Callum McCarthy: The challenge of Basel II for regulators

Speech by Mr Callum McCarthy, Chairman of the Financial Services Authority, at the Institute for Independent Business (IIB) Singapore Meeting, Singapore, 18 September 2006.

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I am delighted to have been asked to speak at this meeting, and congratulate the IIB on establishing an audience so far away from its home base in New York.

It is a challenge to think what a UK regulator and supervisor should say to a US-based audience in Singapore – other than express mutual sympathy as to the effects of jet lag. I have chosen to talk briefly about selected aspects of Basel II – a subject which is both current and which raises interesting issues of international cooperation, the subject which I've addressed on previous IIB meetings.

There is, of course, a continuity between my previous remarks on and interest in the issues of the responsibilities of home and host regulators and the implementation of Basel II. The implementation of Basel II represents a real, practical and important test of how regulators round the world are succeeding in working together. And I am afraid that the results are mixed rather than unambiguously good. This morning I want to examine some of the issues, and the extent to which we collectively have succeeded in resolving them.

I should make clear at the start that I recognise that different regulators operate under very different legislative frameworks, and in very different political contexts. I am always struck by the enormous difference between the very strong political interest in Basel II shown in the US and that fact that it is not a political issue at all in the UK. And, while the British political (non) standing of Basel II is not repeated in all EU countries (there has been some political interest in Germany and Italy), as a generalisation it is clear that political interest in Basel II in Europe has been a pale shadow of that shown in the US.

The obvious effect of this is the timing of implementation of Basel II, with the striking difference between the EU implementation of the Capital Requirements Directive (CRD) in little over 3 months for the simpler approaches and 1 January 2008 for the advanced approaches, against the US timetable of 1 January 2009 - the first possible date a bank could start using the advanced approaches, subject to the capital floors. These differences in timing present significant but, by definition since they are timing differences, transient problems for international firms and banks which have substantial operations in jurisdictions which are adopting different timetables for implementation – particularly and obviously for EU banks with substantial US operations. There will be extra complexity, diversion of management attention, and costs. The consolation, if such exists, is that timing problems are temporary, and should in time be settled.

Of more serious impact – because not transient – are the questions of how bank regulators and supervisors in different jurisdictions, once they have converged on a timetable for implementation, will converge on interpretations of Basel II which are predictable and, in an ideal world, consistent. I want to set our some areas where we have made progress towards this end, and also some areas where we still need to make further progress.

Within the EU, we have set out very explicitly how the responsibilities of home and host supervisor will be exercised in respect of model approval, for both IRB and AMA model applications – that is, for modelling both credit and operational risk. The principle was laid down in Article 129 of the CRD, and establishes the responsibility of the home supervisor to take the decision on model approval. It requires the home supervisor to consider the views of host supervisors on model approval, but establishes the right of the home supervisor to take the decision if agreement cannot be reached within six months. This principle has been fleshed out by work carried out in the Committee of European Banking Supervisors (CEBS), which has agreed more detailed guidelines for both how home and host supervisors should cooperate, and exchange information; and for the practicalities of IRB and AMA model validation. Both sets of guidelines respect the primacy of the home regulator, while imposing duties as well as rights upon the home regulator.

For home and host responsibilities extending outside the EU, the position is less clear cut. In the UK, our intention is that, where possible, banks should not have to maintain two sets of capital calculations for the same business. This means that, when we in the UK supervise a banking group with activities in other jurisdictions where Basel II has been introduced, we will not start with the presumption that the

FSA interpretation must be applied throughout the group. Instead, we will seek to incorporate in our group assessment the judgments of regulators in other jurisdictions, provided that the scale of the group's activities in those jurisdictions is not so large that such a policy would be irresponsible; and provided that we have confidence in the regulators in those other jurisdictions. I would expect those conditions normally to be satisfied. That will be the position once timing differences have been eliminated. For the period during which implementation timetables differ, the position will be as follows. The differing implementation timetables as between the EU, US and other jurisdictions should not materially hamper a bank's ability to use the advanced approaches in the UK from 2008. Thus a UK group should be able to include advanced approaches for its US operations in its waiver application. Likewise, a UK firm that is part of a US banking group can apply to use advanced approaches in the UK, even though its home regulator will not have approved those approaches.

Since Basel I is not CRD-equivalent in respect of credit risk, as it will not always give a result that is at least the amount required under the Directive, we will not be able to allow a UK group to include the requirements of a US banking subsidiary as calculated under the existing US rules during the period 1 January 2008 and US Basel II implementation. We will however deem equivalent a scaled-up credit risk requirement to be CRD-equivalent if the US subsidiary in question falls into the 'well capitalized bank' category.

I think we have succeeded in establishing sensible, pragmatic and workable arrangements for Pillar 1 requirements and model validation. Pillar 2 questions are likely to prove more difficult. Pillar 2 was not conceived as a one size fits all measure. It was not designed to be formulaic or prescriptive. It is therefore quite possible that, in seeking to address similar risks not captured in Pillar 1, the application of Pillar 2 to two similar banks in two different jurisdictions could easily produce two very different outcomes. It is crucial therefore that supervisors and firms share a common understanding of the key characteristics that underpin Pillar 2. In Europe, CEBS has sought to do exactly this and has developed guidelines setting out a common understanding of what the supervisory review process under Pillar 2 should seek to achieve. But we have to recognise that much of this common understanding comprises a recognition, rather than an elimination, of differences. We will all understand better the different decisions which different EU regulators and supervisors will take – but banks will face the potential frustration of the same facts resulting in different decisions by different supervisors. It is an area of predictable sensitivity.

But it is not simply a matter of resolving some of these 'big ticket' home/host issues. Banks' chief risk officers are equally concerned by differing interpretations of key concepts and definitions used in different jurisdictions. Perhaps the most prominent of these relates to the divergent approaches to the definition of default that are emerging as between the US and other jurisdictions. This too is a predictable area of sensitivity.

The Accord Implementation Group (AIG) under Nick le Pan's Chairmanship has been grappling with these and other issues, with some success, notably in the context of home-host information sharing and cooperation. But it is important that we continue to work at these issues, particularly on a trans-Atlantic basis. EU supervisors, all subject to the common discipline of the CRD, are of necessity succeeding in forging many EU-wide elements of convergence. The most important task for the AIG – and arguably for the Basel Committee – will be to develop global convergence. I am delighted – and relieved – that we have as Chairman of the Basel Committee my fellow panellist this morning, Nout Wellink of the DNB, whose experience and skills so clearly fit him for this important and difficult set of challenges. I hope it will give banks who are aware of these issues some comfort to learn that regulators and supervisors share your concern, and are working to develop solutions.