Jaime Caruana: Implementation of Basel II and other key issues relating to banking supervision in Latin America and the Caribbean

Opening speech by Mr Jaime Caruana, Governor of the Bank of Spain and Chairman of the Basel Committee on Banking Supervision, at the joint meeting of the FSI and ASBA, Miami, 25 April 2006.

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Introduction

First of all, I would like to thank Rich Spillenkothen and Josef Tošovský for inviting me to participate in this joint meeting of the FSI and ASBA, during which we will be able to discuss various key issues for banking supervision in Latin America and the Caribbean over the next few years.

Two things are evident from the agenda. The first is that there are a large number of key topics to discuss today and tomorrow, which demonstrates the importance and timeliness of this meeting, which I am sure will be fruitful for all concerned. The second is that Basel II continues to be a central and priority topic for supervisors and the banking industry alike, as evidenced by the presence here today of major banking representatives, whom I would also like to thank for attending.

It is well known that the Committee has devoted a large part of its efforts over the past few years to first developing and then implementing the revised Capital Framework. Today, we have the opportunity to debate different aspects relating to its implementation and application. Once the phase of theoretical debate and standards drafting had been completed, the Committee's activities, in particular through its Accord Implementation Group (AIG), focused on implementing the Framework. The time has therefore come to confront this practical reality, with all its difficulties and problems, through a dialogue with the industry and the global supervisory community.

This is a major task, given that the aim is to strengthen banking systems and the international financial system, rendering them more robust, more stable, and thus more capable of contributing effectively to the growth and stability of our economies.

Despite the importance of Basel II, the proposed agenda also shows us that this is not the only topic currently of interest to the supervisory community. Tomorrow, we will be discussing one of the Committee's key projects, which, I am convinced, affects all these supervisors gathered here today. I am referring to the Basel Core Principles.

With these introductory words, I would like to provide a general overview of the Committee's work in these areas. First, I will focus on the revision of the Basel Core Principles, before moving on to talk about the implementation of the revised Framework. I will be referring to the necessary collaboration and coordination between supervisors, and will briefly touch on the other implementation-specific issues that the AIG is currently working on.

Revision of the Basel Core Principles

Looking at recent press headlines, one could easily conclude that the Committee's activities over the last few years have been almost exclusively focused on Basel II. Yet during this entire period the Committee has been devoting considerable efforts to drawing up recommendations that we consider to be key from a supervisory perspective, but which have not received as much attention as Basel II.

The Core Principles revision is a case in point. Perhaps the fact that they are recommendations aimed specifically at supervisors, centred around the effectiveness of supervision without imposing direct requirements on the banking industry - although they obviously affect that sector's activities indirectly - explains why this has not generated the same glut of headlines as other initiatives. However, I believe that we would all agree on the important place that the Principles have occupied and continue to occupy, and we know that compliance with them is a priority for virtually all supervisors.

The aim of the Core Principles is to establish a set of minimum requirements to be met in order for banking supervision to be considered adequate. This permits the identification of areas in need of improvement and facilitates planning to achieve these improvements. The passage of time has shown that the Core Principles have satisfactorily met these objectives since they were first issued in 1997. Moreover, they have permitted the establishment of an internationally accepted benchmark with which to evaluate the supervisory approaches of different countries. In so doing, they have helped to improve and encourage the convergence of banking supervisory standards, thereby contributing to global financial stability.

So why revise them, even if the changes are only minor? For one thing, are all familiar with the changes that have taken place in the banking sector, in financial systems in general and in banking supervision since 1997. New challenges have emerged or existing ones have grown in importance, and this has often led to new recommendations being developed by the Basel Committee and other international bodies. In addition, experience has been gained in applying the Core Principles in different countries. The Financial Sector Assessment Program (FSAP), a joint initiative by the IMF and the World Bank, has become the main source of information on their application, with over 100 FSAP missions completed to date.

Second, when the Methodology was published in 1999, the Committee already envisaged that the formulation of these principles should be regarded as an iterative process, with advances in regulation and supervision being incorporated as experience was gained in applying them. The Committee therefore decided that, in order for the Core Principles to remain a fully effective, flexible and globally applicable standard, the time had come to update its content.

Of course, the changes that have taken place since 1997 also include Basel II. However, I would like to point out that the Committee has explicitly stated that, despite the advisability of moving towards Basel II, full and strict implementation is a decision that rests solely with the authorities in each country, and that it may not be the first priority for some countries. Consequently, it is not the Committee's intention to use the update of the Core Principles as a way of dragging countries towards Basel II implementation. The revised Framework is in no way a necessary prerequisite for compliance with the revised Core Principles, even though, as I have just said, I think there are powerful reasons for holding Basel II up as the direction in which regulation and supervision should be moving.

The revision followed two basic directions. The first was to limit the changes to those aspects that were essential and key to maintaining the effectiveness of the Core Principles without removing the continuity and comparability with the previous standards.

Examples of these essential changes are the inclusion of a new "umbrella" principle recommending that banks have integrated risk management systems, which covers all the aspects common to the various types of risk. In the same vein, the emphasis has been placed more on risks that received less attention in the existing version of the Core Principles: interest rate, operational and liquidity risks. Finally, it should be noted that the criteria on the prevention of money laundering and terrorism financing have been updated.

Thus the revision does not call into question the work carried out on the basis of the 1997 Principles, or indeed the planning of reforms on that basis. Neither is there an urgent need to update the assessments; in this respect, one should stress the validity of the self-assessments carried out by the countries themselves, as a complement to the assessments performed by the Fund and the World Bank during their FSAP missions.

The second general direction followed by the Core Principles revision was to keep their character of a single universal standard for assessing the quality of banking supervision, independently of the complexity of each country's financial system. To maintain this universality, on the one hand, it was decided to place greater emphasis, throughout the text, on the idea that the Principles should be applied proportionally, always taking into account the material impact of the risks or the complexity of activities, which allowed application to be adapted to less sophisticated financial systems. On the other hand, the new Principles, by taking into account the most advanced practices, have gained in validity as regards the assessment of complex financial systems which were previously outside the scope of many of the established criteria.

I would like to express my view that this universal character is one of the most positive aspects of the Principles. To achieve this, the Committee worked closely with a very large number of supervisors. Thus the initial drafts were prepared using groups made up of equal numbers of representatives from Committee members and non-members, involving both the IMF and the World Bank as interested parties.

The drafts having initially been approved by the Committee in October last year, they were then submitted for consultation to a limited audience comprising only other international standardsetting bodies and regional supervisors' groups. In this regard, I would like to take this opportunity to acknowledge the important contribution made by ASBA, which, together with other regional groups, was responsible for numerous improvements to the documents that were finally issued for public consultation on 6 April.

Finally, I wouldn't want to move on to the next topic without first pointing out that the Core Principles revision is a fine example of how collaboration with the maximum number of supervisors and international regulatory bodies can be not only possible, but also clearly beneficial in terms of the quality and applicability of the resulting recommendations, and this is definitely a method that the Committee has earmarked for the future.

Basel II implementation: cross-border cooperation between supervisors

Another area in which collaboration between supervisors is absolutely vital, and which we will have the opportunity to discuss in depth today, is the implementation of Basel II in a cross-border context. In this respect, the banking sector has come up with a number of requests and proposals. We are aware of the importance of this topic as regards ensuring the consistent cross-border implementation of Basel II and reducing the burden of work on industry and supervisors alike. The work has been, and continues to be, intensive and I believe that it is necessary to keep moving forward pragmatically.

Many of the issues raised by the banks cannot be regarded as arising directly out of Basel II implementation; rather, they have always existed in connection with the supervision of internationally active groups, although obviously these are genuine problems. Cooperation between supervisors is a complex process which takes time and cannot be resolved by decree; I think that the way to move this process forward is by focusing on real topics and real cases, and that the time for discussing hypothetical or theoretically possible situations with no practical relevance has passed.

However, we should recognise that Basel II implementation in international banking groups poses new challenges and requires a greater degree of coordination between the actions of home and host supervisors, especially as regards the adoption of advanced approaches.

Having accepted the need to keep moving forward on coordination, I would like to voice some concern that these difficulties might be used to justify the tendency, on the part of international banking groups that are moving over to the advanced approaches, to use less sophisticated approaches in host countries, including in those that allow advanced approaches. Indeed, some observers are reporting, without justification in my opinion, that the low level of implementation of advanced approaches in subsidiaries may stem from the lack of coordination among supervisors. We run the risk of ending up with international banking groups in which the advanced approaches tend to be used almost exclusively by the parent company. I think that this outcome is neither optimal nor desirable, and falls short of the goals of improving the stability and efficiency of the international financial system, to which Basel II can make a much more effective contribution if it is applied appropriately.

Problems also arise over how to consolidate the capital of these subsidiaries. Take, for example, a bank applying an advanced approach at group level with subsidiaries outside the home country that use a standard approach. This bank will have to perform a double calculation: first, using the method applicable under the approaches adopted by its subsidiaries; then, it must recalculate those same subsidiaries' requirements using the approach for the group as a whole, ie that of the parent company in the home country, for consolidation purposes in order to calculate the overall capital requirement. This double calculation can impose a heavy burden - although a necessary one in some instances - and will in any case require close collaboration between home and host supervisors to ensure that the entity's overall system adequately takes account of the characteristics and sensitivity of the local market.

The AIG is attempting to pinpoint which criteria would be acceptable at the consolidated level, assuming the - fairly frequent - scenario of a bank with subsidiaries governed by local requirements that differ from those of Basel II. On this and other topics, the AIG is recommending that a certain degree of flexibility be applied, always taking into account both the material effect of these differences in terms of capital and the regulatory burden for the entities. This implies accepting, where appropriate, one single calculation for specific subsidiaries, resolving the question of the group calculation through aggregation rather than consolidation. However, this flexibility must be limited, strict and responsible; it must provide the smoothest and least costly transition possible, but it should not give rise to arbitrage problems. As I have said, this is a hot topic, and it is not easy, but given the advisability of the principle of having the entire group use a single approach in, I repeat, both subsidiaries and the parent, while ensuring that the overall risk culture and systems remain adapted to the sensitivities of each market, it is also advisable to ask host countries to make additional efforts to study and allow, to the extent possible, the application of this principle.

This is just one example of the questions on which the AIG is actively engaged. As regards the distribution of tasks and the necessary coordination between home and host supervisors on the efficient implementation of the revised Framework, the AIG, together with the CPLG - the Core Principles Liaison Group, which includes 16 non-member countries as well as the IMF and the World Bank - has prepared a paper on information sharing between supervisors. This document, which we hope to be able to publish shortly, once we have incorporated a number of comments received during the public consultation period, does not resolve all the problems, but it does represent a significant step forward in improving coordination and the distribution of tasks between supervisors.

We are also keeping a close watch on how cooperation is being handled in practice between countries with supervisory responsibility for institutions belonging to international banking groups. In this respect, the AIG is gathering and sharing information and experience on the functioning of bilateral agreements and of supervisory colleges. In my view, either of these two collaboration methods can be fully valid, depending on the size and complexity of the group concerned.

Over the years, these kinds of agreements on the exchange of information and reciprocal cooperation have been established among supervisors as a means to perform effective crossborder supervision. Time has shown that such agreements are more effective when the relations between home and host supervisors are based on mutual trust.

In this regard, I believe that we as supervisors should steer clear of excessively formalist and legalistic approaches and try to be pragmatic. I think that the questions which need answering are more operational than legal in nature. It is a matter of finding a way of cooperating that makes us all more efficient in the use of our resources, reduces the supervisory burden for the banks and improves the stability of the financial system.

Finally, it is my view that, over and above the formal standards and protocols, the really important thing is cooperation and communication in good faith between supervisory colleagues. Cooperation is, therefore, a two-way street, and I believe that we all understand that we need to accept a minimum level of flexibility, based on mutual trust and reciprocity, if we want cooperation between supervisors to be effective.

Basel II implementation: other aspects

Turning now to the other topics currently being discussed, I would like to mention Pillar 2 of the revised Framework as an aspect which is receiving increasing attention. Concretely: the Group is currently exchanging views on how this pillar can and should be applied consistently within an international banking group. As we can see, the question of cooperation among supervisors is not limited to the use of advanced models under Pillar 1, and it is thus necessary to be able to exercise this degree of flexibility as regards the nature and scope of such cooperation.

There are also certain topics on which it would be desirable that both banks and supervisors move forward more decisively. For example, as regards operational risk and the so-called hybrid approach - which sets out how the capital requirement for operational risk calculated as an aggregate using advanced models (AMA) can be distributed or assigned within a banking group - we as supervisors find ourselves in a situation where it would be advisable for us to take steps to clarify some aspects of this approach, but where we need the industry to make clearer progress in developing concrete assignment models.

There are other eminently practical topics that are being discussed by the AIG. Without wishing to provide an exhaustive list, I would just like to mention that it is examining the material effect, in terms of capital, of the differences that continue to exist in some jurisdictions on subjects such as the definition of default. The Group is also engaged in an exchange of views on how to interpret “user testing” and so-called “LGDs in stress situations”. The AIG is attempting to establish the circumstances in which all these differences may be acceptable, when they affect different entities within the same banking group, and under what circumstances it would be appropriate to standardise the treatment of some of them.

Another practical aspect of implementation relates to the growing use by a number of institutions of external models and databases, known as “vendor products”. The Committee has recently published a newsletter clarifying supervisors' expectations in terms of the requirements to be met in order for these types of models and databases to be accepted under IRB approaches.

Conclusion

As we can see, there are a fair number of open topics on the table as regards Basel II implementation. Many of them already existed under Basel I, but now we have a much better idea of their size and nature, and have created better structures and processes to address them. Since work started on the application of the new capital recommendations, the Committee members and the supervisory community as a whole have made considerable progress in understanding and resolving difficulties, and along the way we have improved the level of cooperation and trust between supervisors, as well as the level of communication and mutual understanding with the banking industry on such sensitive subjects as the management of risks and capital.

The reality we supervisors are facing was already complicated even before the introduction of Basel II. But now the quality of our knowledge and the way in which we handle the risks and challenges have improved thanks to the revised Framework's introduction. I would say that all of this is, in my opinion, positive.

I would like once again to extend my thanks to ASBA and the FSI. I have always found it very useful, instructive and a genuine pleasure to participate in the events organised by both of these institutions, so today is a double pleasure, and I would like to thank everyone for the excellent collaboration that we have built up over the past few years.

Thank you very much.