

Jaime Caruana: Basel II progress

Remarks by Mr Jaime Caruana, Governor of the Bank of Spain, at the Institute of International Bankers Breakfast Dialogue with Government Officials, Washington DC, 26 September 2005.

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Thank you very much. It is an honour to be here once again for a productive dialogue with members of the Institute of International Bankers, and it is equally an honour to be on a panel with such distinguished colleagues from the United States and the United Kingdom.

I will keep my remarks as brief as possible so that we can have plenty of time for your questions and comments. It will probably come as no surprise that I will focus my remarks this morning on the same topic that I discussed with you last year: the new framework for capital adequacy, or Basel II.

As you are probably aware, the Basel Committee published the Basel II Framework in June last year. At that time, the Committee indicated that while the Framework was mostly complete, several important technical matters still needed further work. Specifically, the Committee determined that more work was necessary with regard to (1) elements of the trading book and the treatment of so-called double-default effects for hedged transactions; and (2) the estimation of loss given default during periods of economic downturn.

Over the ensuing months, members of the Committee and several of its working groups engaged in intensive work with industry participants—many of whose institutions are represented here today—to develop practical and prudent solutions in these areas. In addition, I am pleased to note that we worked very closely with our colleagues in the International Organization of Securities Commissions in the areas of trading book and double-default. In July this year, the Committee issued guidance in both areas.

With the publication of these documents on trading book/double-default and downturn LGDs, the Committee has concluded the policy development stage of Basel II. The industry has voiced the opinion that, while it could be possible to continue refining the Framework, it is more important that there be a pause to allow banks to implement the Framework. I very much support this view. Our priority now should be to achieve high-quality implementation.

A good example of how we, industry and regulators can collaborate, without the need to add additional rules, is what we did in the case of low-default portfolios. Several types of portfolios may have low numbers of defaults or a bank may not have sufficient loss experience of its own (e.g. portfolios of exposures to sovereigns, banks, insurance companies or highly rated corporates).

The industry was concerned that the lack of sufficient statistical data in some portfolios and the resulting difficulty in backtesting risk parameters would result in LDPs being excluded from IRB treatment. We have published a newsletter clarifying our view. We have made it clear that a relative lack of historic data should not automatically preclude portfolios from use of the IRB approaches and that relatively sparse data might require increased reliance on alternative data sources and data-enhancing tools. These alternative data sources and data-enhancing tools are mentioned in a non-prescriptive manner in this newsletter.

I would like to spend the remainder of my time this morning discussing this implementation stage. Specifically, I would like to discuss three aspects of implementation that I believe will be of interest to internationally active banks: (1) the forthcoming quantitative impact study, or QIS 5; (2) the work of the Accord Implementation Group; and (3) the role of non-G10 supervisors in Basel II implementation.

What I will not discuss, however, is individual countries' approaches to implementing Basel II. A great deal of work is under way in a wide range of countries to implement Basel II through legislation and/or regulation, and while I believe this work is proceeding quite well, my colleagues on this panel are in the best position to address specific questions about national implementation since this is a matter for national supervisors.

QIS 5

Turning now to implementation, the Basel Committee has announced that it will conduct a fifth quantitative impact study beginning next month and running until the spring next year. The purpose of

this study is to evaluate the calibration of the Framework and assess the impact of the recently published guidance on trading book, double-default and downturn LGDs.

While this exercise will require considerable effort on the part of both banks and supervisors, the Committee believes it is essential to have recent and high-quality data in order to facilitate implementation. And the earlier this exercise is conducted, the more time there will be to reflect on the results and consider any necessary recalibration of the Framework.

The United States and Germany have conducted QIS4 studies and the former is currently studying the results. On 13 July 2005 we published the necessary package for the QIS5 (Fifth Quantitative Impact Study instructions and Workbook).

I believe that with QIS we will have sufficient information to allow us to make a careful analysis of the impact of Basel II, and we have the tools at our disposal to make any necessary changes to the calibration.

Accord Implementation Group

The second area of implementation I would like to discuss is the work of the Basel Committee's Accord Implementation Group, or AIG. The AIG is chaired by Nick Le Pan, whom many of you know as the Superintendent of Financial Institutions in Canada and who is also the Vice Chairman of the Basel Committee. As Nick discussed at the IIB's annual conference here in Washington in March, the AIG plays a critical role in trying to ensure consistency of implementation of Basel II across borders.

As representatives of international banks, I know that consistent cross-border implementation of Basel II is a high priority not only because you want supervision to reflect as much as possible the manner in which your organisations are managed, but also because you may be concerned about supervisory burden. Let me assure you that it is also in the best interest of supervisors that we try to minimise as much as possible any duplication of effort and make the most of our limited resources.

Having said that, I should also be clear that Basel II will never be implemented with 100% consistency across borders, just as Basel I is not currently implemented with 100% consistency. There are important differences in laws, financial markets and supervisory practices, among others, that make it impractical to expect that Basel II will look exactly the same in every country.

The role of the AIG, then, is to share information and promote—not mandate or enforce—consistency in implementation of Basel II. It is clear that there is no “one-size-fits-all” approach to implementing the new Framework. Rather, implementation should be tailored to the specific circumstances of a bank and the jurisdictions it operates in.

It seems to me that to enhance consistency we need to work on improving vertical co-operation, namely home-host issues, and also horizontal co-operation, that is to say convergence of practices. We think that the bottom-up approach is the most efficient and less prescriptive method of achieving these goals.

In this regard, one of the primary methods the AIG uses to promote cross-border co-operation is to encourage home supervisors of the 50 or 60 largest internationally active banks in Basel Committee member countries to engage in practical outreach to host supervisors and the bank to open clear lines of communication and co-operation. While these outreach efforts were initially considered to be “case studies”, they have since evolved into actual implementation planning. Since one of the most important aspects of this planning is the bank's own Basel II implementation rollout plan, it is important that internationally active banks not only have such a plan in place, but also that this plan should be communicated within the bank, especially to subsidiaries that are significant in the context of the overall bank or of a particular market.

This cross-border work has accelerated over the past year, but the Committee recognises that more must be done in order to foster greater consistency. We will continue to work with groups like the IIB to identify high-priority implementation issues for the industry, and we will also continue to encourage home and host country supervisors to develop detailed, practical implementation plans that are tailored to each bank's unique circumstances.

Outreach to non-G10

The third area of implementation that I would like to address is outreach to supervisors outside Basel Committee member countries, especially since the IIB has actively encouraged the Committee to promote consistent standards for cross-border implementation.

For many banks, perhaps the ideal situation would be one in which they could adopt the same approach in every jurisdiction in which it operates. The widest possible adoption of Basel II would certainly have the benefit of reducing supervisory burden for banks, but it would have benefits for supervisors as well. Because Basel II fosters enhanced risk management, more effective supervision, greater transparency and financial stability, I believe that it is in many countries' best interest to adopt the new Framework.

Having said that, however, we also have to recognise that countries are in varying states of preparedness to adopt Basel II. When I talk with my fellow supervisors, I therefore emphasise the benefits of Basel II, but I also encourage them to get the basics right and not jump into Basel II implementation before they are ready. Even so, I believe that it can be extremely useful for countries to start implementing already some of the principles behind pillars 2 and 3 of the framework as preparation for the formal transition.

This dialogue takes many forms. In addition to the informal discussions that I and my fellow Committee members have with our non-Committee member colleagues, we also have several formal mechanisms in place. For example, the Committee has a long-standing working group that includes representatives from sixteen non-member countries, and we have increased our interaction with this working group. In July this year, the Committee met in joint session with this working group in Krakow, Poland to discuss, among other things, Basel II implementation issues.

In addition, the AIG has encouraged non-G10 supervisory participation in working groups that are addressing issues related to validation and operational risk. The AIG has also engaged in encouraging work with non-G10 supervisors to consider principles for information sharing among home and host supervisors. I believe that this dialogue will, over time, foster greater consistency among Committee and non-Committee members. The Committee is therefore committed to heightening this dialogue and will consider further ways to promote consistency.

Thank you very much, and I look forward to your questions and comments.