Nicholas Le Pan: Basel II implementation – assessing progress to date and next steps

Remarks 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 7th Annual Global Association of Risk Professionals 2006, New York, 28 February 2006.

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Let me thank GARP for inviting me here today.

There is a famous actress, it might have been Tallulah Bankhead, and she had a very deep voice. Her view was not to worry much about risks. She said, “Whatever happens, happens,” and, “If you got to go, you got to go”. Well that’s not the attitude towards risk and risk management (or implementing Basel II) that we need. I think more of “The General”, George Patton, whose quote is, “Take calculated risks. That is quite different than being rash”.

I think some of what General Patton had to say is very relevant to today’s risk management environment and also to Basel II. Let me be clear – I don’t think regulators in the Basel Committee have had an irresponsible “you got to go” attitude to implementing Basel II.

Hugely important, but sometimes forgotten, is that Basel II better relates capital to risk. That is key to supporting financial stability and key to supporting improved risk management practices. This is a huge benefit in my view-for consumers of financial services, for banks, for regulators and for economies.

Assessing impacts

One of the biggest challenges in implementing Basel II is dealing with the uncertainty of impacts. It is not possible to precisely plan the impacts, push the green start button and expect that there will be no surprises. Nor is it possible to adopt Basel II and believe that it will lead to minimal impacts on the capital of each and every bank. Implementing Basel II has risks. Like General Patton, we want the risks to be understood, we don’t want to be rash. We want protection against surprises, and we want confidence that our ability to react-as banks, as regulators-is up to the task.

We want the static analysis of impacts to be reasonable-but we will only get a really good feel of how the new system will work when we are in the parallel run period and the new system is up and running. And no fiddling with the rules now can change that.

And that is why it is so dangerous to just focus on the arithmetic-risk management and regulation and supervision is not just about arithmetic and higher mathematics, neither is Basel II.

Nor can we just focus on adjusting the scaling factor as a means of “getting it right”.

That is why we have floors-protection.

That is why we have the ability to work with banks, and to regulate if necessary, to constrain the use of certain parameters in Pillar I. That’s why we can require a better, more robust job by a bank in taking account of downturn conditions-something that has not been well done, or done at all, by some banks in their quantitative impact assessments provided to regulators and reported publicly.

That is why we have Pillar 2-which in my country, Canada, includes target capital levels of 7/10 (Tier I/Tier II) to be considered well capitalized. We don’t just care about minimum capital, we also care about the actual capital held by banks. As regulators and banks and policymakers we can focus too much on Pillar 1.

That is why countries like Canada are keeping our leverage test (though we have indicated we will review the levels of the test to make sure that it does not wipe out all the benefits for individual banks). I gather the leverage test has been a bit of an issue here in the U.S. as well!

Lets also remember the important role for judgment in implementation-a theme I return to again and again. Consider the role of judgments in assessing impacts. A number of major banks have done estimates or simulations of how the Basel II Pillar 1 minimum capital will move over a credit cycle,

recognizing that we are, at the moment, in some of the best credit conditions we have seen for a while. The estimates for peak to trough variation in minimum capital range from 15-30% over a cycle. I encourage more banks to do this type of analysis.

So if we set the minimum capital requirement today exactly equal to the capital under the old system then, when we have a downturn, minimum requirements might be 15 - 20% higher than under the current rules–is that what we want? I don't think so. You can't get away completely from these over-the-cycle effects–they are inherent in a system that is more risk based. I would even argue they are desirable in telling markets what is happening to the riskiness of a bank over a cycle. But, that means judgment is going to be required in assessing impacts and deciding how to react, not overreact, to them.

But banks' know about cyclicality too. And banks have lots of incentives to smooth out the path of their actual capital over a cycle–fluctuations in actual capital along with minimum capital are likely to lead to consequences in the marketplace, raising capital at certain times in a cycle is costly, managing the bank when there are big changes in actual capital could be quite disruptive.

Home host issues

While there is not going to be perfect uniformity of implementation I believe that a reasonable degree of consistency across major jurisdictions is going to be hugely, hugely important. That's not only to deal with level playing field issues, but it is also trying to make sure that the investments that banks have made are dissipated through multiple duplications and inconsistent approaches to how Basel II is implemented.

The glass is half full, but it is also half empty in that regard as we sit here today. However I take heart from the fact that there are better-working processes in place than before, including at the AIG (Accord Implementation group), and we continue to make progress.

Industry concerns about home-host implementation issues are rising.

Some arise from the US decisions to delay implementation and use different floor calculations. There is uncertainty about how U.S. and foreign banks will be treated in various jurisdictions. Some of this will hopefully be alleviated when the US decisions on implementing Basel II and Basel 1a are issued. There are genuine concerns re: systems costs. There are worries about potential level playing field issues in how the US intends to implement Basel II and Basel 1a relative to approaches in other jurisdictions.

Many major banking groups want to have a number of their subsidiaries remain either on Basel I or on a version of the Basel II standardised approach that is as close to Basel I as possible, at least for a transitional period. Banks are concerned that without this approach, systems costs of implementation will be materially higher if they are forced to develop "throwaway" systems that will only be in use for one or two years.

The industry has sensed a slowing down of so-called supervisory colleges. AIG members generally agree that these efforts have slowed down, but often members' focus on solving home-host issues has simply shifted to more bilateral interaction with host supervisors. Going forward, AIG members anticipate an acceleration of both multilateral and bilateral work later in the year as approval work intensifies.

In some cases differences across jurisdictions in interpretation of key provisions are becoming apparent. For example, supervisory expectations for the use test as well as implementation of the downturn LGD (Loss-Given-Default) principles.

The implementation implications of areas of the Framework where there is not uniformity of treatment (e.g. differences in the definition of default) are also becoming more apparent.

In areas like the AMA (Advanced Measurement Approach) hybrid approach, we have industry waiting for further supervisory guidance and supervisors waiting for greater industry initiative.

There are also areas of the framework, particularly Pillar 2, where it has long been clear that country approaches would differ. The closer to the implementation date, the more some banks are worried about the implications of these differences in terms of capital. As well, banks and supervisors have in some cases been focussed more on the homehost aspects of Pillar 1 and issues of application of

Pillar 2 within a banking group, and the degree of host-home reliance. These issues are now coming more to the fore.

Finally, home-host implementation issues are in some cases raising other issues not related to Basel II.

Some of these industry concerns are due to residual unrealistic expectations – there will not be uniformity of implementation or a very strong lead supervisor role, no matter how much industry would like it.

I want to emphasise that some are making home-host issues a scapegoat. For example, a number of banks are opting to adopt as much as possible simple approaches in host jurisdictions. Some observers have claimed that this is a sign of failure of home-host cooperation. It is essential that supervisors and policymakers take a reasoned perspective on these issues. In particular a number of banks who are choosing simpler approaches are doing so for their own reasons such as focussing their scarce resources on advanced approaches in the home country. Attributing these trends solely to home-host regulatory issues is unhelpful.

Where is this going? I believe in the short term for many large banking groups there are a limited range of portfolios and countries where close cooperation is required in implementation of advanced approaches for credit or operational risk. It will be important to continue to move these discussions forward. I think over time the number of these discussions will expand.

In some cases host supervisors need to decide if simplified versions of Basel II approaches can be made available to foreign banks in their country to ease implementation costs. Canada has tabled its approach in this regard at the AIG and Core Principles Working Group (CPWG) meetings for information and it is available publicly. A number of jurisdictions indicated willingness in principle to consider these types of approaches. This willingness needs to be converted, however, into practical outcomes.

I believe the infrastructure for enhanced home-host cooperation (both bilaterally and through colleges) on approval/validation issues has been put in place. It needs to be used as approvals accelerate in the second half of the year. The AIG will continue to collect information on progress and share experiences.

In addition, communication between the AIG and industry on frequently asked questions about implementation issues needs to be enhanced. The AIG has plans in place to do so. We can't solve all issues and some cannot be discussed fruitfully now until further adoption decisions are made in certain countries.

There are selected areas where indication of some flexibility in implementation would be beneficial. I am encouraged by many supervisors willingness in this regard. One example is cases where the use test could be implemented flexibly (e.g. strict interpretation of the use test may not be appropriate regarding either downturn LGDs or using Basel II analytics in provisioning).

There are areas of implementation where the opportunity for supervisors to share experiences on a more "real-time" basis would be beneficial in achieving more consistency. At its last meeting the AIG had a major discussion and sharing of information on LGD issues. Several banks presented their approaches to downturn LGDs for portfolios like mortgages where this is a very relevant issue. The AIG is establishing a monthly "clearinghouse" conference call on LGD issues. It will allow supervisors to share experiences regarding LGDs in the applications they are considering, identify and discuss minor LGD implementation issues as they arise, identify any further LGD issues that other groups should address, and share information on what supervisors are telling banks about LGD issues such as where supervisors are allowing banks not to compute downturn LGDs, and criteria for acceptable downturn methodologies, and what is the range of outcomes for LGD on certain portfolios.

Supervisors need to decide in what circumstances they are going to accept AMA allocations and banks need to be more responsive in proposing more risk based allocation methods. The AIGOR (Operational Risk Subgroup of the Basel Committee Accord Implementation Group) is working on an elaboration of the home-host information sharing principles as they apply to operational risk as a way of encouraging home-host cooperation and continues to invite banks to present their AMA approaches, including allocation methods.

Now what's going to happen for banks as a result of those so called gap year issues and different transition periods? Some of that we can't know until the U.S. has actually published their rules. And we've certainly been encouraging the U.S. authorities to clarify as much as possible, and hopefully in

ways that reduce the need for foreign banks operating in the US to have to throw away or redo systems. But U.S. authorities have also been helpful in clarifying that gap year and floor differences don't necessarily mean problems for foreign banks status in the U.S. But if a major foreign bank with material operations in my country was going to have a very large reduction in consolidated capital I'd certainly be interested in knowing more about the reasons for that. I also welcome the U.S. authorities stated willingness to help other supervisors with respect to U.S. portfolios of foreign banks.

Now let's flip this the other way around. There are a range of major US institutions who would ideally like to use advanced techniques outside of the US in advance of them being able to qualify in the US.

AIG discussions suggest that this is very unlikely to be acceptable to regulators except in the few cases where material retail portfolios in a host country have modeling, data, analytics and risk oversight largely locally.

Obviously, working all this out will require ongoing interaction between regulators and banking organizations. You can't mandate cooperation and coordination through international agreement, especially since what this means in practice will vary from case to case. A good deal of the platform for enhanced cooperation has already been laid. And again we are talking about judgment and trust, because those are key to reliance.

It will be hugely important that regulators and banks use feedback mechanisms and existing relationships to identify issues that are anomalous, to promote more cooperation, to enhance trust and reliance. And we have to be prepared to put significant ongoing effort into it for home host relationships to be a success story in implementing Basel II.

Difficult areas for implementation

While many aspects of Basel II are challenging, there are several areas that I know are of particular focus to the industry. One is downturn LGDs. The principles that were developed on implementation of these are important. They are sensible and practical, such as making clear that banks can produce material to show that default weighted long run average LGDs are enough for some portfolios.

On the incremental default risk charge in the trading book we are making progress, together with securities regulators, in responding to industry suggestions for what expectations ought to be for banks incorporating this into their capital calculations. Doing so is hugely important and is a major contribution to dealing with issues of tail risk and illiquidity raised in the recent Corrigan report.

We have produced good material on validation issues (with more upcoming on expectations re vendor models). The sharing of experiences in validation and actual interaction with banks has been very useful in promoting consistency. I think that will intensify as the year progresses.

Looking forward I would urge more focus on stress testing and on overall governance. Stress tests need to be meaningful and are hard to design well. The results then need to be taken into account by bank management, with good exercise of judgment. I expect this to be an area that the AIG will come back to. Without being formulaic we also need to recognize that Basel II results in an increased richness of information on a bank's risks and capital and some of that should find its way to the Board of Directors.

Importance of other pillars

Let's not forget Basel II is also about market based regulation. It's fascinating what proportion of the time people spend on Pillar one. We forget Pillar two and Pillar three a little bit at our peril, collectively.

I believe that disclosure is broadly in pretty good shape in the much of the banking industry, but there are certain areas where Basel II is going to put requirements and forces in place to enhance disclosure, and that's a hugely important part of better judging what's behind banking organizations approach to risk and what's behind banking organizations approach to capital. And I think that will be important from a counter party perspective and I think it will also be important from an analysts and financial community perspective.

And the challenges for banks in better relating their desired capital better to risk, and for supervisors in judging that assessment, are real.

Delay issues

Now some have called for an overall delay in all countries in order to sort things out. I think that misses the point, even if it were possible without amending legislation or rules in a number of countries. In part the real impacts of Basel II are only going to be known with more certainty once we actually go live, but with the protections I talked about earlier.

I respect the U.S. decision regarding the delay. I understand the decision, though I wish it hadn't been necessary. It certainly makes major banks in the United States and from outside the United States worry about cross border implementation challenges and I understand that added worry.

In Canada, based on our discussion with banks, I believed it was better to proceed than to drag this out. We had more flexibility to deal with in implementation issues as we were not requiring our major banks to be on advanced approaches as the U.S. was.

We realize fully that there are challenges. But we believe that major Canadian banks are making steady progress in implementation and we believe that that progress is consistent with international peers and that issues are solvable.

Implementation plans for the more complex and advanced approaches under Basel II pose significant execution risk. I don't believe that those challenges are unique for a project of this size and importance.

And while those risks may potentially impact the implementation date of IRB compliance systems for individual portfolios or individual banks in Canada, we believe there is sufficient flexibility in the new framework to accommodate contingency for bank plans, if necessary, so that banks can have a Basel II compliant capital calculation by the start date.

I have had a look at the initial results from the QIS 5 in Canada. We're still in the process of assessing the impacts. Some of the results have too big a reduction for my liking, but we need to understand that better. Some aspects of the framework were not included by banks in their calculations such as downturn conditions or the new trading book rules that would have raised capital. But I will say that at this moment I do not see any highly worrisome results that would call into question the whole framework.

I've been consistently saying to institutions in Canada for some years now that, if they want to come with double digit reductions in capital for credit risk in the early years, they are going to have a heck of a lot of explaining to do.

But remember that Basel II is more risk sensitive, so the notion that minimum capital for some organizations is going to go down, and for others it might go up, is a notion that I fundamentally embrace. We may have important discussions, about how much, over what time frame, and so on. But fundamentally we accepted, when we signed on, that that was the world we were going to be in.

Success factors

Let me close with a few success factors for people to keep in mind. Basel II is a major IT project, so a lot of this is about how well banks manage a major IT project and the risks in those kinds of projects.

Don't forget pillar two and pillar three.

Don't forget the need for ongoing two way communication between regulators and banks. Don't forget the banks role in talking to host supervisors if you want cross border implementation to go better.

More effective relationships between home and host supervisors is a success factor. I think we've built a lot of the basis for an enhanced relationship with the help of the AIG and we're going to need to continue to use those as we get to the serious stages of implementation.

Improving risk measurement and management is a key success factor, and I've indicated today areas where I think more focus is needed.

Lastly some softer things. Basel II is about an increase in the willingness and capability of all the participants to make complicated judgments. It is about an increase in the degree of cooperation and trust between supervisors in a major banking group. And it is an increase in the level of richness of discussions within banks and between banks and their supervisors about risk and capital. I think all of those are good things.

Thank you very much.