Remarks on Basel II

By Nicholas Le Pan

In this paper Le Pan focuses on some key issues related to Basel II, such as complexity, impact on capital and home-host implementation, and offers ten thoughts on the post Basel II world.

I. INTRODUCTION

I have been asked to say a few words this morning about Basel II and where we are with respect to impacts and next steps. The focus will then turn to what I think Basel II means for financial regulation going forward—the 'post-Basel II' world. Before doing so, I want to recall the objectives of Basel II.

From behavioural finance, I note two adages. "If you don't know who you are, markets are an expensive place to find out." And "a process is always a bet on the people implementing it". Both of these are very relevant in considering Basel II.

II. BACKGROUND

Why are regulators doing this? Basel II is designed to better relate capital to risk. This is key to supporting improved risk management practices in internationally active banks, which is Basel II's explicit objective. This is where the financial stability benefits are. These are important benefits in my view—for safety and soundness, for consumers of financial services, for banks, for regulators and for economies.

Another clear goal of Basel II is to have more forward-looking rules that have a better capacity to evolve. This is to be achieved by rules better related to the risk management processes actually used by banks.

Better relating capital to risk is to be achieved by the three-pillar approach: risk-based minimum capital requirements (Pillar 1); support for more risk-based supervision and banks themselves better relating the level of their actual capital related to risk (Pillar 2); and improved disclosure (Pillar 3). This three-pillar approach is important because supervisors don't just care about minimum capital; they care about the actual capital held by banks.

The Basel Committee on Banking Supervision (BCBS) explicitly was not prepared to put all of its eggs in one or two of these baskets. Nor was it prepared to go to full acceptance of banks' internal models because of our experience, borne out by subsequent developments, that the quality of these (and the data input into those models) was not always of the highest, or even adequate, quality. Basel II is on the continuum between purely regulatory measures and reliance on banks' internal processes.

I urge those who continually rush to judge Basel II against these objectives to not let the best be the enemy of the good. Basel II is clearly not the best—but I think it is a lot better than Basel I.

There are also three other realities the Committee was dealing with. First, there is a large difference between complexities of major, internationally-active banking organizations and smaller or mid-size banks (and the BCBS understands that, even though the framework is for internationally active banks, a lot of countries are likely to apply it more broadly). That's what led to the menu of options approach: simple standardized, standardized, foundation and advanced. Each is more risk-focussed than Basel I. The Committee did not believe that a 'one size fits all' approach to rules continued to make sense.

Second, there is a lot of difference in the starting point of individual banks and supervisors within and outside of the G-10. For many countries, objectives such as improving the governance and basic capability of bank supervisory agencies and basic bank risk management, and improving the accounting and legal foundations of the economy, were more important than moving to Basel II. The advanced approaches under Basel II are not appropriate for a wide range of banks and banking supervisory systems in the world today. Even getting to the standardized approach and Pillar 2 should not be the priority for a range of countries, compared to focussing on other things designed to meet the BCBS core principles of banking supervision. The BCBS, the IMF and the World Bank have been saying this for a number of years. You can't buy advanced or even foundation approaches under Basel II 'off the shelf' in a box.

The IMF and World Bank are now working on what criteria they will use to assess countries that say they are implementing Basel II. Because we know that when you call something 'advanced' there is a natural tendency for people to think they are somehow "less good" if they aren't there, we probably made a mistake in the name. The IMF and World Bank will have to focus on flexibility in implementation to reflect local conditions. They also should look to basic preconditions being in place for successful implementation. Otherwise, Basel II could add to risks, not reduce them.

The third reality the BCBS is dealing with is the increasing difference between how major banks manage themselves and the legal entity structures that supervisors have to deal with because of the national basis of law and depositor compensation arrangements. These issues are not going to change any time soon. Banks increasingly manage themselves on a business line basis without much regard for legal entities. And a lot of the risk management (and Basel II) are based on analytics and financial economics that make sense at the consolidated group-wide level. This divergence has major implications for home-host implementation challenges. The BCBS couldn't disregard this nor could we not try to proceed.

The role of Basel II in promoting improved risk-information and risk-management practices at major banking groups is not one those banks will often readily admit to in public. But they often, in my experience, do so privately. A lot of the benefit is in basic things, such as better enterprise-wide current data to help assess risks. This benefit is real, in my judgment, and it is just as important in promoting financial stability as such issues as the impact of Basel on minimum capital levels. Having these improvements in risk management tied to capital means the improvements get focussed on. The incentive structure within banks, how capital gets allocated, how business line ROEs are determined, how risks of individual businesses are assessed and the links to compensation are very important and are being influenced by Basel II. These risk- management improvements are focussed on because 'money talks' in major banks.

The BCBS fundamentally also believes that continuing to widen the divorce between mechanisms major banks use to manage themselves and regulatory capital measures was not a healthy incentive structure for banks or for supervisors. It is better they both focus on the same things (though from somewhat different perspectives).

Basel II is also about more focus in supervisory processes, because of the role of supervisors in Pillar 1 and, of course, in Pillar 2. It means enhancements in all countries' supervisory processes. While, as a supervisor, I might want to quibble about this detail or that, I fundamentally think those enhancements are desirable. The supervisor's role is not to run the bank. That is clear, for example, in Pillar 2, where it is the bank's responsibility to relate capital to risk and the supervisor's responsibility to react and challenge as necessary. I like to think of supervisors operating under a 'trust but verify' mentality. There is a fine line here, and some countries' approaches to implementation might risk being so detailed they go over that line.

Basel II is also about better disclosure to benefit counterparties, financial analysts, and ultimately markets. I will have more to say about what I think has to happen for this to be effective.

Basel II has of course been criticized for its impacts (on capital, pro-cyclicality, level playing field and so on) and for its complexity.

III. COMPLEXITY

On complexity, I think the criticism is in part misplaced. The most sophisticated banking organizations are complex, and simpler banks can use much simpler Basel II approaches (the simple standardized annex in the BCBS framework is only a few pages).

But, in part, the criticism is correct. Once a rules system starts down the road of being more tailored to circumstances (i.e., risks) there is a tough job to know when to stop (look at the size of tax statutes in pursuit of 'equity' or 'neutrality'). There is also a tough job of knowing where to be on the "detailed rules versus principles" continuum (Basel has both). And, in part, there is a symbiotic relationship between banks and supervisors that leads to more complexity than is probably necessary in some areas. Banks would note that parts of the framework were not as risk sensitive as they would like and 'quants' would go off to apply the latest financial/risk economies to try to get the risk focus better. Banks often say they want principles when they really want more detail and less judgment so they have more assurance they will know how to comply and their counterparts won't get better treatment. Sometimes supervisors want more detail too, to help make judgments.

Some very important parts of the Basel II framework are actually highly principles-based (e.g., Pillar 2, AMA for operational risk, treatment of the charge for major credit events in the trading book, how to handle downturn conditions)—and the BCBS has resisted the push in many areas for more detailed rules.

With respect to complexity, the key question in my mind is "What conditions are necessary to produce the environment for simplification and a more uniform principles- based approach?" I think, before we make adjustments, we need more experience with the impact of the framework as it is, and more convergence and acceptance of the judgments made by banks and supervisors. We can only get that through implementation that occurs with "insurance" (i.e., constraints such as floors on unintended impact). If we don't wait to get that experience before adjusting or simplifying, we risk making changes that will be in the wrong direction.

I also note I've been giving speeches for many months suggesting that banks and supervisors, at their peril, focus on Pillar 1 too much and not enough on Pillar 2 or Pillar 3.

IV. WHERE ARE WE WITH RESPECT TO THE IMPACTS?

QIS 5 results are preliminary for lots of reasons—quality of modelling, lack of internal challenge/validation, partial implementation, and not taking account of some key principles, such as economic downturn conditions for portfolios (that can have a major effect on mortgages in several countries). And these are static impacts. We cannot know how Basel II works with a high degree of certainty until the new system is up and running. No tweaking now can change that basic reality – hence, the proposal for parallel run periods and transitional floors on capital reductions.

For Canada, the average QIS 5 result is a single digit capital drop—5–7%—I won't get too excited about that. I note the new U.S. framework accepts an aggregate 10% drop before there is a commitment to recalibrate in some way.

The dispersion in impacts in the Canadian results is not something that can't be handled within the framework. Dispersion is inherent in a more risk-based system. What is important is that dispersion be based on real differences in risks, not on model, bank process or data weaknesses, or judgments driven by hubris.

In the short run, it is key to implement the parts of the Pillar 1 framework that are now very general, such as taking account of downturn conditions and the new trading book rules that will require more capital to deal with tail risk events and potential illiquidity for a range of complex products. These will have a material effect on capital impacts and on the cyclicality issue.

V. CHALLENGES IN IMPLEMENTATION

I want to emphasize three of the biggest challenges in implementation—these matter in their own right and how they play out will affect the post-Basel II world.

Home-host Implementation

I have spoken about the tension caused by the differences in how internationally active banks manage themselves, national legal requirements and Basel II analytics. Much of these analytics and the theory behind them are often most relevant at the banking group level. But host countries have legal responsibilities that must be recognized. The relationship between home and host countries is changing in part as a result of Basel II. Host countries need to rely on home countries, as more analytics and risk management are done centrally, and home countries need to rely more on hosts to assess the validity of the local application of Basel II analytics and data. I don't think you can mandate trust and reliance—they have to be built. The Accord Implementation Group (AIG) has enhanced the structure for home-host cooperation. It is now time to use it more. Home-host issues are a challenge to reasonably efficient implementation, but there are benefits as well. Now that the draft of the U.S. Notice of Proposed Rulemaking is public, we need to focus more on practical home-host implementation issues.

The AIG is a first for the Basel Committee. It does not have a mandate to control implementation, prescribe harmonization or convergence or produce pages of implementation guidance. But I do think that by sharing information, it is helping promote more consistency in implementation.

The Role of Judgment in Banking and Bank Supervision

I've been arguing that those who think Basel II is only about arithmetic and higher mathematics are missing the boat judgment matters. Sharing information among supervisors and among banks to reduce the chance of large unintended consequences in the exercise of judgment is important. Banks should not treat Basel II as a compliance exercise.

Dealing with Impacts

Understanding and dealing with a diversity of outcomes as judgments by banks and supervisors are used in implementation will serve to reduce those outcomes that are unintended. We must provide information about diverse rules and have analytical resources applied by markets to interpret differences. Since we can't know the impacts with a high degree of certainty in advance, I argue it is very important to proceed, but with appropriate caution, feedback loops and constraints, until confidence rises.

How these three challenges work out will also greatly affect level playing field considerations.

VI. FINANCIAL REGULATION POST BASEL II

It is fair to ask what the vision will be like post Basel II. I take this as three questions.

First, how much progress are we likely to make in achieving the Basel II objectives and which, based on experience to date, are the ones that are likely to be hardest to make real progress on?

In addition, there is, I think, a degree of consensus about what a modern supervisory/regulatory structure ought to look like. That consensus is embodied in a range of comments, in the implicit or explicit work of international bodies, in the core principles of banking supervision from the BCBS and in the FSAP work of the IMF and World Bank. Of course, what this means in any one country and getting the correct preconditions in place matter a lot. But I would argue that key elements of that vision include:

- Supervision and regulation on a consolidated basis
- Supervision that is risk focussed
- Early intervention to deal with material prudential problems
- Regulation and supervision that achieves its objectives without significant unnecessary burden on private markets and the efficiency and success of the financial services sector in intermediating savings and serving consumers and economies.

So, secondly, it is fair to ask how the post-Basel II world will look against those objectives.

A third interpretation of the question is, "What might the regulatory agenda look like post Basel II?"

Before proceeding, I must note that the notion of a "post-Basel II" world is not a meaningful short-term concept. The implementation of Basel II is certain to proceed in phases for some years across countries and within countries (and within banks). Those phases will expand the scope of Basel II implementation geographically (broadening) and will expand the use of intermediate and advanced techniques (deepening).

So, I consider the landscape five to seven years from now. Many major markets will be well into implementation, the current floors will be expiring, and a number of major emerging markets will, on their currently expressed intention, be well started in their, often-simpler, version of implementation.

We also must remember that Basel II is a lot more than Pillar 1, credit risk, AIRB. Pillar 2 and Pillar 3 are very important, as is the inclusion of operational risk, even in the basic or standardized approaches.

Of course, short term implementation of Basel II in advanced markets is not completely assured as we speak. I am glad the U.S. draft rules are public. I believe that U.S. regulators are committed to moving forward. It would be hugely disruptive if they did not. But the U.S. implementation is not "in the bag".

VII. TEN THOUGHTS ON THE POST BASEL II WORLD

Now, I intend to posit ten thoughts/hypotheses/predictions/questions/issues about the post-Basel II world. Undoubtedly, some will prove wrong, but I think some will prove correct.

1. Basel II is a regulatory environment that celebrates differences more than before—standardized versus complex banks and standardized versus advanced capital calculations. While Pillar 3 promotes more disclosure, we are heading into a world with a lot less uniformity (at least for a while) and therefore a lot less simple, apparent comparability between banks. Of course, a good deal of the simpler, apparent comparability of the current system is illusory. But many, including financial analysts and rating agencies (which sometimes operate on simple measures) will need to adjust their lens for this less straightforward environment. Better analyzing the capital of a bank based on the new information will require more resources.
2. What are the chances of achieving the risk measurement and risk management objectives of Basel II?
   a. Some objectives are clearly achievable, such as better data and analytics. The role of risk managers within global firms is being enhanced relative to others. One key to success will be the extent to which management and Boards of Directors use this information without becoming a slave to it—the role of judgment. I think we will see a bit too much box ticking at the beginning, in some cases, (even though Basel II does not require as much as is happening now in some banks or jurisdictions) and then, hopefully, the pendulum will swing back as confidence in judgments rises.
   b. The push for better stress tests and more rigorous relating of capital to risk under Pillar 2 are also positives from a risk management perspective. I worry that some jurisdictions are treating this relation as more of a formula than it needs to be. A lot of the potential benefits in these areas will depend on how seriously banks and regulators treat these matters. Doing meaningful stress testing across risks and for 'tail events' is difficult.
   c. The impetus for focus on operational risk will be more entrenched and this risk will be better understood and managed. Banks have incentives to reduce their charge for operational risk by managing it better. I argue that this is beneficial, as operational risk has, in my judgment, risen in importance relative to credit risk over the past few years. The push to better data, including industry-wide data collection efforts on operational risk events, will prove useful.
   d. I hope that there is not so much reliance on analytics that we forget the role of judgment Some have stressed the group think problem of common analytics—I think it is not at all clear in practice, though a theoretical concern.
   e. There are interesting empirical questions of the extent to which risk differentiation will turn up in pricing and thus in ROEs, and whether markets

and quasi-market mechanisms such as rating agencies will accept a lot of risk differentiation. This is key, as Basel II is not about minimizing risk—it is about understanding the risk-return tradeoffs and pricing and accounting for them better, internally and externally.

f. Basel II should reduce some of the arbitrage that occurs under Basel I, which has implications for risk in banks. Undoubtedly, there will be arbitrage opportunities under Basel II, but my sense at this stage is that they are less than under Basel I, and not serious enough to materially affect risk of internationally active banks.

3. How will Basel II work to reduce the chance of serious financial stability problems and how will Basel II operate in a problem bank situation? Partly, I think the benefits will be preventative and will depend on the risk measurement and risk management implications I have just outlined. Part will come from under-developed parts of Basel II, such as treatment of downturn conditions, stress tresting and credit risk in the trading book, that I referred to earlier. We must get on with these. Part of the benefits can also come from the Pillar 2 requirement that supervisors possess the legal authority to intervene to require more capital if necessary and that they deal proactively with problems. This benefit extends to countries that implement this part of Basel II (if they don't already have it) even if their banks remain on standardized approaches. Of course, the ability to act is always dependent on the will to act. I do worry somewhat that many influences (Basel II, risk management principles based on financial analytics, market tradability of credit risk, and new international accounting fair value standards) are pushing banks to mark to model valuation. That may make it harder, in practice to determine when a bank is seriously undercapitalized and harder for a supervisor to make that determination stick, including in court.

4. Supervisory communication, trust and reliance will rise post implementation of Basel II. We have a ways to go in this, as part of the home-host implementation challenge. This also has material benefits in building capacity, including in times of crisis. The additional home-host communication and interaction in implementing Basel II will, I hope, pay benefits in other supervisory areas, including dealing with cross border problems. Basel II is altering the home-host relationship because, in a number of cases, both need each other more than they did before. The BCBS has released a number of papers on home-host cooperation in implementing Basel II (in some cases together with non G-10 countries) that expand on some existing, time-honoured principles. An offshoot may be a desire down the road to look at whether the Basel Concordat on home-host relations needs to be elaborated on.

   Some banks or countries may implement Basel II inappropriately. How many of them will be detected and deterred early enough? IMF FSAP assessments will help in this regard, as they will undoubtedly ask some penetrating questions of countries that say they are implementing Basel II (e.g., What they have done to 'up their game'?).

5. I think Pillar 2 will leave a material legacy for regulators and supervisors. It is already leading to enhanced supervisory systems in a number of important countries. Many are using it as a trigger to get added resources or to beef up the sophistication of their staff, their access to data or analytical tools. That is good.

   It matters even for supervisors of mid-size banks, which are often very sophisticated in certain areas. Pillar 2 allows supervisors to be able to do their job better. Banks also benefit from having supervisors with whom they can more effectively dialogue. But woe will be the supervisor who only focuses on Basel II. Running a risk-based, early intervention regulatory and supervisory regime is a lot more than implementing Basel II. FSAP assessments against Basel core principles for effective banking supervision will continue to be relevant in driving that point home.
6. What about future changes? Undoubtedly, course corrections will be required. What about simplification? Basel II is an interesting experiment in the principals versus rules debate. It has both, as I have noted. And my personal experience is that, when we have put in place principles, industry wants more rules to know where they stand and that they are being treated fairly relative to their competitors, and when we put in place rules, there are complaints of over-prescriptiveness. I do know that the more we tilt toward principles, the more there have to be information-sharing mechanisms like the AIG (at a minimum) to have a reasonable evenness of implementation. But we need more experience with the system operating in practice before we consider changes in the framework.
7. There should be implications for improving bank governance. This will be among the more difficult to achieve as the tendency is to treat these things as a compliance exercise—'Tell me if my capital went up or down,' says the board, 'and did I get a return on my systems investment?'. What is at stake in changes in capital is often a lot more than the value of the bank's systems investment. Basel II is producing more information and richer, higher-quality information on risk and on capital relative to risk. Some of that should percolate up to senior management and the board of directors. If it doesn't, we will have missed an opportunity. And Basel II means some different things for oversight functions to watch—the capability of control and challenge functions within banks, such as risk management and internal and external audit, to effectively challenge the 'quants'.
8. I hope that the AIG will set a new standard for assistance in implementation of international rules. And let me assure you, as one who has been part of some heated discussions with banks, simplistic views of supposed regulatory capture don't, in my judgement, apply.
9. There will be a further rules agenda. Potential Basel II adjustments, simplification and movement to get closer to major banks' internal models, are part of that agenda, but until we are farther ahead in implementing Basel II, as is, and get more experience of impacts, I believe that more adjustments now

may just as easily be in the wrong direction than the right direction. Also, in some cases, the data are not, in my judgement, good enough to rely on correlations in credit-risk modelling, for example. We will be on the continuum for some time between purely regulatory measures of credit and operational risk and approaches that build more fully on internal models. The definition of capital needs to be looked at, but that is also tricky and the BCBS does not, at this stage, have plans to start this. We need Basel II implementation to proceed farther first—there are scarce resources in supervisory agencies and in banks.

10. Basel II will have impacts on prudential regulation of other sectors. In Canada, for example, we are already needing to respond to questions from sophisticated insurers about their possible use of models for determining capital.

VIII. CONCLUSION

I started by noting: “If you don’t know who you are, markets are an expensive place to find out.” Overall, I do think that, a few years from now, we will be able to conclude that Basel II contributed to internationally active banks and their supervisors knowing themselves and each other better, and thus reducing the incidence of expensive ways of finding that out.

IX. NOTES ON CONTRIBUTOR/ACKNOWLEDGMENTS

Nicholas Le Pan resigned as Superintendent of Financial Institutions for Canada effective October 2006, after serving five years in the position.

Previously, he served as Deputy Superintendent of Financial Institutions, Office of the Superintendent of Financial Institutions, Canada (OSFI) from May, 2000. He has also served the Office as Deputy Superintendent (Supervision) from 1997, in which capacity he was responsible for overseeing the Supervision programs for banks, other deposit-taking institutions, life and general insurers and federally regulated private pension plans.

Mr. Le Pan joined OSFI as Deputy Superintendent (Policy) in 1995, and was responsible for OSFI’s input into legislative development, preparation of regulations and guidelines, precedents, identification and analysis of emerging issues as well as various international and Canadian regulatory coordination efforts.

Before joining OSFI, Mr. Le Pan served in 1995 as Special Advisor in the Department of Finance, leading a task force that finalized a government white paper on the supervisory, deposit insurance and policyholder protection regime and pursuing legislative implementation of the proposals. He also served the Department as its Assistant Deputy Minister, Financial Sector Policy Branch, led the

1992 comprehensive review of financial institutions legislation, and was actively involved in international negotiations on financial services. He was a member of the Board of Directors of the Canada Deposit Insurance Corporation. Prior to that, he held various positions in the Department of Finance dealing with tax and budget matters.

He was Vice Chair of the Basle Committee on Banking Supervision and chaired the Basle Accord Implementation Group. He was also a member of oversight bodies for Canadian Accounting and Auditing Standards and for the Canadian Public Accountability Board. He is a Director of the Toronto International Leadership Centre for Financial Sector Supervision.

Mr. Le Pan received a Bachelor of Arts degree (Honours) in Economics from Carleton University and a Master of Arts degree in Economics from the University of Toronto.