (operational risk) ;
- The home/host issue in consolidated supervision;
- The consistency of the cross-border implementation (such as in the «roll out»);
- The pillar 2 implementation, etc.

2 • Convergence at the international level

- The AIG has elaborated **«High level principles for the cross-border implementation of the New Accord» (**August 2003), which are consistent with the European Directive.
- In order to define more precisely the relationships between **home and host supervisors**, the AIG has developed “case studies”. These are real cases, gradually moving from a learning exercise (for both banks and supervisors), towards a joint pre-validation exercise. For instance, one such case study, concerning the French group Société Générale, has been conducted in Paris last September, in which the Czech supervisors were involved.

A very pro-active dialogue and a much enhanced cooperation is presently taking place at the international level in order to implement successfully Basel II.

3 • Convergence in Europe

Convergence and cooperation are even more needed in EU as we are in a single market –and, for many of us, in a single monetary zone – .

- Moreover, it is a long tradition in Europe:
  - The Groupe de Contact" (1972)
  - The 1st Directive on Banking coordination (1977)
  - The Banking Advisory Committee (1979)
  - The 2nd Directive on Banking coordination (1989),
  - … And now CAD III.
- Also, MoUs and informal exchange of information have existed for long.

3 • Convergence in Europe

Basel II implementation is an unique opportunity to deliver enhanced supervisory convergence in Europe for at least two reasons:

- The new European Capital Directive-CAD III is more precise and more demanding than Basel II, in particular as far home/host relationships are concerned. For example, it develops further the concept of "**consolidated supervisor**" and helps clarify responsibilities (See, for example, art 129 in CAD III), which is consistent with the strengthening of the EU unified financial market;
- An institutional process of convergence has been initiated with the creation of the **CEBS** (**Committee of European Banking Supervisors).**

3 • Convergence in Europe

The Committee of European Banking Supervisors (CEBS) is a major improvement towards convergence and the establishment of an internal market for financial services

– It was established as of 1 January 2004 (Secretariat in London),
– It is a so-called “Level 3 Lamfalussy Committee”,
– It is comprised of supervisory authorities and central banks.

3 • Convergence in Europe

The institutional tasks of CEBS are the following:

- To advise the Commission, in particular as regards the preparation of draft implementing measures in the field of banking activities;
- To contribute to the consistent implementation of EU Directives and **to the convergence of supervisory practices**;
- To enhance supervisory cooperation, including the exchange of information.

3 • Convergence in Europe

For the near future, promote an efficient and consistent implementation of Basel II/CAD III is both:

• The major challenge of the CEBS as well as

• An unique opportunity of delivering concrete results in supervisory convergence, as well as developing an EU common supervisory culture

In this respect, the CEBS is working on:

- national discretion options,
- common harmonized reporting,
- supervisory disclosure,
- validation process,
- ECAI recognition, etc.

3 • Convergence in Europe

Reduction of national discretion options in CAD 3 implementation

- 30 national discretion options will be removed from the Draft Directive. Indeed, it is not as much as we had expected when we started the exercise, but it is not unsignificant either. … And it is not the end of the story.

CEBS is establishing a harmonized framework for supervisory reporting

- CEBS aims at simplifying the reporting requirements of EU banks, in order to lessen the administrative burden for European banking groups.
- A working group (COREP) has been set up to design an EU harmonized framework for Basel II.
- It will be followed by EU harmonized reporting forms for IAS balance sheets and loss and profit accounts.

3 • Convergence in Europe

According to the mandate received from the EU Commission, the CEBS is working to improve supervisory disclosure

- A CEBS Task Force has been set up in September. It aims at improving supervisor transparency through:
  - determination of the supervisory elements to be disclosed to comply with the EU CAD III Directive (see slide 8);
  - building an uniformed framework for this supervisory disclosure, in order to enable meaningful comparison across EU countries.
- A report will be available for formal consultation by the CEBS by mid-2005.

3 • Convergence in Europe

Efficient and consistent validation of the advanced approaches used by banks to calculate regulatory capital

- The CEBS supports EU supervisors in drafting common validation guidelines for Basel II/CAD III sophisticated approaches (IRB/AMA);
- The CEBS maintains a close collaboration with the Accord Implementation Group (AIG) to prepare the validation process;
- And develops/contributes to case studies on European and international banks, to entail exchange of views between national supervisors and establish good, efficient cooperation between home and host supervisors.

3 • Convergence in Europe

Issues still to be addressed (or further addressed) and improvements to be delivered:

- The role of the «consolidated supervisor» and the home/host split of responsibilities (A long lasting, fast evolving issue … We will learn by doing);
- The implementation of Pillar 2;
- Common approaches and common assessment of equivalences regarding relationships with third countries.

Conclusion

- **A consistent implementation of CAD III/Basel II is one of the major challenges currently facing supervisors.**

- **The implementation of Basel II will accelerate convergence of supervisory practices.**