Speeches

Jose Maria Roldan, CEBS Chair - Brussels, 6 October 2004

Kangaroo Group

Basel II: Requirements for European Integration

Introduction

I would like to thank the members of the Kangaroo Group for inviting me here today to participate in this interesting lunch debate. I am very pleased to be given the opportunity to contribute to this debate by providing the perspective of supervisors on the issue of Basel II and the related requirements for European Integration.

The Revised Framework of Basel

In the announcement of today's event I was in the first place announced as "Member of the Bank for International Settlements' Basel Committee on Banking Supervision". As you are well aware, the Basel Committee had been working on the revised framework for 5 years, before it was endorsed by the G 10- Central Bank Governors on 26 June and published under the title „International Convergence of Capital Measurement and Capital Standards: a Revised Framework". A first round of proposals for revising the capital adequacy framework in order to make it more reflective of the underlying risks in banking and to provide stronger incentives for improved risk management had already been published in June 1999. This was then followed by an extensive consultative process, two additional consultation papers and three quantitative impact studies. Moreover, consultations were also carried out on national and regional level, not least by the European Commission in the parallel process of preparing the directive proposal for implementing Basel II in the EU.

I think that everybody will agree when I say that these efforts were more than justified, given that they enabled the Basel Committee to make a number of valuable improvements to the original proposals. For example, during the discussion process major concerns were expressed regarding the potential pro-cyclical effects of Basel II. I should note that pro-cyclical tendencies are inherent in financial systems to a certain extent. However, the concerns were taken very seriously and addressed by respective adjustments. For example, the risk weight curves were flattened to avoid that changes in the probability of default that are quite normal throughout the cycle could give rise to extreme movements in capital requirements. Along similar lines, stress testing methods were introduced as relevant components of the supervisory review process, with a view towards driving to more long-sighted measures of risk and more stable capital buffers. As a more general point though, by promoting sound risk management and sufficient capital buffers, Basel II should, in fact, mean that banks will be more prepared for variations in economic conditions, and therefore less likely to need to make drastic changes to lending decisions. Better risk management means less pro-cyclicality.

There were also a number of specific European concerns which were taken into account, e.g. concerning the treatment of small- and medium sized enterprises (SME) and the potential distortion of competition between small and large banks. As regards SMEs, which are the backbone of the production system in several EU Member States, it was argued that a risk measurement system which is only based on the individual companies' ratings would not capture to an appropriate extent the diversification effect for a bank that is lending to a large number of SMEs with activities in different – and non-correlated – sectors. In order to avoid that as a consequence SME lending creates excessive capital requirements for banks, which would inevitably have lead to unfavourable financing conditions for SMEs, various changes were made to the framework, compatible with sound risk management practices: The capital charges for loans to smaller businesses were reduced; a wider range of collateral and guarantees will be accepted; and exposures to SMEs may now be treated as retail exposures and thus be assigned lower risk weights. And capital requirements for SME lending in the EU are now even likely to decrease compared to Basel I (e.g. in the Standardised Approach risk-weight of 75% instead of 100% under the Basel I treatment).

I would also like to take the opportunity to note that Basel II is designed to manage diversity. The “menu approach” allows different kinds of banks (and banking systems) to work within the framework. We have worked very hard to provide options that can be applied by smaller and less complex institutions. This is why we have designed three approaches to credit risk, and three approaches to operational risk, along a scale of varying sophistication.

Implementation of the new framework

However, in some way the agreement on the new capital adequacy framework was only the starting point. Now the framework has to be implemented in order to fulfil its purpose. A recent study showed that from 128 jurisdictions in Africa, Asia, the Caribbean, Latin America, the Middle East and Europe, more than 100 jurisdictions intend to adopt Basel II. This confirms that the framework will be widely implemented across countries and will thus substantially contribute to a further strengthening of the soundness and the stability of the international banking system.

CEBS is facing a number of challenges in implementing Basel II framework and supporting greater convergence of supervisory practices within the EU. One of the key tasks of CEBS is to enhance co-operation and information exchange between supervisory authorities. This is needed to ensure effective and efficient supervision of cross-border banking groups in an increasingly integrated market and ensure a level playing field for the banking industry. There are a lot of expectations around these issues and I'll touch upon them in detail shortly.

At the same time this implementation process raises a variety of opportunities and challenges for both supervisors and banks. Basel II is a comprehensive package which combines rules, principles and market discipline, and which is not just about capital but about providing incentives to enhance risk management. This combination should lead to well-capitalised and better managed banks – good for the institutions themselves and good for the stability of the financial system as a whole. As far as the challenges are concerned, for supervisors these are mainly related to the procedures for the approval and validation of the institutions' internal risk assessment models and methodologies and the implementation of Pillar 2 - not only, but in particular with a view to institutions with cross-border activities. These cross-border issues are mainly related to the fact that under Basel II we are moving from a a rule based and compliance oriented system to a framework which is process based and more risk focused; in other words: the qualitative aspects gain more importance. This implies that for cross-border organisations we need a leap forward in supervisory co-operation, which can not be a simple cross-check that the rules are respected in all jurisdictions.

Even though these implementation issues are more or less similar around the world, the legal and practical circumstances in the respective jurisdictions sometimes require specific approaches to appropriately address them. This is particularly true for the EU, given that the unique Single Market framework requires stronger and further developed co-operation among EU supervisors than normally in place, in order to ensure that supervisory approaches are not a barrier to the process of financial integration.

Requirements for European Integration

I have now reached a point in my speech where I would like to change my "hat" and continue to speak in my capacity as Chair of the Committee of European Banking Supervisors (CEBS). CEBS, which comprises banking supervisors and central banks form the EU/EEA, was established as level 3 banking committee within the so-called Lamfalussy committee structure and took up its activities as of 1 January 2004. One of CEBS' main tasks is to contribute to the consistent implementation of Community Directives and to the convergence of supervisory practices. Given that Basel II clearly further increases the importance of improving and enhancing cooperation and coordination between supervisors – particularly in relation to cross-border banking groups, it will not surprise you that Basel II related issues currently fill around two thirds of our Agenda.

Let me give you a short overview of the efforts we are undertaking in order to deliver our part for ensuring the consistent and smooth implementation of Basel II – something, which is not only necessary in order to avoid unjustified duplications and distortions in competition, but also an essential pre-condition for the further integration of the banking sector.

To be more precise: From CEBS' perspective, work is on one hand required in order to ensure increased convergence of supervisory practices; on the other hand, clear and concrete principles for co-operation processes have to be defined.

Convergence of practices

As regards the first area, convergence of practices, it is clear that more consistent approaches of supervision are in the interest of banks with cross-border activities; at the same time, they avoid regulatory arbitrage and promote the necessary confidence of supervisors to support mutual recognition. Moreover, our efforts are not least driven by the fact that Basel II is a challenge also in the sense that it provides a unique window of opportunity: When you have 25 approaches in place and then you want to reach convergence, at least 24 Member States have to change their way of doing things. However, when everybody is moving to a new framework, it is much less costly to do so moving towards a commonly agreed benchmark

In a first step, we have particularly focused on the application of pillar 2 of Basel II, i.e. the so-called supervisory review process, and we have published a respective paper for consultation with the industry and other interested parties, whose responses are now in the process of being evaluated. This paper covers both, the expectations of supervisory authorities as regards the European institutions' own assessment of the adequacy of their financial resources (so-called Internal Capital Adequacy Assessment process) as well as the so-called “Supervisory Review and Evaluation Process”, under which the supervisor makes its own assessment of an institution and its capital adequacy, and decides which measures to take, if necessary. Finally, the paper deals with the interrelation of these two elements.

Further, we have launched a work stream on the validation of the internal models which will be used by those institutions who implement the advanced approaches under Basel II, i.e. the so-called internal ratings based approach (IRB) for credit risk and the advanced measurement approach (AMA) for operational risk. This work comprises both the technical aspects of validation, and the wider supervisory processes involved, and will cover both quantitative and qualitative perspectives. The objective is to achieve convergence in the way the respective directive provisions are transposed into national laws and regulations as well as on their interpretation and application in day-to-day supervisory practice.

I am pleased to see that we all agree that the Capital Adequacy Assessment Process should be owned by the financial institution itself. And that it is for the institution to define, develop, and manage its Process. The banking industry - like we at CEBS - support the concept of proportionality. The principles are also intended to enhance the level playing field in the EU under the new capital regime. Rest assured that we will stress again and again that the concept of proportionality should play a key role in both the Internal Capital Adequacy Assessment Process and the Supervisory Review and Evaluation Process.

Last but not least, CEBS has been asked by the European Commission and then also by the Dutch Presidency to explore the possibility for reducing the number of national discretions and options included in the capital requirements directive proposal. We have therefore assessed the possibilities for deleting some of the supervisory options, or – where this did not seem appropriate due to specific supervisory needs – to replace them with more developed sets of criteria. The result of our work has been submitted to the Dutch Presidency in mid-September and will now be considered with a view to modifying the directive proposal accordingly. I must say that I really hope that when we come to the final stages of the directive process we will not see new discretions in the text. Our work in CEBS over the past few months has shown us how difficult it is to take them out in order to seek a more level playing field.

Cooperation processes

I will now turn to the second area, the process of supervisory cooperation. Increased centralisation of risk management and internal controls in banking groups together with the more risk-based supervisory approach implied by Basel II means that such co-operation is ever more important.

Ahead of this background, the Commission's directive proposal already sets out general principles in order to provide the framework for enhanced supervisory cooperation in relation to the application of Basel II to EU cross-border groups. However, these provisions need to be further fleshed out in order to make them "workable". This will partly be a task for the supervisors involved in the supervision of a specific banking group: They will need to discuss among themselves how best to organise the different tasks that need to be undertaken under the new framework, and how to resolve the issues that arise.

However, in order to avoid a substantial diversity in processes, i.e. that different groups of supervisors look at different banking groups in different ways, CEBS will also have to play a major role in this respect. In particular, it seems to be required to develop guidelines for these processes of supervisory discussion and collaboration, which will then have to be regularly reviewed by CEBS on basis of the received feedback from supervisors with a view to their appropriateness and effectiveness and – where necessary – revised.

CEBS could also develop common principles in relation to the proposed requirement for the supervisors of a group to have written coordination and cooperation arrangements in place. This would not only facilitate the elaboration of these arrangements, but also ensure balanced and consistent approaches.

Having given you the first tranche of our thinking on Pillar 2, we are now turning our attention to analysing the good number of responses we have received. You can read these for yourself on our website. And of course we will respond formally in due course on the full range of issues you and others have raised. The plan at the moment is that CEBS will publish a full compendium of standards or principles based on our work on Pillar 2, which could act as a guide book for the industry and for supervisors.

Other Basel II related areas of work

Before coming to the end of my speech, allow me to briefly mention two further areas of CEBS' work related to the implementation of Basel II: Firstly, we have recently investigated the possibilities of streamlining certain reporting requirements which are specifically related to the new framework and, due to the positive outcome of this study, we launched a work stream in this respect. Secondly, we are developing a framework for the Basel II-specific information to be disclosed by supervisors themselves, which aims at ensuring their meaningful comparison across the EU.

Conclusions

In summarising my remarks, I would like to re-emphasise that the implementation of Basel II is undoubtedly an important challenge for supervisors and banks. However, each challenge normally also bears a chance for improvement. In our case, this chance for improvement is twofold: Firstly and as I have already mentioned, Basel II will enhance the risk measurement and management of banks, which will not only foster the solidity and soundness of individual institutions, but also strengthen the stability of the whole banking system. At the same time, the new requirements under Basel II also provide a unique window of opportunity to achieve increased convergence of national rules and practices, given that the issue is not to change existing national rules and practices, but – at least to a certain extent – to create new ones; this is of particular relevance in the specific EU context.

CEBS' objective is to actively contribute to this process via delivering two necessary preconditions: supervisory cooperation and convergence. If we are successful in our endeavour, banks will be able to rely on their internal system to a greater and greater extent also for compliance with supervisory requirements and supervisors will review such internal systems on the basis of commonly agreed practices, co-operating in such a way bank are provided with consistent and, when needed, integrated assessments.

However, we have to be aware that this is not an easy task: cross-country differences in legal and administrative systems, and in operational and cultural aspects mean that supervisory practices will not converge from one day to another, and the ability to work as a network requires efforts in enhancing mutual trust; further it is clear that in an enlarged EU achieving consensus on technical solutions is not an easy task. At the same time, we should keep in mind that much bank activity in Europe is still conducted on a domestic basis by domestic banks, and we have to ensure that our approaches reflect the realities of the system. We can therefore only go step by step in order to avoid major disruptions, but I can assure you that we aim to do this in a consequent and straightforward way, and that we are completely committed to the task ahead.

I thank you for your attention.