Nicholas Le Pan: Implementation of Basel II

Inaugural address by Mr Nicholas Le Pan, Superintendent, Office of the Superintendent of Financial Institutions, Canada; Chairman of the Basel Accord Implementation Group; and Vice Chairman of the Basel Committee on Banking Supervision, at the 6th Annual Global Association of Risk Professionals 2005, New York, 1 February 2005.

*   *   *

Introduction

Thank you and good morning. I am delighted to have this opportunity to speak to you about what has become one of my favorite topics - Basel II.

Basel II, of course, is the framework for assessing capital adequacy that the Basel Committee agreed to in June of last year. It embraces a comprehensive approach to risk management and bank supervision. It sets out details for adopting more risk-sensitive minimum capital requirements and, in its advanced approaches to credit and operational risk, reinforces these risk-sensitive requirements by laying out minimum risk management and corporate governance standards that banks are expected to adhere to as a prerequisite for being allowed to use their internal assessments of risk.

I am enthusiastic about the new Basel framework. I recognize that it is not perfect and that both regulators and banks have a lot of work to do before it can be implemented effectively. Nevertheless, I am enthusiastic because I think it conveys the right message.

In particular, the framework focuses on risk. Its purpose is to encourage strong risk management practices and procedures, which is why I am particularly delighted to speak with you - the Global Association of Risk Professionals.

First, I would like to acknowledge the contribution that many of you made to Basel II. In developing the framework, supervisors met individually and in groups with risk managers in leading domestic and international banks. You listened to our concerns and expressed some of your own, you explained best practices and you provided ideas for how we could incorporate risk management practices into the new framework. The Basel II process has introduced a new level of dialogue between banks and supervisors. If we consider even just the new channels of communication established, we can conclude that the Basel II process has already achieved an important success.

But as I said earlier, there is still a lot of work to be done and today I will be talking to you primarily about the implementation of Basel II. I will talk to you about the approach we have organized amongst supervisors to facilitate the implementation process. I will also talk to you about the key role you as risk professionals will play.

I always begin my talks on this subject by emphasizing that Basel II is much more than a compliance exercise. Simply enacting new rules and checking periodically to ensure that they are respected is not enough. Basel II puts the onus on banks' boards and management to focus more on the measurement and management of risks and to better relate risks to capital. It is very important that they incorporate this approach into their governance mentality and actively manage their institutions with this risk focus in mind.

I would also like to emphasize that risk management is not just a quantitative exercise. I am sure that this audience understands that while great strides have been made in the quantification of risk in recent years, risk measurement is not just arithmetic - it is also a matter of expert knowledge and judgment. Without a doubt, the qualitative aspects of risk management are more important than the quantitative ones. Without them, quantitative aspects make no sense, or worse, can be misleading. It is important that we not depend solely on models to make decisions. Management judgment and experience must be exercised in each step of the process, including in designing the models that support risk management and in deciding what to do with the model results.

It is important for me to add that Basel II is not a compliance exercise for supervisors either. Basel II puts onus on supervisors to react to bank's processes and assessments and focus their supervisory efforts. Effective supervision is also a matter of knowledge and expertise, and we too cannot rely so much on models that we fail to exercise prudent discretion. Today I want to tell you about the processes we as supervisors are putting in place at the international level to help us implement Basel II. In doing so I will talk about a number of initiatives that we have undertaken to address issues raised by banks and to improve international cooperation and convergence.

Accord Implementation Group

Some of you will already have heard of the Accord Implementation Group, or AIG, which I Chair. The Basel Committee established the AIG about three years ago. While its membership includes representatives from Basel Committee countries, we have also involved non G-10 countries by having them participate on working groups and providing regional sessions to discuss issues related to Basel II. We meet more formally with key non G-10 countries several times a year. In addition, we have tried to have an ongoing dialogue with the banking industry to identify critical implementation issues.

The purpose of the AIG is to share information and thereby promote consistency in the implementation of the new Basel framework. While in some instances the AIG may propose elaboration or guidance for the Basel Committee's consideration, I should emphasize that the primary function of the AIG is neither to develop new rules nor to guarantee uniformity in application of the new framework.

National discretion

As you are probably aware, Basel II allows for the exercise of national discretion in several areas. One of the questions I am most often asked is - how can we find out what differences exist between countries in how they interpret the rules? Last year the AIG surveyed Basel Committee countries and a few non-G10 countries on how they intend to implement Basel II, in particular how they intend to address issues of national discretion. We shared the results of the preliminary survey with supervisors, hoping that this would encourage more consistency between members. The survey is now being updated and expanded to include more non G-10 countries.

It is surprising how sharing and discussing answers to the survey has sharpened the supervisory focus on the issues of national discretion. I believe it has led to more convergence and, where supervisors make different choices, the rationale for the differences is better understood.

We have not been able to share the results of this survey outside of the AIG because a number of countries are still engaged in national rule making processes. Once these processes, such as the US NPR, are sufficiently advanced, we intend to share our survey results more broadly with all supervisors and the industry. We hope this will help risk managers identify systems requirements, especially where they have responsibilities beyond national borders within their financial institutions.

Cross border issues

This leads me into the second topic I wish to discuss. It pertains to cross-border and home/host issues. When I talk about home/host issues, I'm referring to the responsibilities of the supervisor of the consolidated parent bank (the home supervisor) in relation to the supervisor of foreign subsidiaries and branches of that bank (host supervisors). Of course home/host issues are not new, but for Basel II to be most effective, home/host arrangements need to be strengthened. This is one of the AIG's main priorities, and we were instrumental in the Basel Committee's release of high level principles related to cross border implementation issues. One of those principles concerns avoiding unnecessary duplicative work.

Both the 1988 Accord and Basel II were developed for internationally active banks. What is important to remember is that while these banks are active internationally, they are supervised on a national basis with limited interdependence between supervisors for capital purposes. This may, or more likely may not, correspond with how banks are managed.

Ideally, banks would like to deal with only one supervisor. This is understandable - but unrealistic. For example, I have heard banks suggesting that they ought to deal exclusively with their home supervisor. It may be efficient from the banks' point of view, but I doubt it is acceptable from the host supervisors' point of view. Within those banking organizations, however, it turned out that local management had virtually no knowledge of the Basel II 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. Imagine further that the bank is a significant player in that country's economy.

In such a scenario, it would be natural for that supervisor to then approach the bank's head office to try to understand what the bank's plans are. Multiple detailed requests of that nature would clearly be a head office nightmare and would not lead to cost-effective implementation. Banks need to recognize that if they want to implement Basel II efficiently, they must invest time in keeping local management and host jurisdictions adequately informed.

Banks should understand that subsidiaries with a significant share of total banking assets or operations in a given market - not just those that are significant in the context of the overall banking group - merit special attention. Host supervisors have legal obligations they must satisfy relative to foreign banks operating in their jurisdictions, and they may feel it is even more important to exercise effective oversight where foreign banks are systemically important. But hosts can't just fully repeat what home's have done. I'm encouraging host countries in these cases to focus on what they really need from the home or the bank. Similarly, home country supervisors are encouraged to pay particular attention to the information needs of host supervisors in these situations.

Within the AIG, we have agreed to accelerate discussion between supervisors, and between banks and supervisors on the cross-border implementation plans of the major banking groups. After experimenting with some live situations (or what we have called "real case studies"), we shared views in a document released last fall on what seemed to work and what didn't work so well. I have always been keen to engage non-G10 supervisors in this dialogue as well, and at my next meeting with the members of the Committee's non G-10 liaison group, later this month, I hope we can advance discussion of information needs, especially from the perspective of the host supervisor.

Our initial case studies involved a few internationally active banks. The home supervisor for each bank arranged meetings with key host supervisors and with bank management. During the meetings they discussed the bank's plans for the implementation of Basel II, what the bank needed from the supervisors in terms of direction, and what the supervisors wanted from the banks and from each other.

We hope this approach will be an effective way to promote more effective cross-border implementation. We are encouraging home supervisors for the largest banks to arrange similar meetings along the lines suggested by the AIG. Nevertheless we know that we must remain flexible. Just as each banking organization is unique, so too is each supervisory agency, not to mention the working arrangements among supervisors.

What is important is that home and host supervisors establish clear communication. The nature of supervisory cooperation will differ depending on a bank's implementation plans and the needs of the relevant home and host supervisors. Up until now, information has tended to flow one way: from host to home supervisors. For Basel II to be most effective, however, there will be a greater need for two-way information flows. Consequently, home supervisors are being encouraged through the AIG to discuss how they can most effectively communicate the results of their work to host supervisors in order to give hosts a basis for relying in whole or in part on home supervisor assessments. Likewise, host supervisors are being encouraged to think carefully about the information that they really need from the bank and the home supervisor in order to most effectively and efficiently assess the capital adequacy of subsidiaries in their jurisdictions.

The good news is that significant progress is being made in this area. Indeed, AIG members are clearly moving from case studies into actual, tangible implementation planning. However, given the Basel II timetable, this work will need to accelerate. In this regard, the ability of supervisors to develop detailed supervisory arrangements depends to a large extent on banks' having internal implementation and rollout plans. These plans will allow the banks and supervisors to work together more efficiently.

Op Risk

The AIG is also beginning to focus more on the capital requirement for operational risk, particularly with regard to the application of the advanced measurement approaches, or AMA, on a cross-border basis. An AIG Op Risk subgroup has been established to share supervisory views on challenges to implementation of the AMA. This group has developed a catalogue of issues and has set up three subgroups to look at specific areas:

Corporate Governance, Data Issues, and Quantification/Modeling. The subgroups will develop a range of acceptable practices on how these issues can be resolved, taking into account the experiences of banks.

The subgroup intends to make communication with the industry a standing agenda item. Contact with the industry will include discussions with industry associations as well as bilateral discussions with banks as necessary to help inform our work on a particular topic.

My discussion of home/host issues applies equally in the operational risk context. The biggest cross-border issue related to the implementation of an AMA is the definition of significance: what is a significant subsidiary and when is an allocated AMA permissible. This issue will benefit greatly from discussions at the AIGOR.

I do not believe a formula based definition of this will be a useful way forward.

AIG/CTF Joint working group

There are several other issues we are addressing. For example, the AIG and the Capital Task Force, which was the main body that developed Basel II, recently created a joint group to consider the issue of loss given default estimates and related issues of stress testing under Pillar 1 and 2 of the new framework. We will continue to interact extensively with industry to understand current practices on that front and how those practices might evolve.

Validation

Let me turn to another important topic - validation. One of the greatest challenges - of the new Basel framework is the need for banks to validate and for the supervisors to review banks' validation of the systems used to generate the parameters that serve as inputs into the internal ratings-based (IRB) approach to credit risk.

Ratings reflect a bank's assessment of a borrower's ability to perform despite adverse economic conditions. Because banks also use ratings to determine the amount of capital the bank should hold, there will always be a need to ensure integrity, objectivity, accuracy, stability, and an appropriate level of conservatism.

Internal ratings and default and loss estimates must play an essential role in the credit approval, risk management, internal capital allocation, and corporate governance functions of banks using the IRB approach. Basel II recognises that bank management is responsible for validating the inputs to the IRB approach, while supervisors have responsibility for assessing compliance of banks' validation of rating systems and their inputs with the minimum standards of the IRB framework for credit risk. Supervisors must ensure that the Basel II requirements are being met not only on Day One, but also on a continuing basis. However, it should be noted that supervisors will focus on compliance with the minimum requirements as a means of ensuring the overall integrity of a bank's ability to provide prudential inputs to the capital calculations and not as an end in itself.

The AIG has established a subgroup to examine issues related to validation. I should note that the Validation Subgroup is focusing primarily on the IRB approach.

I should also note that while the Subgroup is made up of supervisors from both G10 and non-G10 countries, it has already held several meetings with banks to gather their views and experiences in this area and has plans to meet with more banks from a range of jurisdictions.

So far the Subgroup has identified six principles that it feels will underlie its future work. We have recently made this available in communication to industry. These are:

Principle 1: Validation is fundamentally about assessing the predictive ability of a bank's risk estimates and the use of ratings in credit processes

A bank's IRB estimates are intended to be predictive. While grounded in historical experience, they should be forward-looking. If the processes that are used in assigning risk estimates are not accurate, then these estimates may not be sufficiently predictive and may under- or over-state required regulatory capital. Consequently, validation should focus on assessing the forward-looking accuracy of the bank's risk estimates, the processes for assigning those estimates, and the oversight and control procedures that are in place to ensure that the forward-looking accuracy of these estimates are preserved going forward.

Principle 2: The bank has primary responsibility for validation

Supervisors do not have the primary responsibility for validating bank-rating systems. Rather, a bank has the primary role. A bank must validate its own rating system to demonstrate how it arrived at its risk estimates and confirm that its processes for assigning risk estimates are likely to work as intended and continue to perform as expected. The role of supervisors is to then review the bank's validation processes and outcomes. In so doing, supervisors may need to rely upon additional processes, either of its own design or of third parties, in order to have the required level of supervisory comfort or assurance.

Principle 3: Validation is an iterative process

Validation is likely to be an ongoing process in which banks and supervisors periodically refine validation tools in response to changing market and operating conditions. We will therefore need to engage in a continuing dialogue on strengths and weaknesses of particular rating systems.

Principle 4: There is no single validation method

While some validation tools, such as backtesting and benchmarking, may prove especially useful, there is no universal tool that can be used for all portfolios in all banks. Backtesting, for example, may prove difficult for portfolios where there is a low level of historical defaults. Validation techniques may converge over time, but in practice there will likely be differences in validation techniques across portfolios and across markets.

Principle 5: Validation should encompass both quantitative and qualitative elements

Coming back to a theme I highlighted at the beginning of my remarks, it might be tempting to think of validation as a purely technical exercise in which outcomes are compared to estimates using statistical techniques. Indeed, in some circumstances such technical tools may play a critical role in such assessments. But it will not be enough to focus solely on comparing predictions and outcomes. In assessing the overall performance of a rating system, it is also important to assess the components of the rating system, such as data and models, as well as the structures and processes around the rating system. This should include an assessment of controls (including independence), documentation, internal use, and other relevant qualitative factors.

Principle 6: Validation processes and outcomes should be subject to independent review

Bank validation processes and results should be reviewed by parties within the banking organization that are independent of those responsible for the design and implementation of the validation process. This independent review may be accomplished using a variety of forms. The review process may be distributed across multiple units or housed within one unit, depending on the varying management and oversight frameworks of banks. As an example, internal audit could undertake this review process using internal technical experts or third parties independent from those responsible for building and validating the bank's rating system. Regardless of the bank's control structure, internal audit has an oversight responsibility to ensure that validation processes are implemented as designed and are effective.

Given those six principles that will underlie its work, the Subgroup has identified some specific issues for discussion. These include:

- Rating System Design;
- Risk Quantification;
- Risk Rating System Operations;

- Oversight and Control Functions;
- Use of Ratings; and
- Specific Portfolio Issues.

In particular, the Subgroup will explore tools and techniques that banks use in validating their own rating systems and that supervisors use in reviewing bank validation processes and outcomes. In response to industry concerns, the Subgroup will also explore issues related to portfolios with low levels of historical default, as well as the use of pooled data. Of course, the work that we can do will depend to a large extent on how far work has progressed in banking organizations.

I should emphasize that the Subgroup is not responsible for developing a uniform, prescriptive approach to validation. Rather, it will serve as a clearinghouse for sharing and cataloguing information on tools or techniques. Interaction with industry representatives on practical approvals is underway.

Conclusion

I hope this has given you a flavour for the work we are undertaking in implementing Basel II. Let me emphasize that this is just a smattering of what is going on in the supervisory community.

As we approach each issue 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 practices in internationally active banks, and further enhancing supervisory focus all present huge opportunities - for banks, for supervisors, and for our markets and economies.

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

I look forward to that result.

Thank you.