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Challenges for implementing Basel II for European supervisors

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European supervisors share with their colleagues around the world a wide range of challenges regarding implementing Basel II[*]: For instance, meeting adequate human resources and staff training, succeeding in information sharing and cross-border supervision, ensuring consistency in implementation of the new regulation. However, the European situation is also specific insofar as the European countries already have an obligation to converge so as to ensure a regulatory level playing field and to contribute, in their area, towards the achievement of the European Single Market. The European situation may seem paradoxical: the challenge of Basel II may be greater for them as it complicates European convergence but, at the same time, Basel II presents an unprecedented opportunity for greater supervisory uniform practices.

The legal and practical European environment poses some specific challenges to European supervisors.

One cannot downplay the fact that cross-country differences in legal and administrative systems as well as operationally and culturally mean that supervisory practices cannot converge overnight, and the ability to work as a network requires efforts in enhancing mutual

[*] [Editor's note: The Basel Committee for Banking Supervision adopted in June 2004 revised standards governing banks' capital adequacy, the so-called Basel II framework. In October 2005, corresponding new capital adequacy rules were adopted in the EU, based on the Basel Committee's standard. In addition to banks, the capital adequacy provisions in the EU directives also apply to investment firms and management companies for securities funds. In Norway the new capital adequacy rules will take effect as from 1 January 2007.]

trust. It is clear that in a large union of member states, achieving consensus on technical solutions is not an easy task.

European supervisors today are operating in a European regulatory framework based on "the Lamfalussy approach"[1], a four-level regulatory process designed to make the decision-making procedures faster and more flexible, while still ensuring the uniform application of Community law. However, the European Commission, in its year end 2005 "White Paper"[2], noted that the rate of transposition of Community law by Member States within agreed deadlines is not high enough, and Member States need to demonstrate stronger commitment and deliver proper implementation in a timely manner. This is a major challenge for EU-25. For banking supervisors, who were given new powers by the Lamfalussy approach, the ability to ensure the convergence of practices is partly dependent on the existence of national options or national discretions allowed by the European legislation itself.

The vast majority of the European financial industry has decided to implement Basel II which is an additional challenge for their supervisors. Both large and small institutions are impacted and many banks are already applying elements of Basel II. There are different demands and expectations with regard to supervision. The large scope of institutions applying to the Capital requirements directive (CRD) – which will transpose Basel II capital framework into EU legislation – has led supervisors to use a "proportionality" principle which was a key demand from the industry: European supervisors have designed several approaches to credit risk and several approaches to operational risk. This will enable institutions to opt for Basel II approaches that are in line with their level of sophistication.

Implementing Basel II is all the more challenging given that European banking institutions and their supervisors are facing modification of the financial accounting framework at the same time, through the adoption of the new International Accounting Standards / International Financial Accounting Standards (IAS/IFRS). Accounting standards play a crucial role in the information and decisions of economic agents, and in ensuring the effectiveness of market discipline. As such, their adoption is closely connected to the disclosure provisions in "Pillar 3" of the new Basel II framework. This is a positive development which leads to harmonisation of reporting and public disclosure of financial statements. However, this is a simultaneous regulatory "shock" that European supervisors have to address. Indeed, it has raised some questions from the perspective of financial stability, because there is concern that these standards could weaken the criteria that regulatory capital has to fulfil, namely that capital must be permanent and readily available for absorbing losses. There were also some doubts on whether the new standards could introduce high volatility in institutions' financial statements and, more particularly, into regulatory capital, in ways which might not reflect the economic substance of institutions' financial positions. In order to preserve the definition and maintain the quality of regulatory capital, the Committee of European Banking Supervisors (CEBS) has developed Guidelines on "prudential filters" for regulatory capital, in partnership with the Basel Committee; the

[1] "Final Report of the Committee of Wise Men on the Regulation of European Securities Markets", chaired by Baron Alexandre Lamfalussy, 17.2.2001
[2] "WHITE PAPER Financial Services Policy 2005–2010"

filters are designed to adjust regulatory own funds for changes appearing in the accounting equity of institutions that apply the new accounting standards for prudential purposes.

European supervisors have seized the opportunity that Basel II presents to further enhance their convergence practices and co-operation processes.

The new requirements under Basel II provide a unique window of opportunity for European banking supervisors to achieve increased convergence of national rules and practices, because the issue is not so much to change existing national rules and practices, but to create a new paradigm. Implementing Basel II is of particular relevance in the specific European context: it is less costly to move towards a commonly agreed benchmark than to adjust to dozens of various practices.

Role of the Committee of European Banking Supervisors (CEBS)

European supervisors have developed a range of tools to allow for supervisory convergence to continue. CEBS, which was established January 2004, combines high level representatives from banking supervisory authorities and central banks from the EU/EEA. Its role is to ensure the efficient and consistent implementation of Basel II in Europe through close co-operation among supervisors and convergence of supervisory practices. It acts as a catalyst for common implementation of the European directive on capital requirements. It has already achieved the removal of a number of items for national discretions from the draft. CEBS is working to enhance convergence through common training of staff from supervisory authorities, staff exchanges, joint on-site examinations.

European common reporting framework

In order to achieve harmonised implementation of the capital requirements directive, European supervisors have built a common prudential reporting framework which covers credit risk, market risk and operational risk, and which is applicable to all EU credit institutions and investment firms. This system, known as “COREP”, reduces the reporting burden for cross-border groups. It provides a comprehensive, harmonised framework that allows for national flexibility on data reporting. Groups operating on a cross-border basis will be able to use the same reporting framework, including non-European banking groups operating in different member states. This new framework, whose templates are available on the CEBS website (www.c-ebs.org), also allows for strengthened co-operation between supervisory authorities. It facilitates information exchanges between those in charge of the different entities in a same group and it should limit information requests from different supervisory authorities. This new supervisory tool has not achieved a full harmonisation yet, but it is a huge step towards it.

Supervisory disclosure

The implementation of Basel II/Capital Requirement Directive is leading European banking supervisors to improve the disclosure framework. This new framework provides a comprehensive overview of supervisory rules and guidance to enable meaningful comparisons among the national approaches and to detect inconsistencies in the implementation of the new regulation. CEBS has produced specific guidelines for implementing the framework. The Committee and national authorities will publish on their websites four types of information: regulation and guidance, options and national discretions, supervisory review under pillar 2 of Basel II (criteria and methodologies used by the national authorities in the supervisory review and evaluation process), and aggregate statistical data on key aspects of the implementation of prudential framework in each member state. The supervisory disclosure program will be a very powerful tool for a convergent European implementation of Basel II.

Convergence on validation of internal systems

Basel II gives banks choices on managing credit risk, from a more simplistic and less risk sensitive to a more complex but highly risk sensitive approach to determining capital adequacy. The most sophisticated approaches permitted allow institutions to use their own estimates of risk parameters. These estimates are used to calculate the institution's capital requirements. The accuracy of the resulting capital requirements therefore depends on the precision of the estimated risk parameters. The Basel II framework requires supervisory authorities to grant an institution permission to use the advanced approaches for regulatory purposes only if they are satisfied that it meets certain minimum requirements, and in order for institutions to do so they must meet higher risk management standards than are required under the less risk-sensitive approaches.

Although validation of bank's rating systems is foremost the responsibility of the banks themselves, supervisors must have a thorough understanding of them in order to ensure the overall integrity of banks activities in this area. European supervisors have drafted and adopted common validation guidelines for Basel II's sophisticated approaches. In this process, CEBS has maintained a close collaboration with the Basel Committee's Accord Implementation Group (AIG). By producing guidelines for supervisors on validation of internal systems, CEBS is helping the community of European supervisors to address one of the cornerstones of Basel II. CEBS' final guidelines on the implementation and validation are due to be published in the spring 2006. Following industry comments, CEBS has made several changes to the guidelines, most important being a profound change to internal governance, in particular with regard to the role of senior management and directors. In addition, the introduction of a "good faith" clause, means that supervisors may refrain for a certain period of time from applying certain parts of the paper for institutions that have (after having contacted their supervisory authorities) already developed their systems prior to release of CEBS' guidance.

Cross-border supervision

Validation of the internal systems has brought to the forefront of European supervisors' agenda the issue of relations between the "Home" and the "Host" supervisors of a cross-border banking group, or, in other words, the role of the "consolidating supervisor". The issue of information sharing and cross-border – or "home/host"-supervision is particularly critical within the EU, where co-operation among supervisors is an absolute obligation. The need for effective cross-border supervision is not new, but, under Basel II, is likely to receive greater attention than in the past, not least because bank's internal rating systems call for enhanced trans-national co-operation between supervisors. The increase of cross-border banking in the EU and the emergence of pan-European institutions have also increased the need to strengthen co-operation and convergence in supervisory practices and requirements. CEBS task is to ensure that banks and investment firms face similar prudential requirements across the EU in order to achieve a level playing field. In its work, CEBS has to consider various opposing forces affecting the financial markets. National legal responsibilities of supervisors do not always correspond with cross-border banking structures with centralised business lines and risk management functions. Retail markets are still fragmented with significant national differences, and deposit guarantee schemes are based on national solutions. All these challenges must be considered when drafting European level guidance.

Validation is a joint supervisory effort which is at the heart of co-operation; in exceptional cases where there is an absence of agreement after a certain period of time, the consolidating supervisor of the parent bank may decide ultimately which internal system should be used in the banking group. The "home/host"-implementation within the EU has to achieve a delicate equilibrium of responsibilities between authorities, and to take into account the treatment of systemically important subsidiaries, a possible change in the liquidity regulation (liquidity is currently supervised by the host supervisor), the possible need for some revision of the European deposit insurance regulation, and the management of possible cross-border crises. Via a system of delegation of tasks already in place, the objective of the European supervisors is to avoid duplicative tasks for both supervisors and institutions, and to reinforce the efficiency of banking supervision, while at the same time, seek to reduce regulatory burden.

Monitoring of convergence

CEBS' guidelines for co-operation between consolidating supervisors and host supervisors lay down a practical framework for co-operation and for the exchange of information. In parallel, CEBS is seeking increased co-operation through operational networks of supervisors cutting across consolidating and host supervisors. Indeed, CEBS will be increasingly called to address issues emerging during the implementation of the Capital Requirements Directive and of related CEBS guidelines. Operational networking mechanisms will be established to identify these issues. This work will be conducted mainly through case studies focused on supervisory co-operation and practices involving cross-border banking groups and questionnaires to compare implementation plans. This work will allow identifying possible areas for further work. A survey of implementation issues will be prepared in order to allow for an assessment of the progress made in 2007.

In addition, CEBS seeks to achieve greater convergence in the interpretation, implementation and application of the new legislation through discussion of queries arising from members, industry and the Commission, including from its joint Commission / CEBS / National Treasuries "Transposition Group". CEBS has created a "Frequently Asked Questions" section on its website in connection with monitoring the implementation of the directive.

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Standards and best practices are set and defined at the global level, for banking capital requirements as for many other financial issues. Europe has experience in harmonising rules and overcoming diverging traditions and practices of different markets and players. This experience proves very useful in implementing Basel II, in particular as regards the dimension of cross-border supervision.

Conversely, by pushing on convergence of practices, Basel II is making the traditional European supervisory co-operation a more pro-active process, and is fostering European banking integration. Basel II calls for a more judgemental supervisory approach in order to be fully risk sensitive. Two conditions are necessary to allow European supervisors to exercise such a judgement: convergence of practices and enhanced transparency – in a nutshell, building a common European supervisory culture. This is a long term process, but for the CEBS and European national supervisors, who are accountable to the European institutions, banking system, and the public at large, for the creation of a regulatory level playing field, it is no less than a "succeed or perish situation".