Implementation of Basel II

BY JAIME CARUANA

In this article Jaime Caruana, Governor of the Bank of Spain and Chairman of the Basel Committee on Banking Supervision, first discusses the current status of the Basel II Accord. Next, he offers his perspective on macroeconomic issues related to the capital framework, focusing especially on pro-cyclicality. Finally, he discusses three important Basel II implementation issues, namely calibration, validation, and cross-border supervision.

I. INTRODUCTION

I would like to thank Sir Howard Davies and the organisers from the London School of Economics for inviting me to share my thoughts on a topic that occupies much of my time and energy: implementation of the Basel II international capital framework. I will speak today in two capacities: from the perspective of an EU central bank with responsibilities for banking supervision, and as current Chairman of the Basel Committee on Banking Supervision.

I would like to share several thoughts with you this morning. First, I will talk briefly about the current status of Basel II. Second, I will offer my perspective on macroeconomic issues related to the capital framework. Finally, I will spend some time discussing three important Basel II implementation issues: calibration, validation, and cross-border supervision.

II. CURRENT STATUS OF BASEL II

I would like to begin with an overview of the Basel II framework. It is not my intent to describe the framework in great detail, but rather to highlight some of the key features of Basel II.

Basel II represents a significant step towards achieving a more comprehensive and risk-sensitive approach to banking supervision. By more closely aligning banks' regulatory capital requirements with their own internal measures of economic capital required to support their risks, the framework aims to ensure that higher-risk assets attract more capital, and vice-versa.

One of the most important objectives of Basel II is to enhance banks' safety and soundness, thereby strengthening the stability of the financial system as a whole. Given the important role that banks play in generating economic growth, a stronger and more stable banking system should be better-positioned to serve as a source of sustainable growth for the broader economy.

While much of the public attention that has been focused on Basel II has related to the actual calculations underlying the framework, it is important to understand that Basel II is about much more than quantitative minimum capital requirements. Fundamentally, the framework is about establishing an incentive-based approach to risk management and capital adequacy. This is achieved through three mutually reinforcing pillars. The first pillar aligns minimum capital requirements more closely with banks' actual underlying credit, market and operational risks. Qualifying banks may also rely partly on their own measures of those risks, which will help to create economic incentives to improve those measures. These innovations aside, in concept the first pillar is similar to the existing capital framework in that it provides a measure of capital relative to risk. What are new are the second and third pillars.

The second pillar—supervisory review—requires banks to conduct their own assessment of their risks and capital needs, and supervisors to evaluate these assessments to determine whether they seem reasonable. It is not enough for a bank or its supervisors to rely on the calculation of minimum capital under the first pillar. Supervisors should provide an extra set of eyes to verify that the bank understands its risk profile and is sufficiently capitalized against its risks.

The third pillar—market discipline—ensures that the market provides yet another set of eyes. The third pillar is intended to strengthen incentives for prudent risk management. Greater transparency in banks' financial reporting should allow marketplace participants to better reward well-managed banks and penalize poorly-managed ones.

Not only does Basel II represent an unparalleled opportunity for banks to improve their capital strategies and risk management systems, but it also provides supervisors with an opportunity to improve their ability to identify banking risks and to enhance the dialogue with the industry and with each other. We as supervisors must also consider how we can oversee banks in our jurisdictions in a manner that aims to better understand banks' risk profiles and risk management processes. Clearly, all of us—banks and supervisors—have much work ahead of us.

Let me quickly share the timeline that the Basel Committee envisions over the next several years. As you are probably aware, the Committee published the Basel II text last June. Since then, we have been engaged in intensive work on issues related to exposures in the trading book, which I will discuss later in my remarks.

Beginning in 2007, Basel II will "go live." During 2007, the simpler approaches in Basel II will be available to banks. Beginning in 2008, the most advanced approaches will be available to qualifying banks. In order to ensure prudent implementation of the framework, the Basel Committee felt it appropriate that Basel II capital requirements during the first three years of implementation should be subject to "floors" relative to current capital requirements. Therefore, from 2007 to 2009, banks will be expected to make parallel calculations using both the 1988 Accord and the Basel II framework to ensure that regulatory capital requirements do not decline too steeply.

In order to meet this timetable, I would like to turn now to some of the work that will be necessary over the coming months and years. As Basel II represents perhaps the most widely publicized and far-reaching change in approach to banking supervision, it is important that we make every effort to implement the framework as effectively as possible. In my view, there are three critical issues that must be resolved in order to do this. First, Basel II should work at the micro level. That is, as I have already discussed, capital requirements should be prudent and incentives for better risk management should be appropriate. I will not discuss this in further detail, but would like to emphasize once again the importance of the three mutually reinforcing pillars: minimum capital requirements, supervisory review, and market discipline.

Second, Basel II should work at the macro level. That is, does Basel II enhance economic growth, financial system stability, and appropriate behavior over the business cycle? In this regard, I would like to spend some time today discussing this last issue, which is commonly referred to as "pro-cyclicality."

Finally, we must address issues of consistency of implementation across jurisdictions. One of the key objectives of Basel II is to promote a level playing field for internationally active banks. This will place a premium on effective coordination and cooperation among home country supervisors of banking groups and host country supervisors of subsidiaries and branches of those banking groups. Supervisors will need to work closely with each other and with banks to provide effective supervision while minimizing burden and duplication of effort. I will later discuss some of the Committee's efforts in this area.

III. MACROECONOMIC PERSPECTIVE

Let me turn now to a discussion of some of the macro issues that arise in the implementation of Basel II. Clearly, micro prudential regulations can have significant macroeconomic implications. For example, changes in overall capital requirements or in specific capital requirements for particular types of loans may have an impact on lending and economic growth.

Given the significance of Basel II, it is not surprising that the framework has been thoroughly scrutinized to assess its likely consequences in terms of pro-cyclicality, implications of cross-border financial flows (especially to emerging markets) and areas of the economy that are of strategic importance (such as small- and medium-sized enterprises). The Basel Committee certainly welcomes all of these contributions, including those that have been critical of Basel II, because they have resulted in significant improvements to the framework itself and to our understanding of several very important issues. It is important that we continue to monitor and analyze these issues as we move into implementation of Basel II.

Perhaps the macroeconomic issue that has received the most attention is pro-cyclicality. Let me begin by noting that a number of banking variables are correlated with economic cycles. Banking is a risk-sensitive business, and as a consequence there is a natural tendency toward some element of pro-cyclicality. That is, even in the absence of capital regulations I believe that banks tend to extend more credit at the peak of a business cycle and tighten lending during the trough. The real question, then, is whether or not Basel II will exacerbate this aggregate tendency.

I certainly appreciate the work that has been conducted in this field, and I hope this work will continue to shed light in areas where the results to date are inconclusive. While I believe that some of the arguments about pro-cyclicality in Basel II have merit and are worthy of concern, on the whole I tend to have a relatively positive view of the macroeconomic implications of Basel II. The Basel Committee has taken seriously the concerns that have been expressed in this regard, and as a result we have introduced a number of mitigating elements into the framework that give me reason to take a positive view. Let me elaborate further.

Arguments about pro-cyclicality have centered around three sets of issues. First, how relevant is regulatory capital in explaining cyclical lending patterns of banks, and will pro-cyclicality be unduly exacerbated under Basel II? Second, are there elements in the revised framework that can mitigate and offset potentially pro-cyclical tendencies? Third, what will the impact of Basel II be on long-term allocation, efficiency and growth potential for the broader economy? As I will explain further, what I believe all of these issues have in common is that we should not focus so much on the capital rules in pillar 1 of the framework that we lose sight of gains from greater transparency and better risk management that are embedded in Basel II.

Regulatory Capital and Pro-cyclicality

As to the first question, are regulatory capital requirements pro-cyclical and, if so, will Basel II amplify this pro-cyclicality? A downturn can affect regulatory capital ratios in two ways: increased loan losses will reduce the amount of capital that is available, and credit deterioration will result in higher capital requirements as estimates of probability of default and loss given default increase. While such effects are logical, they do not tell the whole story as reality is likely to be more complex. The extent to which capital requirements swing in response to economic conditions will depend largely on the dynamic features of specific banks' ratings systems and the specific characteristics of bank estimates of probability of default.

Moreover, I would argue that being "risk-blind" can contribute more to pro-cyclicality than being risk-sensitive. That is, a bank with inadequate risk management and/or poor provisioning and capitalization will be vulnerable to sudden shocks and will have little room for maneuver in a downturn. As a result, such a bank may have to abruptly cut back on lending in a downturn, whereas a bank that is stable and forward-looking will not have to change its lending practices quite so dramatically in response to economic conditions.

Basel II attempts to address the main contributors to pro-cyclicality, which are inadequate shock absorbers in the form of adequate capital and provisions, poor risk management and weak financial supervision. Nevertheless, some element of pro-cyclicality in a risk-sensitive minimum capital requirement cannot be avoided. It is one thing for the minimum capital requirement to be pro-cyclical, but the more important issue is actual bank behavior. Here I think it is important to note that sophisticated, well-managed banks already allocate their own internal economic capital and take decisions on the basis of risk. That is, their behavior is to a certain extent pro-cyclical today. Because Basel II does not alter banks' own calculation of economic capital—which I expect will continue to drive decision-making to a much larger extent than regulatory capital under the revised framework—I do not expect that bank behavior will be any more pro-cyclical under Basel II than is currently the case. Discussions such as this one may even help to promote bank awareness of cyclical effects as we move into Basel II implementation, which I see as a positive development.

Mitigation of Pro-cyclical Effects

In light of this discussion, let me turn now to the second set of issues: what elements of Basel II can offset some of the pro-cyclical effects that I have just mentioned? I would argue that there a number of factors built into the framework that are designed to ease some of these effects. Indeed, this is an area where discussion of the issue of pro-cyclicality has contributed to improvements in the framework.

Some of the mitigating effects have been included in the capital calculations under Pillar 1, which is the most "mechanical" part of Basel II. For example, although the time horizon used in bank estimates of probability of default is one year, banks are expected to use a longer time horizon in assigning credit ratings to counterparties. In this regard, the Basel Committee has encouraged banks to take account of uncertainty over the full economic cycle when designing and validating their credit rating systems and processes. In addition, estimates of probability of default are expected to represent a long-run average, and estimates of loss given default are expected to reflect downturn conditions.

Perhaps the more important offsetting factors, however, are those that are built into the second and third pillars of the framework. For example, under the second pillar of Basel II, banks are required to hold capital in excess of minimum regulatory requirements and to perform meaningfully conservative credit risk stress tests to ensure that they have a sufficient capital buffer to absorb losses over a full economic cycle. By holding capital during good times against the possibility of future downturn effects, banks should be better-positioned to weather a downturn without having to dramatically scale back their lending. I should note here that, in reality, most banks already operate with actual capital well above minimum capital requirements. There is some evidence of a negative relationship between capital buffers and the economic cycle. That is, banks build up capital buffers during good times that can be safely drawn upon during bad times. This counter-cyclical behavior may be accentuated under the revised framework.

The third pillar of Basel II may reinforce these effects. Indeed, I expect that market expectations are likely to be more of a constraint in reality than minimum regulatory capital requirements. For a variety of reasons, it is difficult for outsiders to understand and analyze the risk profile of a financial institution. By enhancing transparency, the Basel Committee hopes that the revised framework will enhance market discipline by making it easier to understand and compare banks' risk profiles.

Perhaps the most important offset against pro-cyclical effects in Basel II is the increased emphasis on effective risk management in the form of better control structures, sound corporate governance, and investment in technology, information systems and human capital. This is an important channel of influence, as heightened risk management should improve banks' assessment and awareness of risks and should reduce the risk that surprises will lead to unexpected losses. A bank that manages risk effectively should be able to detect problems at an early stage and react promptly, which should in turn reduce its losses. This should enable banks to adjust more smoothly to changing economic conditions and correct mistakes accordingly rather than having to react abruptly. Moreover, early reaction on the part of banks and effective oversight by the markets will hopefully make supervisors less tempted to exercise forbearance. Finally, better risk management should have the effect of reducing losses, which would reduce the need for banks to supplement capital in the event of a downturn.

Economic Impact of Basel II

Let me conclude my discussion of pro-cyclicality with a discussion of the third set of issues: what will the likely impact of Basel II be on long-term allocation, efficiency and growth potential for the broader economy? Of course it is difficult to be conclusive in this regard as we are still several years away from implementation of the framework, but I have some preliminary views in this regard.

As already discussed, the shock absorbers of the banking system—provisions and capital buffers—will be more risk-sensitive and cycle-conscious under Basel II. In addition, stronger and more forward-looking risk management and greater transparency should reduce the likelihood and impact of losses, which should in turn help to preserve capital. If this is indeed the case, then I would expect banking systems as a whole to be more stable and efficient in allocating resources. Pro-cyclicality can almost certainly not be entirely eliminated, but the stability and efficiency of Basel II may contribute to reducing the volatility of economic cycles and improving the overall macroeconomic trend over time.

While it will be some years before we can know whether this will in fact be the case, it is nevertheless a potentially significant development that merits attention as we move into Basel II implementation. Perhaps not surprisingly, I tend to be optimistic in this regard. If Basel II leads to better risk management, which after all is one of the Basel Committee's primary objectives, then I find it difficult to accept that this improved risk management will result in poorer macroeconomic performance of the aggregate banking system.

In the medium- and long-term, I would not be surprised if this effect carries over to a wide range of economies. That is, the combination of improved risk management, enhanced transparency and shock absorbers proportional to risk should improve the flow of financing to a wider range of countries. Market dynamics may reinforce this process if banks adopt higher standards of risk management and capital adequacy assessment and supervisors embrace more risk-focused supervisory approaches. If such markets are perceived to be less risky, market participants may charge lower risk premiums and access to financial markets may be widened.

Of course, even if we regard Basel II to be an improvement over the current capital framework, as a central banker I believe it is very important that we continue to analyze the macro implications and monitor the contribution of the financial system to economic growth and stability. We followed a very open and consultative process during the development of Basel II, and I hope that we will continue to learn from such open discussions going forward. I also hope that other areas of prudential regulation, such as provisioning, will receive heightened attention in the future because it is my firm view that significant improvements and, if necessary, additional compensating factors in such areas may be possible.

IV. BASEL II IMPLEMENTATION ISSUES

I would like to turn now to a discussion of some of the practical issues that we are confronting as we move from development to implementation of Basel II. My remarks will primarily touch upon three topics: recalibration of the framework, validation of bank systems and processes, and cross-border issues. But before discussing those topics, let me quickly update you on an important work stream that has been underway.

When Basel II was published in June 2004, we recognized that more work was necessary in the short run to work with the industry to ensure that the framework kept pace with ongoing developments in the financial services sector and remained sensitive to underlying economic risks. This was especially true in two areas. One is exposures to "double default," where the risk of both a borrower and a guarantor defaulting on the same obligation may be substantially lower than the risk of only one of the parties defaulting. The second area concerns the Basel II treatment of certain exposures arising from trading activities.

Because both banks and securities firms have a great interest in these areas, the Basel Committee has been working jointly with the International Organization of Securities Commissions (IOSCO) to consult with industry representatives and other supervisors on these matters. I should add that this cooperation with IOSCO on areas of mutual interest has been a very fruitful and beneficial experience. We intend to issue a paper for public consultation on these topics within the next week or two[1]. Following an intensive period of consultation, we plan to finalize the treatment of trading activities and double default in July of this year. In addition, we plan to issue guidance on how banks will be expected to take economic downturn conditions into account in their estimation of loss given default.

Recalibration

The first implementation issue that I would like to discuss is recalibration of Basel II. The Basel Committee has long stated its intention to conduct work to verify that the framework meets our objective of maintaining the overall level of capital in the banking system, while keeping incentives to adopt the most advanced and risk-sensitive approaches. In order to meet schedules for national rule-making processes and allow sufficient time to facilitate implementation efforts, we have determined that the calibration of the framework should be reviewed later this year. As a result, the Committee will undertake a fifth Quantitative Impact Study, or QIS 5, between October and December 2005. The QIS 5 exercise should provide the Committee with the most recent, high-quality data necessary to assess the impact of Basel II and ensure that the objectives of the framework have been met. This will allow us to make any adjustments to the framework, if necessary, during the spring of 2006.

The Committee does not intend to set separate data requirements or time-frames for the parallel calculation that will be conducted during 2006, so there should not be duplication of efforts. I should note that national field tests are underway in some jurisdictions, during which banks are calculating their capital requirements in parallel (i.e., under both Basel II and the current framework). The information coming out of the QIS 5 and national field tests will provide a significant amount of information to the Committee in assessing the impact of Basel II. In addition, this data collection exercise will allow us to conduct some preliminary work to understand the cyclical implications of the framework.

[1] Since this speech was delivered, the Committee has published a consultative paper "The Application of Basel II to Trading Activities and the Treatment of Double Default Effects" on 11 April 2005. The consultation period ended on 27 May 2005, and the Committee is currently evaluating the responses received.

Validation

The second important implementation issue that I would like to raise this morning is validation of internal ratings-based (IRB) approaches for credit risk. The term "validation" encompasses a range of processes and activities that contribute to assessing whether a bank's ratings adequately differentiate risk and whether estimates of risk components such as probability of default and loss given default appropriately characterize the relevant aspects of risk, and understanding the dynamics of a bank's rating systems and its use within the bank. Although validation is first and foremost the responsibility of the bank, supervisors must have a thorough understanding of bank validation processes in order to assess the integrity of bank systems and processes.

IRB validation consists of a couple of key elements. First, the rating system itself must be validated. Does the model design have integrity? How accurate are the bank's forward-looking risk estimates? Second, the rating process must be validated. How effectively is the rating system implemented? Does the rating system meet the "use test"? Are sound risk governance structures and systems in place?

To assist supervisors in their efforts related to validation, the Committee published a research paper in February of this year on validation of internal rating systems. In addition, the Committee published six principles that will guide its work on validation going forward. These principles are that: (1) validation is fundamentally about assessing the predictive ability of a bank's risk estimates and the use of ratings in credit processes; (2) the bank has primary responsibility for validation; (3) validation is an iterative process; (4) there is no single validation method; (5) validation should encompass both quantitative and qualitative elements; and (6) validation processes and outcomes should be subject to independent review.

There are a number of challenges that both banks and supervisors must respond to as they develop validation and assessment tools and techniques. Supervisors and bank management will need to understand how a bank assigns risk ratings and how it calculates default probabilities in order to accurately evaluate the accuracy of its estimates. Basel II establishes minimum standards for rating assignment and risk estimates, but banks nevertheless are given wide latitude in determining how obligors are assigned to rating buckets and how pooled probabilities of default are calculated for those buckets. Although this flexibility allows banks to make maximum use of their own internal rating and credit data systems in quantifying default probabilities, this also poses important challenges for validation.

In particular, consistency may be difficult to achieve across banks and jurisdictions. For example, an obligor-specific probability of default at one bank may embed assumptions of future economic stress scenarios, while another may not. Likewise, rating philosophies will likely differ across banks. Practitioners use the terms "point-in-time" and "through-the-cycle" to describe the dynamic characteristics of rating systems, but these terms often mean different things to different people. Banks and rating agencies, for example, may focus on different time horizons and have different emphases on current conditions in assigning ratings. When we move beyond probability of default, we find that there are even greater challenges in validating estimates of loss given default and exposure at default. The Basel Committee intends to keep apprised of bank validation practices in order to improve supervisory understanding and promote greater consistency in implementation.

Cross-border Issues

The third implementation issue—or rather, set of issues—that I would like to discuss relates to cross-border implementation of Basel II. Let me start by saying that cross-border issues are not new. The Committee's objective of promoting a level playing field for internationally active banks in Basel II remains unchanged from the 1988 Accord. Nevertheless, the financial world is changing. Markets are evolving. Cross-border activity is growing rapidly, to the extent that a systemic part of some countries' financial systems are dominated by foreign institutions. Financial groups are becoming larger and transactions are becoming much more complex. Internationally active banks are centralizing some key systems and functions, while banking supervision and regulation is predominately a national responsibility. With or without Basel II, all of these trends would make it necessary to enhance cross-border cooperation.

There is no question, however, that implementation of Basel II amplifies the need for carefully structured relationships between home and host supervisors. While I am confident that we will adequately address this issue over time, at the moment I have more questions than answers. For example, how will supervisors approve and monitor advanced Pillar 1 approaches in a consistent manner for banks operating in multiple jurisdictions? How will supervisors recognize external credit rating agencies in different jurisdictions? How will Pillar 2 be made operational for a bank with foreign subsidiaries? How can Basel II be implemented in an effective and efficient way which minimizes regulatory burden on internationally active banking organizations so that they can focus their energies on managing risks rather than managing regulatory relationships? How can this be done in a way that maintains a safe and sound banking system and respects the legal responsibilities and legitimate prudential concerns of both home and host supervisors? These questions highlight the importance of enhancing supervisory cooperation as Basel II implementation moves forward.

If this weren't challenging enough, we have some unique challenges and opportunities within the European Union (EU) context. The Lisbon agenda has established a political objective of making the EU the most dynamic and competitive knowledge-based economy in the world. From the banking supervisory perspective, there are two key factors that work to our advantage.

Firstly, the division of supervisory responsibilities between our countries has long been embedded in common single market legislation in the banking field, founded on the principles of harmonization and mutual recognition. And the European Commission has chosen to address key elements of supervisory cooperation within the proposed directive to implement Basel II, adopting an approach that strikes me, as a European supervisor, as a step in the right direction.

Secondly, we have a new framework—the so-called "Lamfalussy approach"—which should lead to greater efficiency and effectiveness in EU regulatory and supervisory processes. As part of this, the work already done by the Committee of European Banking Supervisors—CEBS—is very encouraging. This committee, directly charged with promoting co-operation and convergence of supervisory practices, has a key role to play in the implementation of the new capital framework in Europe, for example in finding practical ways to apply the provisions which provide for an enhanced role for the consolidating supervisor, and on model approval processes. And it is already producing tangible results.

For these reasons, I believe that the EU can and should go further than others may be able to go in its efforts to ensure consistent implementation of the new capital framework and effective supervision on a cross-border basis. And by making rapid and real progress, we can also promote greater convergence beyond the EU, as others may find our experiences of benefit to the wider search for greater international consistency in the implementation of Basel II.

We can make significant progress in addressing global implementation issues as well. While this is not a firm figure, approximately 100 countries have expressed an interest in adopting Basel II by the end of this decade. I think it is safe to say that every one of those countries, including my own, has limited resources. Therefore, it is in our best interest to establish mechanisms that are as efficient as possible. In so doing, it will be necessary to develop enhanced cooperative arrangements. I believe that Basel II will be a catalyst for promoting such arrangements. Finally, Basel II should be implemented in a manner that strengthens the quality of banking supervision across countries. I sincerely believe that effective and efficient cross-border supervisory relationships represent a "win-win-win" situation for home supervisors, host supervisors, and banks alike.

The Basel Committee has established an Accord Implementation Group, or AIG, which is chaired by Nick Le Pan, Superintendent of Financial Institutions in Canada and Vice-Chairman of the Basel Committee. The AIG discusses home-host issues, promotes consistency in application of Basel II and convergence of supervisory practices where possible, and conducts extensive outreach to non-member countries. The AIG does not develop prescriptive rules or approaches.

I should emphasize that neither the Basel Committee nor the AIG intend to create perfect harmonization across all jurisdictions. This was not the intent of

Basel II, and it would be naïve to believe that pure consistency can be achieved as long as jurisdictions have different legal systems, market practices, business environments, etc. Nevertheless, by providing a forum for cross-border cooperation and exchange of information, the AIG can help members to avoid performing redundant and uncoordinated approval and validation work in order to reduce implementation burden on banks, conserve supervisory resources, and contribute to a more level playing field.

To help guide its own work and that of other supervisors, in August 2003 the Basel Committee and AIG published six high-level principles for cross-border implementation of Basel II. First, national supervisors' legal responsibilities do not change under Basel II. Second, the home supervisor is responsible for consolidated supervision of implementation of the framework. Third, host supervisors have requirements that must be recognized, especially where foreign banks operate through subsidiaries. Fourth, enhanced and pragmatic cooperation, led by the home supervisor, will be necessary. Fifth, redundant and uncoordinated validation and approval work should be avoided. Finally, supervisors should communicate the respective roles of home and host supervisors to internationally active banks.

In order to help make these principles operational, the AIG has promoted practical cooperation between home and host supervisors and internationally active banks through what it initially called "case studies." These case studies, which have in most instances evolved into actual implementation work, involve home and host supervisor discussions and planning based on banks' Basel II implementation plans. These are not top-down exercises originating in Basel; each home supervisor coordinates the work in a way that is most practical in light of the particular bank circumstances and its own supervisory approach. Based on this work, it is clear that successful implementation of the high-level principles rests on adequate flows of information, as well as trust among supervisors.

In addition, banks have an important role to play in fostering successful implementation of Basel II across jurisdictions. For example, the starting point of supervisory implementation efforts is the bank's own implementation plan. Banks should therefore develop solid implementation and rollout plans that can form the basis for dialogue with supervisors. Home and host supervisors need to see and understand these plans in order to establish the most effective techniques for sharing information and cooperating in the context of banks' specific circumstances. In addition, banks should improve their own internal communication of Basel II implementation plans. A number of host supervisors have found that local staff is unaware of the bank's implementation plans, even for their own jurisdictions. Where this is the case, host supervisors are quite naturally inclined to seek more information, which is potentially burdensome on all parties. Greater communication within banks can therefore help to promote supervisory confidence in bank implementation plans.

V. CONCLUSION

While the publication of the revised framework last year was the culmination of a long process of development, it was only the beginning of an important new phase of implementation. As my remarks this morning should make clear, both supervisors and the industry have much work ahead of us to make implementation a success. Nevertheless, if we continue to work together in the same spirit of cooperation that was prevalent throughout the development of Basel II, I am confident that Basel II can be implemented effectively and efficiently.

VI. NOTES ON CONTRIBUTOR

Jaime Caruana has been Governor of the Banco de España and a Member of the Governing Council of the European Central Bank since 2000. In May 2003, he succeeded William McDonough as Chairman of the Basel Committee on Banking Supervision. Before that, Mr. Caruana worked in the Spanish private sector; among other positions, he was managing director of an investment service company from 1987 to 1991 and chairman of a fund management company from 1991 to 1996. Subsequently, he served as a senior official in the Spanish Treasury and Ministry of Trade. Early in his career, he was posted as Commercial Attaché in the Spanish Commercial Office in New York. Mr. Caruana has a degree in telecommunications engineering from the Universidad Complutense de Madrid. He is also a qualified economist and has authored several publications and articles on the Spanish financial system, government financing and public debt.