Implementation of Basel II
Challenges & Opportunities

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Good morning everyone,

Thank you for this kind introduction. And thank you Everett (Schenk) and Larry (Uhlick) for the invitation to this very interesting conference. This is my first time in the United States as Director General for the Internal Market and Services in the European Commission. I am grateful for the opportunity to talk to you about EU-US cooperation in banking and other areas.

Introduction

I am here today primarily to share with you some observations on Basel II. Focusing on regulatory burdens. This is high on our agenda in Europe, as it is on yours. When regulatory costs and the international competitiveness of the banking industry are at stake, it should be at the top of everyone's agenda.

I will also briefly comment on other developments and our EU-US Financial Markets Regulatory Dialogue – the framework for transatlantic relations in this sphere.

Basel II: why we need it

Let me be absolutely clear about Basel II. It is a much better capital framework than Basel I. Basel I served us well since 1988, but banking has become too complex to be addressed by its simplistic approach.

Basel I does not reflect credit quality gradations or deterioration in asset quality. Lumping everything from a Triple-A-rated corporate bond to junk bonds in the same Basel I category helped “capital arbitrage” – banks exploiting differences between regulatory and economic capital. Furthermore, there was no explicit capital requirement to account for operational risk embedded in the many services from which firms generate much of their revenues.

Basel I did not give supervisors a common framework to engage with banks on other important issues, like strategic risk.

In short, Basel I had too little risk-sensitivity and it did not give bankers, supervisors, or the marketplace, meaningful measures of risk.

Basel II closes the gap. It better aligns capital requirements and the way banks manage their actual risk.

Pillar 1 of Basel II is based on many of the economic capital practices of banks. It brings minimum regulatory capital closer to the capital generated by banks' internal models. By providing a consistent framework for banks to calculate minimum regulatory capital, supervisors will be better able to identify

portfolios and banks where capital is not commensurate with inherent risk levels.

It also gives a more conceptually consistent and transparent framework for evaluating systemic risk in the banking system through the credit cycle.

Ongoing and regular dialogue with supervisors under Pillar 2 is an important improvement. This will inform management about how proprietary risk measurement and management models compare with current practices. And where enhancements are needed. It will help firms to improve their internal risk governance by better capital management.

In short, Basel II brings a more coherent relationship between how supervisors assess regulatory capital and how they supervise banks. But the biggest win of the entire Basel II project is that it should make the

financial system safer. It encourages continuing improvement in risk-measurement and risk-management in banks.

Basel II in Europe

The reach of Basel II is profound. Regulatory capital is an important driver of business decisions. Banks get into or out of business lines based on regulatory capital. When it's lower than economic capital, banks have a big market advantage; when it's higher, they have a disadvantage and may exit the business line.

As you know, Basel II applies to *all* banks in Europe, regardless of size. We are convinced of the benefits of the new rules for our firms, our financial system and our economy. So Europe – as most other G-10 countries - has implemented the full set of Basel II approaches. For credit risk and for operational risk.

Europe rolled out Basel II on 1st January of this year for the standardised and intermediate approaches for credit and operational risk. The advanced approaches will be available from next January.

Regulatory Burden

This leads me straight to regulatory burdens. In particular transnational burdens. Many rules you face are transnational not by design, but by impact.

By this I mean that the EU's financial services directives were written by the EU for the EU. Their transnational impact comes because many firms operating in the EU are headquartered somewhere else, or headquartered in the EU but operate also elsewhere.

In an era of complex global financial organizations, standards written in the EU – or the U.S. – reach beyond national borders. This raises many home/host issues and still broader policy questions.

And the crucial question is: can we design financial-sector rules that in fact create an equitable framework that unifies the playing field across national borders?

Surely, if there is *one* area where this should be possible, is it not in the implementation of standards that have been mutually agreed at G-10 level? We believe so. And if there is one area where it should not only be possible but even almost *mandatory*, it should be in global banking regulation.

The global, interrelated nature of banking business, banks' importance for financial systems and economies, and the need for consistency and predictability to maintain competitiveness, dictate that we cannot neglect this.

There are two types of burdens that we need to address as far as Basel II is concerned: the temporary ones and the permanent ones.

Temporary problems

The strong political interest shown in the US has had one direct and important impact: the timing of Basel II implementation. As I said, the EU law that implements Basel II entered into force 2 months ago, with 1 January 2008 the date for the advanced approaches.

This differs from the US timetable of 1 January 2009 - the first possible date a bank could start using the advanced approaches. These differences in timing present extra complexity, diversion of management attention, and costs.

But these problems are by definition temporary.

Permanent problems

More serious in my view – because not transient – are the questions of how bank supervisors in different jurisdictions will converge on interpretations of Basel II.

Banks with significant cross-border operations have understandable concerns about the prospect of each national supervisor asking different questions about implementation, demanding different data, or taking other actions that increase cost or are inconsistent with the Basel II encouragement of group-wide risk management.

Host-country supervisors face the costs of adjusting to differences in the way in which foreign banks will implement Basel II. While home-country supervisors

worry about host-supervisor intrusions, questions, and special rules.

Here I am aware that I am treading on difficult ground.

Supervisors will argue that Basel II is not a treaty but a consensus. And the authorities in each jurisdiction will inevitably apply it in their own specific ways. Reflecting their preferred approaches to bank supervision and regulation. Supervisors will also argue that each host-country supervisor is charged by its government with ensuring that, at least at the bank subsidiary level, legal entities operating within its jurisdiction have adequate capital.

Since 1975, the Basel Concordat for supervisors has recognised a division of labour that holds the home country responsible for consolidated supervision and

the host country for supervision of the legal entities in its jurisdiction, whether domestic or foreign.

The Concordat does not rule out differences in the concerns and objectives of supervisors in different countries.

At the heart of this lies a simple, but sobering truth. It does not matter to a host supervisor that the consolidated group has sufficient capital if, in stress situations, that capital is not available to the legal-entity in that host country. This is what supervisors refer to as the "tensions" from the combination of global banking and sovereign responsibilities. Such tensions have existed for years under Basel I.

This reminds me of a comment by former House Financial Services Committee Chairman, Mike Oxley. He said that everyone favours competition as long as they get to win in it.

He likened this to the fact that everyone wants to go to heaven, but no one wants to die to get there. This is, a lot like transnational financial regulation – it sounds fine until a transnational agreement limits national discretion.

Three aspects of Basel II may raise the level of tension experienced by internationally active banks still further:

(1) Basel II is more complex and includes requirements for capital to cover operational risk,

(2) it has all the uncertainties of the new and untested,

(3) the global competitiveness of our firms is at far greater stake than under Basel I.

And, yes, I do accept that important work has been done and is still ongoing in 'home-host' cooperation. In the Basel Committee and bilaterally. That

supervisors are working together to understand what has to be done, what information has to be shared, and so on. And that there are efforts to reduce the need for host supervisors to duplicate the work of the home-country consolidated supervisor.

But is this really enough? I am convinced that we need to do more. Not by revisiting the division of labour in the Basel Concordat - this is a supremely sensitive issue even **within** the European Union.

But by regulators working even closer together to reduce and ideally eliminate those critically important differences between rules implementing Basel II. Of course, particularly those that pose the heaviest operational burdens on international banks.

By this I **do not** mean complete elimination of *every* difference. National authorities do need to apply Basel II reflecting their preferred approaches and levels of conservatism to bank supervision and regulation. We have done this in Europe. And the US has done the same in its Notices of Proposed Rulemaking for Basel II and Basel IA.

But there are differences that raise substantial compliance costs. In some cases the differences between rules are such that they are even *impossible* for our banks – as well as for US banks - to implement.

To reduce regulatory burdens, our first duty is to take a long, hard look at differences between rules that seek to implement the same G-10 standard.

The US NPR (Notice of proposed rulemaking) process

The current comment periods in the US for the Basel II and IA NPRs offer an important opportunity. All interested parties can compare, contrast, and comment on the two proposals. Indeed, the proposals can change as a result of comments received or new information gathered.

The European Commission will this week offer its own formal comments to the US agencies. The focus will reflect our key concern - to minimise regulatory burdens for EU firms operating in the US and for US firms operating in Europe. Our focus is on those differences that will lead to unnecessary additional operational costs for firms. Examples are definition of default, options available for operational risk, and application of the rules to foreign-owned bank holding companies.

There are perfectly sensible solutions to these problems. Removing the critical differences between our Basel II implementations does not impinge upon home or host supervisory sovereignty. It involves asking simple questions:

- why do these differences exist?
- Is there a good justification for additional costs and burdens for international banks?

If not, let's remove them.

The European Commission will use the NPR comment period to bring these important issues to the attention of the US authorities.

There is another side to this coin. We would like to hear from US firms operating in Europe. What are their concerns?

Are there differences between our rules and Basel II that unnecessarily increase operational costs?

I am saying this because the openness and competitiveness of Europe's financial sector is of key importance to the Commission. We are open to listen and to improve.

Wider Transatlantic Cooperation

There are more areas where we cooperate closely with the US administration and US regulators to reduce regulatory friction. Within the informal EU-US Financial Markets Regulatory Dialogue we deal with issues from banking, but also accounting, auditing, securities, insurance and other fields.

The underlying understanding in this Dialogue is that we are "condemned" to cooperate. "Condemned" because the close integration of the economies of the US and the EU simply leaves no other choice.

We enjoy and appreciate the co-operation so "condemned" may not be the best word…

It was the EU Financial Conglomerates Directive and the US Sarbanes Oxley Act that revealed this truth five years ago.

The effects of rules and regulations are no longer limited to the home jurisdictions. They can no longer be developed in smoke-filled rooms without outside consultation. Nowhere is this effect felt more strongly than in the transatlantic capital market – by far the largest and most integrated in the world.

Over the last five years we have achieved tangible progress – not just because the smoke-filled rooms have disappeared thanks to US and EU health regulations. Now, we try to avoid new regulatory friction by upstream consultation between the EU and

the US. By ironing out differences before they make it onto the statute book.

And by tackling longstanding differences through convergence and mutual recognition of equivalence. This is the approach that we have taken in accounting where the SEC's roadmap is aimed at dropping reconciliation requirements for IFRS by 2009. In parallel the EU will decide about the continued acceptance of third country GAAPs.

Similarly, the SEC has come forward with a proposal to ease deregistration requirements for foreign firms. That means more freedom of movement for capital, less cost and more opportunities for business. And a deeper transatlantic capital market.

In closing, let me underline a few key points.

When implementing Basel II; we in Europe try to avoid unintended consequences and excessive

burden. Our regulatory programme went through intensive initial review and public consultation. Our cost-benefit analysis thoroughly examined likely effects on the economy. But we can always do better. And one area where we must do better is transnational burdens.

This is true for the implementation of Basel II and also for other areas. The challenge for the EU and US will be to reduce transatlantic regulatory burdens, to bring down regulatory barriers across the board - from banking to insurance, from securities to corporate governance.

This is the way to create new opportunities for business and more potential for investment and growth on both sides of the Atlantic.

Thank you for being invited to this conference and thank you for your attention.