



BASEL COMMITTEE ON BANKING SUPERVISION

BANK FOR INTERNATIONAL SETTLEMENTS

Current Developments in the Implementation of Basel II

Presentation to the FSI-ASBA High-level meeting

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1. About the AIG

- The AIG is not Basel II control central
- Supervisors share experiences and communicate range of practices and sound practices, and learn from each other
- Information exchanges and outreach to the global supervisory community (ILGC) and industry
- Shifted over time from writing high-level papers to its current focus on addressing practical problems using case studies



1. About the AIG

- Most of the current issues are not a result of lack of guidance, but of inadequate implementation of the existing guidance.
- The original mandate of the AIG is still very relevant, the AIG is conducting **long-standing work streams**.
- However, due to market developments, the BCBS has requested the AIG to undertake **additional work**.



2. AIG ongoing work streams: Home-host issues

- Home-host issues are at the core of many implementation challenges
 - Home-host issues are longstanding
 - The 1975 Concordat set out the basic guidelines for home-host cooperation in the supervision of international banks
 - The implementation of Basel II has NOT altered the structure of incentives and/or the legal responsibilities of supervisors
 - However, home-host issues are more relevant under Basel II



2. **AIG ongoing work streams: Home-host issues**

- Home-host issues (significant progress has been made):
 - Validation/approval of Pillar I models – who does what?
 - Assessment of group-wide Pillar II internal models
 - Different approaches/timing in different jurisdictions
 - Home and host information needs
 - Systemically important subsidiaries
 - Pillar III disclosures
- Supervisory colleges: significant factor in the success banks and supervisors have achieved around the Pillar 1 approval process. Colleges will also be key for Pillars 2 and 3.
- Joint AIG/ILGC statement on “Progress on Basel II Implementation”



2. AIG ongoing work streams: Home-host issues

- However, the AIG continues working to enhance coordination:
 - ASBA and EMEAP have become members of the AIG,
 - AIG holds periodically joint meetings with the International Liaison Group on Capital (ILGC) to discuss home-host implementation issues.
 - AIG and ILGC organise joint workshops.
 - Next one: 9 May in Bangkok on scaling for complexity in Pillar 2
- Challenge: to strike the appropriate balance between legitimate home/host supervisory needs and the goal of minimising burden on banks and supervisors
- This is true for all three Pillars and there is no silver bullet



3. AIG ongoing work streams: Pillar II

- Varying Pillar II approaches across supervisors, but similar supervisory objectives
- Need to better understand the impact of internal supervisory differences on cross-border banks
- It is important to distinguish between economic capital models and the internal capital adequacy assessment process (ICAAP) more broadly.
- Host supervisors expect local bank management to be adequately informed and empowered. However, global banks should not be required to develop stand-alone economic capital models for each subsidiary.



3. **AIG ongoing work streams: Pillar II**

- Assumptions for capital allocations have to consider the transferability of capital across countries, particularly under stress conditions.
- Assumptions regarding diversification benefits have to be assessed at various levels
 - capital transferability
 - uncertainty around diversification estimates – correlations change over time (particularly during stress periods); reliability of models
 - types of diversification (eg intra-risk and inter risk)
- The AIG is addressing all these issues using case studies



3. AIG ongoing work streams: Pillar II

- The case study based approach to addressing Pillar 2 implementation issues has been effective in terms of outcome.
- However it's been less effective in communicating those outcomes to supervisors not attending the meetings. To promote the visibility and usefulness the AIG has decided to:
 - Create a library accessible to the broader supervisory community that would include relevant Pillar 2 documents and presentations.
 - Develop a paper covering *Experience and Issues with Pillar 2 Implementation* that is intended to draw upon the real case studies presented at the AIG converting them into hypothetical ones
- AIG and ILGC are organizing a joint workshop in May on scaling for complexity for Pillar 2.



4. AIG ongoing work streams: Pillar III

- So far, Pillar 3 hasn't received the attention it deserves.
- To maximise the benefits of Basel II, banks, market analysts and supervisors need to devote greater attention to Pillar 3.
- However, work might be delayed till a sufficient number of banks and jurisdictions have disclosed under the new Framework.
- Timely and relevant information is key for the functioning of markets.
 - Need for bankers and supervisors to reflect upon this in the light of recent market developments.
 - The joint workshop with the industry to be organized in early June in Madrid will be an opportunity to look at these issues in depth.



5. AIG recent work streams

- Due to recent market developments, the BCBS has requested the AIG to undertake additional work in the areas of:
 - Stress Testing and pro-cyclicality: How are supervisors implementing what is in the Basel II text.
 - To be conducted together with the AIGV, avoid overlap with RMMG
 - Expected to report to the Committee in July.
 - Significant Risk Transfer: What approaches are supervisors using to implement the concept of significant risk transfer.
 - The AIGV aims to produce a newsletter for supervisors by July
- In addition, the AIGOR will begin a Loss Data Collection Exercise shortly.



6. Implementation of Basel 2 in the context of recent market developments

- Basel 2 has been in the spotlight as a result of recent market developments,
- There have been two types of (sometimes contradictory) messages:
 - Banks should understand and manage ALL underlying risks
 - Risk transfers off balance sheet were sometimes illusory (both for supervisors and, apparently, for markets and banks)
 - The crisis suggested that models didn't capture the risks effectively
 - Calls to complement (or even substitute) Basel 2 models with simple non-risk sensible measures (“Basel I” type solutions)



6. Implementation of Basel 2 in the context of recent market developments

- Given rapid financial innovation, Basel I capital ratios are no longer accurate measures of bank risk
- Basel II is about aligning bank capital to the actual level of risk (regardless of being on or off balance sheet).
- Basel II models are simple, robust, long-standing and thoroughly tested.
 $PD \times LGD \times EAD$
- At the same time, IRB models are capable of evolving with financial innovation
- The “use test” ensures that top management don't lose contact with the day-to-day risks



6. Implementation of Basel 2 in the context of recent market developments

- Regarding the shift in many banks' business models, from buy-and-hold to originate-to-distribute
 - It is clear that bank's models have been too focused on behaviour under “normal” circumstances
 - Supervisory focus should be on what happens under “stressed” conditions
 - Basel II will set much better incentives for banks to capture and reflect their risk exposures to structured credit activities, both on- and off-balance sheet
- Basel II is a necessary response to a complex and changing environment



7. Conclusions

- The AIG will continue to address Basel II implementation challenges. Effective supervisory coordination and cooperation, and dialogue with the industry are key to maximising the benefits of the Basel II Framework.
- Need to be realistic about where industry and supervisory perspectives are aligned and where they differ (eg assumptions around transferability of capital)
- Need to focus less on short-term issues and understand the long-term benefits of implementation (especially in light of recent developments)
- At the same time, the framework can and should evolve over time to reflect financial innovation. In light of recent developments, the Committee has already begun to evaluate certain aspects of the Basel II framework