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Closing Address: Implementation of Basel II - The Next Steps
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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

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Thank you ladies and gentlemen. Let me thank the IIF for inviting me here today to give the closing remarks to talk about next steps in the implementation process. I know that I am the only thing that stands between you and a beautiful Spanish evening. When I thought about the title of "implementation and next steps", several points came to mind. I thought first about that great story by the English author John Buchan, "The 39 Steps". But of course Basel II is not really about intrigue. I next thought about many of those books one can buy in airports or shows on television, "10 Steps To A Better You". Well of course, Basel II is a bit about that, both for banks and supervisors. Then I thought about the steps in a recipe. However, unfortunately we all know that there is not one recipe for implementing Basel II - there is not one formula. Banks and supervisors have to do what is right for them within the framework set out in the Basel documents. I then thought about that great aphorism "The longest journey begins with a single step". Are we at the beginning of the end or at the end of the beginning? I don't know – but what matters is that we all have to get on with it. Lastly, I thought about dance steps. Of course, some of this is about dancing, working together in a coordinated way to produce good results.

A year ago, the questions I got asked the most frequently were, "When will the Accord be finished?, Will it be finished on time?" Well, the Committee delivered the mid-year framework on the timeframe it promised. Now the questions I get the most are, "How is implementation going?, What are you going to do with implementation challenges?" I believe that Basel II can be implemented well. Not perfectly, but well. What I want to talk about is what it takes for high quality implementation to occur. And then, I want to use cross border issues as an example of those factors.

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.

Next, communication is necessary between supervisors, between supervisors and banks, within banks, and within the supervisory community. We talked about the fact that one of the things that is going on with supervisors is movement of the Basel II responsibility from policy development types to front line supervision staff. Within banks, it is also necessary to spread knowledge of techniques and the approach of the bank beyond the core group responsible for implementation.

A practical attitude is essential for effective implementation of Basel II, both within banks and by supervisors. At lunch time today, Charles Dallara referred in his remarks to the fact that one particular aspect of the framework was in the views of the IIF more of a pigs ear than a silk purse. Practical implementing people don't worry so much about whether something is a pigs ear or a silk purse, they ask questions like "Can it fly? And if not, how do we make it fly?"

I want to emphasize the need for an attitude towards 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. For example, I saw earlier today, presentations that suggested there ought to be harmonious and relatively uniform implementation of Pillar 2 across different countries and that the results for a given situation would be the same across different jurisdictions. That is not realistic. We all know that the Basel Capital requirements today are minimum requirements and that it is up to each jurisdiction to choose to require capital levels higher than what is mandated by those minimums, with hopefully full knowledge as to the possible impact of those choices. As well, in those circumstances, I would anticipate that banks in that jurisdiction would take the responsibility to make sure that the supervisory and regulatory authorities were aware of the implications of those choices. All that is well and good, but to require and suggest that effective implementation of Basel II requires that degree of uniformity across jurisdictions is unrealistic.

Again, I have seen circumstances recently when industry groups or certain individual institutions have called for a resolution to the home/host issue by suggesting that banks ought to deal almost exclusively with their home jurisdiction. 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 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.

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 either. And so, in many ways supervisors and banks have similar incentives to try to find ways to economize on the use of resources in order to do an effective job.

Now let's talk about the home/host issue and how some of these principles annunicated apply. I believe the home/host issue is one of the most important to effective implementation of the new Accord, and it is amongst the highest priority of issues the AIG is considering. You have heard this morning from my colleague of the FSA about the concept of real case studies. In a way, that is an oxymoron – how can you have a real case study?. But, what I think is important to realize is that 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 15 of these started and we need to broaden and deepen the number. They cover both credit risk and operational risk, though, I believe the number of operation risk case studies needs to increase. Many involve non-G10 countries in Asia, Europe and Latin America.

And what drives the need for enhanced cooperation and coordination? We have to realize that it's 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. So 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.

We started these case studies because I believe that trust 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 studies to happen, to draw out and share some of the lessons learned, to draw out some of the countries outside of the AIG that are conducting these kinds of exercises, and to provide feedback to banks and from banks to supervisors. 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 30 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. 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. Home jurisdictions on the other hand, 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. 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 cooperations lead to changes in the jurisdiction or the mandate of home or host supervisors.

I think these real case studies by themselves will enhance communication between supervisors and the banks they regulate, will promote realism and practicality in implementation of the Accord and will build trust that is essential to effective implementation. I want to emphasize that banks have a key role in making this home host cooperation and coordination work. It is impossible for supervisors to develop approaches to enhance communication and cooperation if they do not have reasonably well worked out bank implementation plans to react to.

Let me close by talking for a few moments about some of the other areas that the AIG will be focusing on. We have created a group to look at Validation issues, to go through validation issues 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 later this year once it has been updated. 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. Our focus during the course of this year is likely to be on the more specific elements of Pillar 2, such as how to assess concentration risk.

Overall I believe that these efforts can be highly successful through the sharing of information to both help in the development of thinking in the supervisory community, to help promote better cooperation and coordination and to spread learning both between supervisors and between banks and supervisors. We have to remember that there is no one step recipe book for implementation of the Accord – no magic 39 steps. On the other hand, with goodwill, good feedback and ongoing communication, Basel II can be implemented well. I look forward to that result.

Thank you.