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Implementation challenges: the role of CEBS in the EU

Introduction

I would like to begin by thanking Charles Dallara and Peter McCarthy of the IIF for inviting me here today to join such a distinguished set of guest speakers. The implementation of Basel II is probably the biggest issue facing banks and their supervisors right now, and I congratulate the IIF on organising this timely event.

Although I will talk today about the implementation of Basel II from the perspective of Europe and of European banking supervisors – and, of course, Nick Le Pan will speak later today from the Basel point of view - I think that we are facing the same kinds of implementation issues all over the world. Furthermore, given the interconnections between banking markets, the European perspective is sure also to be of interest to those of you who represent non-European institutions which have entities operating within the EU, or which compete with EU entities operating in their home countries.

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. I will inform you of the efforts that we are undertaking to promote this outcome.

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 principles, standards and recommendations, which can then be implemented into our national practices. 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, it goes without saying that one of the key tasks of CEBS is to enhance supervisory co-operation in general within Europe. This is, of course, of particular relevance to discussions about the most effective and efficient way to supervise cross-border banking groups, especially in the context of Basel II.

Those of you who are familiar with the EU financial services committee structures 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 market in Europe. 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 Europe.

CEBS approach to co-operation and convergence in the context of Basel II

We all know that Basel II will be a challenge, and that both banks 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 18 months time.

So what are the main issues that we need to address in the EU? We have only to read the comment letters sent to the Basel Committee and the European Commission on their respective most recent consultative papers on Basel II/CAD3 to get a feel for the implementation issues that are of general concern to both banks and supervisors around the world. Let me just mention a few key phrases that crop up time and time again: consistency, convergence, co-operation, competition, cross-border implementation…

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.

These are precisely the issues that CEBS has been set up to address in the European context. I mentioned earlier that one of our key tasks is to enhance supervisory co-operation in the EU. And this is not something to be taken lightly – it is against these tasks that the success or failure of CEBS will be judged.

From the European banking supervisors' perspective, the best way of enhancing supervisory co-operation in the context of Basel II would be through a strengthening of consolidated supervision in certain areas. This is a well-tested and well-understood concept in EU banking supervision. CEBS has already presented its views on this matter to the Commission in the context of discussions about the future directive, and we have communicated our firm intention to play a key role in enhancing co-operation in this context.

We think that stronger supervisory co-operation should go hand-in-hand with increased convergence of practices, and with clearly defined and concrete principles for co-operation processes. Our approach therefore can be categorised as a mixture of substance and process. Let me explain what we are doing in these two areas.

Convergence – the substance

It is clear that convergence of approaches is essential to promote a more consistent framework of supervision and to promote the necessary confidence to support mutual recognition.

In this context, you may have seen that CEBS recently published a set of draft principles of the application of pillar 2 of Basel (so-called "supervisory review") in the European Union. This is one of the main areas in which the industry has expressed concerns about the potential for inconsistencies of supervisory approach.

The paper that we have published has three main elements.

Firstly, it details what the supervisory authority will expect from European institutions in their own assessment of the adequacy of their financial resources (so-called Internal Capital Adequacy Assessment process, or "ICAAP"). This is a very important aspect of pillar two – the bank's own responsibility to assess its capital needs. Many sophisticated banking organisations already make such assessments, but this will be a new concept to other institutions, and, given that the new capital framework will be applied to all banks and investment firms in Europe, we need a system and set of expectations that are proportionate to the circumstances concerned.

Secondly, it deals with 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. It is clearly important to seek a convergent approach across Europe, to have sensible common principles on the basis of which European supervisors can operate.

Finally, the paper deals with how these two elements fit together and inter-relate - how an institution's own assessment process feeds into the supervisor's process, and how the supervisory outcomes might be determined.

CEBS published this consultation paper as soon as it was physically possible for us to organise it – and even before the publication of the Basel II mid-year text, and the Commission's directive - because we thought it was important to enter into a dialogue with the industry as soon as possible on pillar two issues.

We believe that the principles will go a long way towards ensuring a level playing field in the EU, and towards a consistent approach for EU banking groups. I would encourage you to obtain the paper (from our website www.c-ebs.org), and to respond to it during the open consultation process that is currently underway, and which will close on 31 August. We look forward to receiving comments from all interested parties.

As we continue our work on pillar two, we are also taking forward convergence work on the validation of advanced approaches to credit risk and operational risk under Basel II as a matter of top priority. This work spans both the technical aspects of validation, and the wider supervisory processes involved, and will cover both quantitative and qualitative perspectives.

Our aim is to achieve convergence in how the directive standards on validation are transposed into national legislation, rules and guidance, as well as in how these standards are amplified and interpreted in practice in the EU member states. This will be a major piece of work for CEBS for the rest of 2004, and we will also seek close co-operation with the AIG sub-group on validation and data issues.

Finally, on the theme of substantive issues, you will probably be aware that there are a number of areas in the capital framework where national supervisors are given options or discretions as to the approach they can adopt. In the interests of achieving a greater degree of convergence, CEBS has been asked by the European Commission to explore the possibility for reducing the number of these national discretions and options included in the draft directive to implement Basel II in the EU. This is an extremely challenging task. Our aim is to find possibilities to delete the options, or to replace them with more developed sets of criteria. At the same time, we have to balance national circumstances and the need for flexibility.

Co-operation – the process

Turning now to the second aspect of our approach to the implementation of Basel II in the EU, and given my earlier comments, you will not be surprised when I say that CEBS intends to play a key role in developing and implementing enhanced processes for supervisory co-operation in the EU, in the context of the new capital framework.

In order to avoid duplication of efforts in relation to cross-border banking groups, it is clear that the relevant supervisors for each group 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. This is particularly an issue with respect to the validation of advanced approaches, as I have mentioned earlier.

However, having different groups of supervisors looking at different groups in different ways at different times could, in fact, lead to diversity in process and even distortion on local markets, unless there is an overarching mechanism for ensuring consistency of approach in the organisation of such discussions.

CEBS intends to provide such an overarching mechanism, for example through developing guidelines for this process of supervisory discussion and collaboration in relation to the application of Basel II to EU cross-border groups, and, over time, through receiving feedback from members as to how the process is working, enabling us to review and revise the guidelines as necessary.

CEBS could also develop common principles to facilitate the elaboration of written co-operation and co-ordination arrangements for the supervision of certain groups, in order to ensure balanced and consistent approaches.

We are already looking into these issues, and will continue to do so over the next months, including in the light of the final provisions of the Commission's proposed directive.

Conclusions

I hope that this has given you a flavour of the initiatives that CEBS is taking in the area of implementation of the new capital framework in the EU. I believe that the combination of approaches - convergence and co-operation - can be very effective, and that this is a positive, flexible and proportionate way of contributing to the issues which concern us all at present.

In concluding my remarks today, I would like to note that although CEBS is still a young committee, we have made good progress in the six months since our formal creation. With the full establishment of our Secretariat in London in the autumn, I hope that we will be able to increase the pace of progress.

Such acceleration is certainly necessary as we enter the implementation phase of Basel II. But let me also note that while Basel II is CEBS' highest priority, we are also working on other issues, including accounting issues (especially in the context of International Accounting Standards) and reporting requirements, to name just two.

And allow me to take this opportunity to stress the importance of transparency and dialogue as we enter into the new phase of Basel II. We need to work together to ensure smooth transition to the new framework in the EU. For our part, CEBS intends to be transparent and open. We have a website (www.c-ebs.org), and we have already published three papers for open consultation, including one on our consultation processes. We will also establish a consultative panel to act as a sounding board and to provide us with high level advice. And we want to hear your views.

I look forward to our debates in the future and thank you for your attention today.