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1. Introduction

The topic for this conference is Cross Border Banking: Regulatory Challenges. I like the word "challenge". John Ford had a great line. "We're not lost. We're locationally challenged." "Locationally challenged". That has a lot to say about cross border banking for both banks **and** for regulators. If only governance and control systems everywhere could be seamlessly doing their job. If only regulators could be as well.

Many of the more prominent, serious failures in banking organisations have been due to the challenges of overseeing foreign operations. These have sometimes been safety and soundness problems, while at other times they concerned reputation lapses, and were costly. So, while I will focus on regulatory and supervisory challenges and what regulators are doing, I will also say a few words about the banks themselves.

I don't think we will totally tame the challenge of regulation or effective oversight in a cross-border world. Progress is occurring, though more is possible. The aim is to have a greater understanding of real risks, a greater ability to deal with inevitable mistakes and surprises and a greater comparability (the ubiquitous more level playing field) and more financial resiliency and financial stability.

A few caveats. I am going to be talking mainly about subsidiaries, not about branches. However, some branches can be systemically important and some subsidiaries are run much like branches. Again, we must recognise that the stylized assumption of which countries are ‘homes’ and which are ‘hosts’ is not accurate. The biggest homes are also often the biggest hosts. In addition I will not be focussing on cooperation in a crisis. However, I think that continuing to build enhanced communication and cooperation in meeting more day-to-day regulation and supervision challenges will also pay off when serious problems arise.

I intend to use Basel II as an example, as it is a main driver of enhanced cooperation among prudential regulators. The Accord Implementation Group (AIG), which I chair, does not have a strong harmonisation mandate from the Basel Committee countries. I do not think we are going to see major changes in international regulatory architecture or fundamental changes in responsibilities over the next few years, yet progress in enhanced cooperation and communication is essential. So I think the more bottom-up approach we are following through the AIG is important.

2. Background

While any discussion of challenges must focus a fair amount on the development of policy and rules we must still recognise that regulation, supervision and risk management in a cross border context are about people and relationships and behaviours.

Over the past 24 months there have been approximately 191 Basel Committee and subgroup meetings about Basel II. I don't know how many dinners and lunches that is, but it's a lot.

Some would look at the trips and dinners as a frivolous waste. Some of the participants may (privately) see them as an inevitable and inescapable round of challenges to their personal desire to remain fit. For me they are an investment in relations, trust and understanding. These qualities are hugely important in building more effective cross border regulation and supervision. One of my colleagues has referred to this as supporting "the community of regulators and central bankers". When we can't be everywhere and do everything ourselves, we are in the world of reliance. And reliance on someone you don't feel you know, understand and trust is pretty unlikely. If forced, it can be downright risky. And not every regulator is up to the challenge, nor will everyone meet challenges in ways that are easily recognisable to other regulators. So informal contact is also a key part of building reliance.

There are several trends that are changing the dynamics of the cross border banking challenge.

1. The changing nature of banks

It is now trite to recognise that banks are no longer run on jurisdictional lines and there is often no concurrence between legal entities and business lines. So there is a mismatch between national prudential and insolvency regimes, responsibilities to legislatures and how banks operate. Economies of scale in risk measurement and modelling exacerbate that mismatch. Banks also want to capture the economic or regulatory benefits of cross correlations between risks at the enterprise-wide level. Certain risk management methodologies really only make economic sense at a group-wide level. These trends lead to more centralized operations of oversight and risk management functions. Marketplace success, however, demands material local autonomy and local knowledge for some businesses, and local input into risk assessment. So we have a stronger push-pull between group-wide oversight and local oversight. Bank governance, control functions and regulators, have to understand how well this tension is being managed within the bank.

Many aspects of what banks do are getting a lot more complex. A good deal of this complexity of instruments, hedging and risk management transactions, netting and risk transfer, happens as risks are aggregated up from separate business units, legal entities and countries within the banking group, and are dealt with closer to the group-wide level. Much of the bank's funding strategy is at a group level. Tax issues can also have a major impact on how certain parts of bank's operations are structured from a legal and business perspective.

The good news is that the number of significant subsidiaries is not large for many of the large internationally active banking groups. The bad news is that even previously non-significant operations can create costly surprises.

2. <u>The changing nature of risk and risk management</u>

I also believe that the relative importance of risks may be changing. I emphasise the word <u>relative</u>. Credit risk is still generally the most important, but the rise of operational risk relative to credit and market risk is a key development. In the market risk area more focus is needed on things like liquidity risk (the fact that in stressful times marketability is not liquidity) and more extreme event scenarios. These are raised in the "Corrigan" report and are also dealt with in part in the Basel Committee's recent changes to the framework for market risk capital. Many of these risks are less well understood and lend themselves less to standard analysis techniques. The demands on expertise, in banks and in home and host regulators, are rising.

We also have the risks related to the use of the banking system for criminal and terrorist acts. And we have outsourcing of activities that are outside of the regulatory oversight net in some cases.

How is risk management changing? All of us know that Basel II is much more than a compliance exercise. The same is true for other aspects of safety and soundness regulations and market conduct regulations (including suitability rules, KYC, AML/CTF). Simply enacting new rules and checking periodically to ensure they are being respected is not enough. Behaviours matter. Basel II, as an example, puts the onus on banks' boards and management to better focus on the measurement and management of risks and to better relate risks to capital. While the modelling aspect of risk management has definitely increased, risk management is not just a quantitative exercise. Banking is not just about arithmetic and higher mathematics. Neither is bank supervision. For risk managers and regulators the challenge is assessing how the judgements are being made.

The rise of reputation risk is part of the relative changing nature of risks. This includes the risks arising from the more aggressive expectations of consumers, investors and the legal system, as to how they should be treated. These risks can be large and can arise even in parts of a bank's operations that previously would not have been thought of as material to its safety and soundness.

There is also a move to expect banks to be more vigilant in “policing” the behaviours of third parties with whom they are dealing. These trends can add to cross border challenges—they can bring conflict of law and conflict of enforcement challenges. They bring in new participant regulators to the cross border arena.

3. The changing nature of Bank regulation and supervision

Partly in response to these challenges, bank supervision and regulation is becoming more judgemental, more reliance based—relying in a ‘trust but verify’ approach on bank oversight and control systems. I think this trend is generally accelerating and I think it is a good thing for more effective and more efficient bank regulation. Pillar 2 in the new Basel II framework is supporting and pushing this development in many countries. More commonality here allows more supervisors to more easily share, cross border, information on how they view a bank’s risks.

There are also more integrated supervisors, which can affect the ease of home-host relations. We are seeing more peer assessments of regulators against agreed core principles. More basic commonality of approaches is occurring, with appropriate variation for national circumstances. Again this makes enhanced cross border cooperation more feasible.

Basel II is not a compliance exercise for supervisors. Basel II puts the onus on supervisors to focus their supervisory efforts, and react to a bank's processes and assessments. Effective supervision is a matter of knowledge and expertise, and we too cannot rely on models to the point where we fail to assess the qualitative aspects of banks' risk management practices, and exercise prudent discretion.

Also, many, including myself, would like rules to be more in the form of principles. One implication, however, is how principles-based rules are interpreted in different jurisdictions matters more than if the rules were detailed. The judgement issue again.

4. Penetration in foreign markets

The penetration of foreign banks in countries where financial liberalisation has taken place over the past fifteen years has become significant. In several countries, the largest retail bank is a foreign-owned subsidiary and foreign-owned banks may dominate the banking market. This situation raises legitimate host country concerns with respect to their ability to safeguard the stability of their financial systems. It puts pressure on them to understand more about the group-wide bank and the quality of its oversight and controls. To avoid duplication, they must implicitly or explicitly rely on processes in part occurring outside their borders.

Those four changes in banks, risk, risk management, bank regulation and supervision, exacerbate the cross border challenge. Host country supervisors want to better understand what is happening on a consolidated basis that can affect them. Home countries want to better understand how centralized control systems are working in practise in significant offshore operations. Supervisors (and banks) in different countries need to understand more thoroughly how principles-based rules are being interpreted and applied by their counterparts. And the less-well-defined nature of risks that are rising in importance makes for more cross-border challenges. Regulators also have incentives to cooperate and share more information in order to economise on scarce resources.

Remember, effective cross border regulation and supervision is a lot about trust and communication. You can't communicate effectively, much less trust, someone who operates a system not even remotely close to your own.

3. What to do – Some Suggestions

I have four suggestions on what to do in the short term to make progress.

First, International organisations involved in rule making and standard setting need to make sure their governance and processes are adapted to the world I have just described. Involvement and effective consultation with the range of regulators and industry participants affected is important. In the past, these organisations focussed mostly on their contribution to the standard setting process and much less on their contribution to the implementation process. This must change.

In the case of Basel II the BCBS created the Accord Implementation Group, which was, a ‘first’ for the Committee. Its mandate is not to force harmonisation but to share information and experiences and thereby promote consistency in the implementation of the Accord. We have strong feedback loops to industry and involve non-Basel countries in a good deal of our work.

Second, we must explicitly consider cross border issues in rules processes. In the case of Basel II the BCBS has explicitly recognised that cross border cooperation has to be enhanced for effective implementation of Basel II. The Basel Committee has set out some principles for enhanced cooperation in implementation of the new framework (High-level principles for the cross-border implementation of the New Accord).

While attention is, understandably, now on QIS4 in this country and QIS5 in other countries, with the possibility of changes, specific implementation challenges and timetable issues, I think enhanced cooperation in cross-border implementation is essential if the Basel II framework is to be implemented well. I have been emphasising the need to not take our eyes off that ball. The principles deserve repeating.

Principle 1

The New Accord will not change the legal responsibilities of national supervisors for the regulation of their domestic institutions or the arrangements for consolidated supervision already put in place by the Basel Committee on Banking Supervision.

Principle 2

The home country supervisor is responsible for the oversight of the implementation of the new Accord for a banking group on a consolidated basis

Principle 3

Host country supervisors, particularly where banks operate in subsidiary form, have requirements that need to be understood and recognised.

Principle 4

There will need to be enhanced and pragmatic cooperation among supervisors with legitimate interests. The home country supervisor should lead this coordination effort.

There are implications for all if this doesn't work well enough. Banks would face unacceptably high implementation costs, and they may react in ways that would reduce the benefits, to home and host countries, of the new framework (e.g., by not adopting more sophisticated approaches in local markets or by shifting from subsidiaries to branches). Both home and host country regulators could lose out on obtaining the quality of information that they would ideally like to meet their mandates.

Principle 5

Wherever possible, supervisors should avoid performing redundant and uncoordinated approval and validation work in order to reduce the implementation burden on the banks, and conserve supervisory resources.

Principle 6

In implementing the New Accord, supervisors should communicate the respective roles of home country and host country supervisors as clearly as possible to banking groups with significant cross-border operations in multiple jurisdictions. The home country supervisor would lead this coordination effort in cooperation with the host country supervisors.

We are making progress in this area. At this time, many internationally active banks have started their discussion on implementation plans. We are seeing a variety of communication approaches being used. Some jurisdictions have initiated informal discussions that take place on a bi-lateral or tri-lateral basis, depending on the complexity and the nature of the relationships. Others have organized "colleges" of supervisors where the home supervisor for each bank arranges meetings with key host supervisors and with bank management. During the meetings they discuss the bank's plans for the implementation of

Basel II, what the bank needs from the supervisors in terms of direction, and what the supervisors want from the banks and from each other. Indeed, AIG members are clearly moving from case studies into actual, tangible implementation planning. However, given the Basel II timetable, this work needs to be accelerated. Not all the work happens in these groups but they can foster closer cooperation that pays benefits in other enhanced relations.

I believe this approach, strongly grounded in practicality, and bottom-up not top-down, is the most effective way to promote better cross-border implementation of Basel II. The Accord Implementation Group started these efforts because we believe that enhanced trust and communication is not built solely by talking, but by doing. The AIG monitors progress against the principles at every AIG meeting. Going forward, this has to be done by regulators, not by any form of central control.

Third, let's avoid simplistic changes in 'Grand Design' that are not achievable. Ideally, for example, major internationally active banks would like to deal with only one lead supervisor. This is understandable – but unrealistic. It may be efficient from the banks' point of view, but I know it is unacceptable from the host supervisors' point of view. And many G-10 countries are both home and significant host supervisors, so I doubt it would be acceptable to them as well.

Lets remember that while regulators and supervisors can do a better job to reduce duplicative work, banks have a role as well. Sometimes local management of certain subsidiaries has virtually no knowledge of the Basel II implementation approach to be adopted by the parent bank. Banks need to recognize that 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.

Fourth we must continue to foster practical effective communication. Implementing an initiative like 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 organized or regardless of what work is being done by the home supervisor. Neither of these extremes will work in my view.

I am encouraging home country supervisors to pay particular attention to the information needs of host country supervisors especially in situations where the bank is systemically important in the host market. Similarly, I am encouraging host countries to focus on what they really need from the home country or the bank about group wide operations in order to increase reliance and do their job. They may not need everything.

E. Some Next Steps re: Basel II Home Host Cooperation

In this regard, the BCBS, in association with the Core Principles Liaison Group (CPLG), a BCBS working group which includes representatives from sixteen non G-10 jurisdictions, is in the process of finalising a further paper addressing the question of information-sharing between home and host supervisors under Basel II. The paper is confined to Basel II implementation and does not address wider information sharing issues. However, if considered desirable, work undertaken in the context of Basel II may help prepare the way for broader guidance in the future that addresses additional aspects of home-host cooperation.

The focus of this paper is on significant foreign subsidiaries. It covers general principles to guide the information sharing process and examples of the types of information that supervisors should consider sharing. It suggests how to reduce the chance of uncoordinated requests by different banking groups.

The paper also covers the key role of banks in supporting effective home-host cooperation. It is a fundamental element of corporate governance that local management should understand and manage a banking subsidiary's risk profile and ensure that the subsidiary is adequately capitalised in light of that profile. Subsidiaries therefore need to have or have ready access to Basel II implementation information that is directly relevant to their operations (this information may reside in part in the subsidiary or in part in the parent depending on the methodologies being used).

This paper therefore envisages a menu of options from which pragmatic choices can be made.

I think the process of developing this paper, which I hope will be released soon for consultation, has, by itself, built lines of trust and communication.

D Conclusion

Since dealing successfully with being “locationally challenged” is a lot about trust and reliance, I want to close by reminding all of us of four things.

1. It’s good to trust but also to verify
2. The only way to make a person trustworthy is to trust them
3. When you really trust someone, you have to be okay with not understanding some things
4. A person who trusts no one can’t be trusted

Thank you.