Introduction

Thank you ladies and gentlemen. Basel II implementation is one of the most important challenges over the next few years - for banks and for bank supervisors. Adoption of the new framework in countries domestic rules is a matter for national processes. But, regardless of the approach countries take for adoption, implementing Basel II well has huge benefits, again for banks, for bank supervisors and for financial stability.

A year ago, the questions I was asked the most frequently were, “When will the Accord be finished? Will it be finished on time?” Now the questions I get the most are, “How is implementation going? What are you going to do with implementation challenges? What are the next steps?”

In talking about steps I am reminded of various sayings. “The longest journey begins with a single step.” “Don’t be afraid of a big step, you can’t cross a chasm in two steps.” “It is only by taking small steps that we can look back after a while and see how far we have come.” I think all of these are relevant to the Basel II journey.

I believe that Basel II can be implemented well. What I want to talk about this morning is:

- What I believe it takes for high quality implementation to occur.
- Cross border issues. There are understandable worries in both home and host jurisdictions about how this will work in practise. There are also understandable worries in the banking community about the same thing. And I believe Basel II provides a unique opportunity for us to enhance cross border communications and cooperation in a way that will be beneficial to us and to financial stability.
- The work of the Accord Implementation Group going forward.

Background

Recently, the Financial Stability Institute (FSI) released a paper that speaks to the preliminary views of the implementation of the new capital adequacy framework in non-Basel Committee member countries. The results of this survey are very interesting. 88 non-BCBS jurisdictions, including Africa, Asia, the Caribbean, Latin America, the Middle East and non-BCBS Europe intend to adopt Basel II - this represents about 87% of banking assets in those jurisdictions. Furthermore, the paper indicates that many of the countries have a preliminary plan to implement the new framework before 2009.

Including the Basel member countries - that puts the total countries intending to adopt the new Accord at over 100. I think it’s safe to say that implementation of the new Accord is in the forefront of the minds of the majority of supervisors and banks around the world.

Even countries which have no immediate plans to implement Basel II are often highly interested in the current thinking and experience of others. They want to garner useful insights now that will help them in the decisions they will want to consider. Experience in implementing Basel II can be very useful for countries who want to make improvements in their regulation and supervision in advance of considering how to approach Basel II.

We also must recognise that one of the strengths of Basel II is its flexibility. As supervisors we must ask ourselves what benefits the new framework will bring in the context of our own domestic banking system. Each jurisdiction must determine the possible impact of the new framework for their banking industry and supervisory resources. Each country must determine the conditions, scope and timing for implementation. Basel II contains a menu of options that allows differences in approaches in relationship to the nature of banks and the nature of markets in which they operate. Jaime Caruana commented on that in his opening address, but it deserves emphasising.
Shortly we will have four panel sessions. The papers that have been prepared focus on very important issues in implementation. For each paper there are questions to kick start discussion. I believe this is a unique opportunity to share views and experiences to date.

There are no jurisdictions nor banks that have all the answers. It is only through discussion, sharing of experiences and views that all concerned can proceed. We will have reports back from the leaders of each of the sessions. There is ample time for questions. In some cases there will undoubtedly be key questions or areas of discussion that will bear repeating and further discussing in the plenary session that follows. I encourage you to ask questions, raise concerns and make comments.

So what does it take for Basel II to be implemented well?

Within banks, it is highly important that Basel II not be treated as a compliance exercise. It has to become part of the management and governance of the bank with a greater focus on risks and how those relate to the capital the bank is holding.

We also have to remember that Basel II is about judgement. Judgements made by banks and judgements made by supervisors. Despite the additional room for analytics inherent in the Basel II framework, we all have to remember that banking is not just arithmetic or higher mathematics. Neither is bank supervision.

It is essential that banks adopt a disciplined approach to implementation with strong project management skills and high quality efforts to identify gaps between where they now are and where they would like to be under Basel II, together with a realistic plan for moving to eliminate those gaps. Many supervisors using the same approach to assess where they are, relative to where they want to be.

Next, communication is necessary between supervisors, between supervisors and banks, within banks, and within the supervisory community. One of the things that is going on with supervisors represented on the BCBS is movement of the Basel II responsibility from policy development types to front line supervision staff. More and more supervisors are getting involved. That is occurring in Basel countries, with increasingly active involvement of non-G-10 countries who are participating in the Core Principles Liaison group (CPLG) and directly in a number of Basel working groups, through sessions run by regional groups, the FSI and so on. Communication is particularly important in the cross border challenge - something I will return to in a few minutes.

A practical attitude is essential for effective implementation of Basel II, both within banks and by supervisors.

I want to emphasize the need for an attitude of ongoing improvement and learning. That’s because there is not one way to implement Basel II and because Basel II calls for improvements in risk management practices and in focus of supervisors.

Feedback is key from banks to supervisors and supervisors to banks.

Lastly, so is realism about what can be achieved and the need for trust and respect for the judgements of others. I am concerned sometimes about the degree of realism I see within industry about what can be achieved. Some talk about close to uniform treatment across jurisdictions. That is not realistic.

Again, I have seen circumstances recently when industry groups or certain individual banks have called for a resolution to the home/host issue by suggesting that banks ought to deal almost exclusively with their home jurisdiction. That’s not realistic. At the same time, within those organizations, local management and important local markets had virtually no knowledge of the implementation approach to be adopted by the bank.

Imagine the situation of a host supervisor who communicates with the bank’s local management and is unable to get even the most rudimentary sense of what the bank’s approach to Basel II implementation will likely be. It would be natural in human nature for that supervisor to then start approaching the bank’s head office to try to understand what the bank’s plans were. Multiple detailed requests of that nature would clearly be an implementation problem and would not lead to cost effective implementation. But, banks that neglect to deal with host jurisdictions adequately, are part of the problem.

What I am saying to you today I have also been saying to banking organizations because of their key role in effective implementation.
Let me say that I also believe that cost effective implementation is in the interest of not only banks but of supervisors. Supervisors don’t have unlimited resources, neither do banks. And so, in many ways we all need to try to find ways to economize on the use of resources in order to do an effective job.

**The workshops**

Workshop A is chaired by Enrique Marshall, Superintendent of Banks and Financial Institutions in Chile. It covers planning the transition to Basel II. It highlights the essential need for countries to take account of their situation in deciding on their approach to Basel II. We have emphasized that each country will determine the conditions, scope and timing for implementation. Assessment of national priorities is essential in deciding the way forward. But the material prepared for this workshop also emphasizes that Basel II, implemented in a way that respects national conditions is an important opportunity to enhance national practises in regulation and supervision and to enhance risk management practises at banks. Some of the questions for discussion touch on factors to be considered in developing an implementation plan, challenges in taking account of local market conditions and the impact on supervisory resources.

Workshop B, chaired by Jerry Hawke Comptroller of the currency in the U.S. focuses on implementation of advanced approaches. There are unique challenges for banks and supervisors getting ready for advanced approaches. While standards for advanced approaches for credit risk are reasonably well developed there is less of a current industry standard in the cases of the AMA for operational risk. Areas for discussion include approaches for assessing readiness of banks, validation issues and home host issues particularly in the cases of AMA.

Workshop C, with Daniel Nouy, head of the Commission Bancaire in France chairing, covers the process for implementing pillar 2. That is a key part of the framework promoting better risk assessments by banks and more focussed analysis of those risk assessments by supervisors. Pillar 2 is also key to the expectation that internationally active banks ought to operate at capital levels above the pillar 1 minimum (without requiring a series of automatic capital add-ons). Pillar 2 is deliberately phrased in a general way as it is recognised that supervisory practises and approaches differ across countries. As well, Pillar 2 requirements of the new accord will undoubtedly be met differently by larger more sophisticated banks than by smaller less complex entities. Cross border aspects of Pillar 2 are important. These topics are the questions for discussion.

Lastly Workshop D, with Ryozo Himino Secretary general of the BCBS chairing, covers the topic of home/host relationships. While home host relationships are nothing new, they take on a particular importance in implementing Basel II. Enhanced communication and cooperation will be required for effective implementation particularly in the case of complex major banking groups with material cross border operations. This workshop will review the Committee’s high level principles for cross border implementation, and the work in developing real case studies and practical implementation plans.

**Cross border issues**

I want to say a few more words about cross border issues. I know that it is on a lot of minds in this room. A paper on the lessons learned to date from the AIG work on cross border case studies has been made available. It is in draft because it is work in progress. These real case studies are the precursors, and can transition easily, into the kind of practical enhanced arrangements and supervisory plans between home and host jurisdictions that are crucial to the effective implementation of the Accord. We have some 17 of these started and we are broadening the scope and deepening the number. They cover both credit risk and operational risk. Many involve non-G10 countries in Asia, Europe and Latin America. Some non G-10 countries are starting these in addition.

And what drives the need for enhanced cooperation and coordination? We have to realize that it’s not just Basel II. It flows from the fact that how banks manage themselves is changing. But it is not only the case that banks risk management operations are increasingly being managed centrally. Banks operate in a variety of different modes. For some portfolios there is an increasing degree to which the analytics and judgements are made centrally. For other portfolios local information and local inputs into modelling and analytics are hugely important.

And we have to recall that countries don’t fall into neat categories as home’s or hosts. Members of the Basel Committee are both home countries and hosts. So are many non G-10 countries. And we have explicitly recognised that the significance of a bank to a host country is not just determined by how big
the host country bank is relative to the total bank. What matters also is how important the bank in the host country is as a share of the host country market.

Implementing Basel II well does not mean home country control and host countries blindly accepting in all cases capital calculations done elsewhere (no matter how much some banks would like that approach). Nor does implementing Basel II well mean a free-for-all with host countries acting totally independently in their jurisdiction regardless of how the bank is organised or regardless of what work is being done by the home supervisor. Neither of these extremes will work in my view.

Because of the different ways banks are organised it’s not just the case that host countries need to think about how they can better rely on home jurisdictions. In many cases, home countries have the need to be able to get more information from host countries about the relevance of the banks’ models and analytics associated with that host country’s market.

The AIG started these case studies because I believe that enhanced trust and communication is not built solely by talking about it, but by doing. My job, and the job of the AIG, is to push these kinds of efforts to happen, and to draw out and share some of the lessons learned. The AIG has recently prepared a paper on a framework for conducting real case studies. The paper I have referred to provides ideas on how to organise real case studies and enhanced cooperative arrangements. It emphasises that there is not one way to go about this. And it speaks to the need for communication and a practical attitude.

Let me give you an example of some of the earlier lessons learned. These case studies are built on the concept that a relatively small group of supervisors, the home and significant hosts, should first start to try to work out and react to a bank’s plans, about how they can better coordinate their efforts. Well, the moment the other supervisors involved with the bank heard about this, they wanted to know what was going on, when would they be part of this? And in some cases they hadn’t been told - a very simple lesson in communication. Similarly we learned quite early on in some of these cases that bank’s plans were not well developed enough for supervisors to determine how best to coordinate their actions.

My own conclusions of the progress to date draw out two essential points. First, host jurisdictions need to think more than they have to date of what information that they would need in order to be able to rely more on calculations, analytics and so forth developed outside of their jurisdiction. Second, home jurisdictions need to think more about effective ways to communicate the work that they will have done and the results of that work in assessing the use of these centrally driven risk management techniques so that hosts have a basis on which to rely.

Let me also emphasise in no case should these enhanced home/host relationships follow a specific formula. I am aware of all kinds of forms of cooperation ranging from simple sharing of information to joint participations in examinations. And in no cases should these enhanced communications and co-operations lead to changes in the jurisdiction or the mandate of home or host supervisors.

Work of the AIG

Let me close by talking for a few moments about the work of the AIG. One of our main priorities is cross border issues. We have been instrumental in the Committee’s release of high level principles related to cross border issues generally and for operational risk. We will want to share experiences and course correct as necessary on how these principles are playing out in practise. We will continue to share experiences from the real case studies and from development of actual implementation plans.

The AIG is not a rule setting body - it is not expected to produce rules or extensive guidance.

We have created a group to go through validation issues for advanced approaches piece by piece, to take account of industry views and to produce a kind of cookbook of approaches to validation that can be used by supervisors.

We have also recently created together with the Capital Task Force, which has been the main body that has produced the Accord itself, a joint group to consider the issue of downturn LGDs and the related issues of stress testing under Pillar 2 of the Accord. I anticipate that this group will produce some guidance on implementation of the Accord and will also interact extensively with industry on current practices and how those practices might evolve.
The AIG will be delving more into the Op Risk area, focussing on the AMA approaches and implementation challenges there. We will be involving and have involved non-G10 countries in both the validation and the AMA work.

The AIG already completed earlier this year, a survey of preliminary intentions of national discretion items amongst Basel Committee countries. A number of non-G10 countries also chose to indicate their intentions and as a result, were provided information on G-10 countries intentions at that stage. The Committee has agreed in principle to publish this information and we will be updating it and sharing it among supervisors later this year. I think it helps supervisors to know the intentions of others as they make their decisions and information on country choices is also helpful in considering cross border implementation.

We spent a fair amount of time on Pillar 2 in the AIG and will likely get back to that both during the course of this year and early next year. That resulted in some clarifications issued by the Committee. Our focus during the immediate future will be on the more specific elements of Pillar 2, such as how to assess concentration risk.

The AIG is meeting regularly with the CPLG working group on capital. The discussion is productive and frank at times. We have cleared up some misunderstandings and we are having real dialogue on challenges and approaches to meet those challenges.

Conclusion

As we each approach issues of implementing Basel II - when, how and so on - I think it is important to keep in mind not only the challenges but also the benefits. Better relating capital to risk, promoting enhanced risk measurement and management practises in internationally active banks, and further enhancing supervisory focus, present huge opportunities. Opportunities for us as supervisors, for the constituencies we serve and for our banks, our markets and economies.

While there are challenges and while implementation won't be prefect, with goodwill, good feedback and ongoing communication, Basel II can be implemented well.

I look forward to that result.

Thank you.