Summary of Joint Meeting between the Basel Committee on Banking Supervision and the Institute of International Finance

Thursday, 9 October 2003
Hosted by the Banco de España
Madrid, Spain

Participating Organizations

Supervisory Agencies:
National Bank of Belgium & La Commission Bancaire et Financière (Belgium); Office of the Superintendent of Financial Institutions (Canada); Commission Bancaire (France); Deutsche Bundesbank & Bundesanstalt für Finanzdienstleistungsaufsicht (Germany); Banca d'Italia (Italy); Bank of Japan & Financial Services Agency (Japan); Commission de Surveillance du Secteur Financier (Luxembourg); De Nederlandsche Bank (Netherlands); Banco de España (Spain); Finansinspektionen (Sweden); Eidgenössische Bankenkommission (Switzerland); Financial Services Authority (United Kingdom); Federal Reserve Board, Federal Reserve Bank of New York, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation (USA); Secretariat, Basel Committee on Banking Supervision; European Commission; Financial Stability Institute.

Industry Representatives

Abbey National plc; ABN AMRO Bank N.V.; Australia and New Zealand Banking Group Limited; Banco Bilbao Vizcaya Argentaria; Banco Itaú S.A.; Banco Santander Central Hispano; Bank of Nova Scotia; Bank of Tokyo-Mitsubishi, Ltd.; BNP Paribas; CIBC; Citigroup; Commerzbank AG; Credit Suisse Group; Deutsche Bank AG; Fortis; HSBC Holdings plc; ING Group; Institute of International Finance; Lloyds TSB Group plc; Mizuho Financial Group, Inc; Mizuho Financial Group, Inc; Morgan Stanley; Riyad Bank; Royal Bank of Scotland; Sanpaolo IMI S.p.A.; Société Générate; UBS AG; UFJ Holdings, Inc; UFJ International plc; Unicredito; Wachovia Corporation

Background

This note summarizes the joint meeting of the Basel Committee on Banking Supervision (hereafter, the Basel Committee or the Committee) and the Institute of International Finance (IIF), held on Thursday, 9 October 2003 at the Banco de España in Madrid. It highlights the major issues discussed regarding the Basel II proposal and is organized thematically.

Overview

Submitted by legal division

The chairman of the Basel Committee, Jaime Caruana, opened the joint meeting by welcoming members of the IIF to discuss the proposals for the New Basel Accord (the New Accord) and the industry's reactions. During the introduction, a U.S. member of the Basel Committee noted that, because the U.S. public comment period on the Advanced Notice of Proposed Rulemaking was still open, U.S. law required that the meeting - and future discussions during the comment period - be summarized and made part of the public record.[1]

In their opening remarks, IIF members expressed their commitment to the principles of Basel II. The IIF members suggested that the Committee calibrate capital to unexpected losses only; recognize the benefits of diversification and moving as quickly as possible to the use of full credit risk modelling for regulatory capital purposes; simplify the proposed New Accord as much as possible, such as modifying the treatment of collateral and maturity; and work with accounting standards-setting bodies on the treatment of provisioning and other issues.

The IIF member banks agreed that some delay in finishing the Accord might be necessary to address key concerns arising from the third consultation period. However, they urged the Committee to seek to complete the New Accord with no more than a six-month delay.

Members of the Basel Committee indicated in response that they understood the importance of minimizing any potential delays. However, Committee members noted that they could not offer insight into the likelihood of a delay given that they were scheduled to discuss the timetable for the New Accord at their own meeting the next afternoon.

Potential Revisions & Future Consultations

Assuming that the Committee were to amend the proposals in the third consultative paper (CP3), IIF members questioned what type of follow-up consultation or impact studies the Committee might undertake.

Committee members answered that the comment letters raised several important issues, such as the appropriate treatment of expected versus unexpected losses. Should changes to CP3 be necessary, the Committee believed that it had collected sufficient information through the third quantitative impact study to study potential effects. Supplementary information could be requested directly from supervisors. In addition, during the last year of the two year transition period described in CP3, the Committee would monitor banks' parallel calculations and could make minor adjustments to the Accord as needed. Members of the Committee indicated that some individual jurisdictions have announced plans for impact studies on a national level and that these efforts could help to inform supervisors.

IIF members repeated a request made earlier in consultations that the Committee recognize the benefits of diversification when setting the minimum capital requirements.

[1] Pursuant to the Administrative Procedures Act.

Committee members noted that the New Accord does indeed recognize diversification in that it ascribes an "average" level of economic benefit to banks that would be consistent with that of a well-diversified, internationally active bank. Representatives from the Committee added that they would work with the industry to develop ways to measure the economic benefits of diversification, but only after the New Accord was in force.

IIF members expressed their view that a better dialogue between the Basel Committee, accounting standards-setting bodies, and the industry was necessary, especially on reporting and accounting issues such as the treatment of provisions; the definition of capital; and risk reporting versus financial reporting.

Committee members highlighted the long history of their discussions with accounting standards-setting bodies and noted their agreement that such discussions should continue.

In response to a request from the IIF regarding ways to simplify the new rules, members of the Committee indicated that no simple answers existed. Several areas where supervisors are considering ways to reduce the complexity of the rules include the treatment of securitization, certain credit risk mitigation techniques, and selected aspects of the internal ratings-based (IRB) approach to capital and the relevant qualifying criteria.

During the final portion of the meeting, individual IIF members delivered short comments on specific sections of the New Accord and invited Committee members to share their thoughts on the issues. The major topics addressed included the treatment of securitization; the treatment of specialized lending; the treatment of trading book items; the need for greater supervisory cooperation across jurisdictions under the New Accord; and the treatment of operational risk. Each major topic is summarized below.

- *Securitization*

An IIF member acknowledged that the New Accord seeks to prevent institutions from arbitraging the capital framework through securitization. He urged prudence in setting requirements, given the importance of securitization as a risk management tool and as a source of funding for one-third to one-half of many leading banks' assets.

Members of the Committee agreed with views expressed by some banks that internal models offer the only real solution to the treatment of securitization exposures. Yet, for various reasons, including the state of industry practice and the substantive impact on overall capital, the Committee would not recognize full credit risk models in the New Accord.

- *Specialized Lending*

A member of the IIF shared a view expressed by some, but not all, IIF members that the current treatment for specialized lending (e.g., project finance) was considered too conservative. Some IIF members believe that the "supervisory slotting criteria" approach generated capital charges that were too high.

Committee members attributed this issue more to the implementation of the new rules rather than to their development. The Committee wants banks to make use of the best data available and developed a proposal that will allow qualifying banks to estimate probability of default under the corporate IRB framework.

- *Trading Book Issues*

IIF members expressed concern over the treatment of certain trading book items within the New Accord and noted the importance of this topic because of the growth of the trading book in many institutions. It was suggested that several areas of the New Accord that address the trading book need clarification and improvement with respect to both calibration and implementation. It was agreed that the IIF would submit a specific proposal to the Basel Committee that would address the key concerns of IIF members on these matters.

- *Coordination of Supervision Across Jurisdictions*

IIF members welcomed the Committee's recent paper in which it outlined the principles that should guide cooperation and coordination between national supervisors in implementing the New Accord across countries.[2] Nonetheless, the private sector representatives shared various concerns about potential discrepancies arising in the application of the New Accord across countries. One idea that industry representatives proposed was to establish a "lead" supervisor for internationally active institutions.

Some Basel Committee members responded that they could not endorse the lead supervisor concept, as this might be construed as subverting a national supervisor's legal responsibilities to regulate local offices of banking organizations. It was clarified that home supervisors still have a special role to play, and that the Committee's Accord Implementation Group was currently evaluating potential ways through which to foster greater cooperation between home and host supervisors.

- *Operational Risk*

An IIF member shared the sense of the important progress achieved in the development of a treatment for operational risk in the New Accord. Implementation raised special concerns, he cautioned, in that supervisors across jurisdictions would need to collaborate especially closely on the supervision of banks employing an Advanced Measurement Approach (AMA) to operational risk. While the IIF's Working Group on Operational Risk (WGOR) understood the constraints on supervisors, they felt that the process of

[2] Basel Committee on Banking Supervision, High-Level Principles For The Cross-Border Implementation Of The New Accord, August 2003 (http://www.bis.org/publ/bcbsl00.htm)

implementing the AMA needed to be significantly simplified by allowing a global institution to submit an AMA model to its home supervisor for review and approval. The model would include a documented approach for apportioning a group level regulatory capital requirement to individual subsidiaries and a list of jurisdictions for which model approval was sought.

The WGOR was aware that there were concerns that the recognition of diversification benefits in a group-wide capital calculation which was allocated down to legal entities could result in these legal entities being under-capitalized on a standalone basis. However, it was felt that there were solutions to this problem, such as the floor, Pillar 2, and the use of a gearing factor to reduce the diversification benefits.

Basel Committee members noted that the Committee had not yet had the opportunity to consider the merits of the IIF's proposal to establish a home/host approval process for the use of an operational risk capital approach, and therefore the Committee would not be able to comment directly on the proposals at this time.