

**Op Risk USA 2005
Annual Conference
New York, NY
April 5, 2005 (9h10-9h50)**

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Introduction

I would like to thank *Risk* and *Operational Risk* Magazines for inviting me to speak. It is a pleasure for me to be here this morning to discuss an area that is of particular interest to me – operational risk. We all know that operational risk management is not a new practice. Banks have always recognized the importance of having controls in place to minimize fraud, reduce errors in processing transactions, and so on. However, the emergence of operational risk as a discipline is a relatively recent phenomenon.

In the past, regulators and management have focused primarily on credit and market risk. Witness the 1988 Basel Accord, which provided proxy measures for credit risk and was later amended in 1996 to include market risk. The new Basel framework broadens this focus to include operational risk. This reflects the importance industry has given to this class of risk. In fact, operational risk management programs are becoming more prevalent in banks. We only need to attend conferences such as this one, to know that this is true.

Basel II offers a new set of standards for establishing minimum capital requirements for banking organizations. It is more reflective of the underlying risks in banking and it combines minimum capital requirements with supervisory review and market discipline to encourage improvements in risk management.

I recognize that operational risk aspects of the new Basel framework will be discussed in great detail over the next two days so I would like to focus my talk on general issues surrounding Basel II, specifically on the work we are doing in preparation for its implementation.

First, I would like to acknowledge the contribution that many of you made to Basel II. In developing the framework, regulatory authorities met individually and in groups with representatives from leading domestic and international banks. Industry groups and individual banks have contributed ideas and proposals, many of which have found their way into the new framework. Indeed, the Advanced Measurement Approaches for operational risk were developed as a result of intensive discussion with industry participants. The Basel II process has introduced a new level of dialogue between banks and supervisors that has already been an important success.

All of us know that Basel II is much more than a compliance exercise. Simply enacting new rules and checking periodically to ensure that they are respected is not enough. Basel II puts the onus on banks' boards and management to focus on the measurement and management of risks and to better relate risks to capital. I would also like to emphasize that risk management is not just a quantitative exercise. This is particularly true in the operational risk context. Without a doubt, the qualitative aspects of risk management are more important than the quantitative ones. Without them, quantitative aspects make no sense, or worse, can be misleading. It is important that we not depend solely on models to make decisions.

Basel II is not a compliance exercise for supervisors either. Basel II puts the onus on supervisors to react to a bank's processes and assessments and focus their supervisory efforts accordingly. Effective supervision is also a matter of knowledge and expertise, and we too cannot rely so much on models that we fail to assess the qualitative aspects of banks' risk management practices and exercise prudent discretion. Today I want to tell you about the processes we as supervisors are putting in place at the international level to help us implement Basel II. In doing so I will talk about a number of initiatives that we have undertaken to address issues raised by banks and to improve international cooperation.

Accord Implementation Group

I chair the Accord Implementation Group, or AIG. The Basel Committee established the AIG about three years ago. Its purpose is to share information and thereby promote consistency in the implementation of Basel II. While in some instances the AIG may propose elaboration or guidance for the Basel Committee's consideration, I should emphasize that the primary function of the AIG is neither to develop new rules nor to guarantee uniformity in application of the new framework. However, the exchange of information that takes place through the AIG is invaluable in enhancing implementation efforts of the new framework. This is especially relevant when it comes to operational risk, as the AMA is less developed, incorporates more flexibility, and requires considerable judgment.

We think we can, and have, made a difference in helping share information and approaches as we all 'up our game' -- by sharing information we can help Basel II be implemented well. I think industry is supportive generally of this approach though occasionally there are calls for more guidance at the same time as there are calls for flexibility.

Cross border issues

I would like to devote much of my time this morning giving you a flavour for how we are tackling cross-border and home/host issues. When I talk about home/host issues, I'm referring to the responsibilities of the supervisor of the consolidated parent bank (the home supervisor) in relation to the supervisors of foreign subsidiaries and branches of that bank (host supervisors). Of course, home/host issues are not new, but for Basel II to be most effective, the Committee recognizes that cross-border cooperation must increase. This is one of the AIG's main priorities, and we were instrumental in the Basel Committee's release of high level principles related to cross border implementation. One of those principles is avoiding unnecessary duplicative work.

Ideally, banks would like to deal with only one lead supervisor. This is understandable – but unrealistic. It may be efficient from the banks' point of view, but I know it is unacceptable from the host supervisors' point of view. When I talk about host supervisors, I'm not just referring to non-G10 countries, because many G-10 countries, including Canada, are not only home country supervisors but significant host supervisors as well. As supervisors, we can do a better job of reducing duplicative work, but banks have a role in this as well. In our experience, we have found that in many cases, local management of certain subsidiaries had virtually no knowledge of the Basel II implementation approach to

be adopted by the parent bank. Banks need to recognize that if they want to implement Basel II efficiently and effectively, they must invest time in keeping local management and host supervisors adequately informed.

Banks should understand that subsidiaries with a significant share of total banking assets or operations in a given market—not just those that are significant in the context of the overall banking group—merit special attention. Host supervisors have legal obligations they must satisfy relative to foreign banks operating in their jurisdictions, and they may feel it is even more important to exercise effective oversight where foreign banks are systemically important. I encourage home country supervisors to pay particular attention to the information needs of host supervisors, especially in those situations where the foreign bank is systemically important. Similarly, I'm encouraging host countries to focus on what they really need from the home supervisor or the bank. This doesn't mean in my view that the host supervisor should automatically get all information that the home supervisor has, or as a matter of right have access to all of the home country assessments of the bank's operations. I am also emphasizing that we cannot be prescriptive in how these relationships work. So much depends on the role of the supervisors, the adoption strategy for Basel II being followed by the countries, and the roll out plans of the banks.

Within the AIG, we have agreed to accelerate discussion between supervisors, and between banks and supervisors, on the cross-border implementation plans of the major banking groups. After experimenting with some live situations (or what we have called "real case studies"), we shared views on what seemed to work and what didn't work as well through a document distributed last fall among fellow supervisors and international trade associations. I have always been keen to engage non-G10 supervisors in this dialogue as well, and at my meeting with the members of the Committee's non G-10 liaison group, six weeks ago, we started a valuable ongoing discussion regarding information needs, especially from the perspective of the host supervisor.

We are making progress in this area. At this time, many internationally active banks have started their case studies or more importantly their discussions of their implementation plans with their home and host supervisors. We are seeing a variety of communication approaches being used. Some jurisdictions have initiated informal discussions that take place on a bi-lateral or tri-lateral basis, depending on the complexity and the nature of the relationships. Others have organized colleges of supervisors where the home supervisor for each bank arranges meetings with key host supervisors and with bank management. During the meetings they discuss the bank's plans for the implementation of Basel II, what the bank needs from the supervisors in terms of direction, and what the supervisors want from the banks and from each other. Indeed, Committee members are clearly moving from case studies into actual, tangible implementation planning. However, given the Basel II timetable, this work needs to accelerate. We also need more focus on how the cross-border implementation of the operational risk approaches will work in practice.

I believe this approach, strongly grounded in practicality, is the most effective way to promote better cross-border implementation. We are encouraging home supervisors for the largest banks to arrange similar meetings along the lines suggested by the AIG. Nevertheless we know that we must remain flexible and recognize that there is no "one-size-fits-all" approach to cross-border implementation. Just as each banking organization is unique, so too is each supervisory agency, not to mention the working arrangements among supervisors.

What is important is that home and host supervisors establish clear communication with one another and with banks. The nature of supervisory cooperation will differ depending on a bank's implementation plans and the needs of the relevant home and host supervisors. Home supervisors are responsible for conducting effective global consolidated supervision and host supervisors are responsible for conducting effective supervision of the local activities. The ability of supervisors to develop detailed supervisory arrangements depends to a large extent on banks having developed their own internal implementation and rollout plans.

A key cross-border issue related specifically to operational risk is the application of the "hybrid approach" for banks implementing a group-wide AMA. The hybrid approach provides a compromise position between a top-down allocation approach with full diversification benefits assigned to subsidiaries, and a full building-block approach with each subsidiary calculating its own AMA capital requirements on a stand-alone basis. Under this approach, a banking group, with supervisory approval, would be permitted to use a combination of stand-alone AMA calculations (or, alternatively one of the simpler approaches) for "significant" internationally active banking subsidiaries and an allocated portion of the group-wide AMA capital requirement for its other subsidiaries.

To help guide supervisors on the implementation of the hybrid approach, the Basel Committee released four principles in January 2004.

The first principle reiterates the sentiments of the high-level cross-border principles that I mentioned earlier, recognizing that banking organizations are subject to minimum capital requirements of home country supervisors on a consolidated basis as well as host country requirements on a sub-consolidated basis. Cooperation between home and host country supervisors is encouraged to minimize duplication in review and approval processes.

The second principle emphasizes that the board and senior management of a subsidiary have a responsibility to understand the operational risk profile of the subsidiary. They must ensure that those risks are managed effectively and that adequate capital is held against those risks.

The third and fourth principles get right to the heart of the hybrid approach. Principle three deals with the inclusion of diversification benefits in calculating AMA capital requirements on a group-wide basis and the extent to which such group-wide benefits might be included in allocating this minimum group-wide capital requirement across subsidiaries. Since experience has shown that capital is generally not freely transferable within a banking group, host supervisors must be comfortable that a subsidiary is adequately capitalized, particularly in times of stress. Therefore, a significant subsidiary will have the choice of calculating either its AMA capital requirements on a stand-alone basis or adopting one of the simpler approaches. Where a significant subsidiary opts for a stand-alone AMA, it may incorporate a well-reasoned estimate of the diversification benefits of its own operations, but may not consider diversification benefits determined at the group-wide level. Other subsidiaries would be permitted to use an allocated amount of the group-wide AMA calculation as their Pillar 1 charge. Even in these cases, however, a host supervisor has discretion to limit the extent to which the group-wide benefits of diversification are reflected in the allocation.

The fourth and final principle states that supervisors, where possible, should balance the above principles with the goal of minimizing the burden and cost of implementing an AMA on a cross-border basis. This could include allowing subsidiaries to leverage off the resources of their parent in developing a stand-alone AMA.

I do not expect the hybrid approach to be universally adopted by supervisors when Basel II is first implemented. But I think it is an important part of the framework that we will see used more over time. Banks are still in the process of developing robust AMAs, let alone determining how the resulting capital requirement might be notionally allocated to subsidiaries. As these methodologies develop, the AIG's working group on operational risk, or AIGOR, looks forward to meeting with banks to discuss progress in this area.

In the short term, until the hybrid approach is implemented more widely, subsidiaries of AMA banks may be left with the option of implementing one of the simpler approaches to calculate their capital charge on a sub-consolidated basis. These approaches are:

- the Basic Indicator Approach,
- the Standardized Approach, and
- the Alternative Standardized Approach.

Ultimately, it is left to national supervisors to determine with their banks what constitutes a significant subsidiary, how broadly the hybrid approach might be available within their jurisdictions and, where it is not, which of the simpler approaches is most appropriate.

AIGOR

As I mentioned a minute ago, to help facilitate discussion of the hybrid approach and other issues associated with the cross-border implementation of an operational risk framework, a working group of the AIG was created to focus specifically on operational risk. The AIGOR, is focused principally on issues related to the successful development and implementation of the Advanced Measurement Approaches. The subgroup was established in December of last year and has held two meetings to date with participation from both G-10 and non-G10 countries.

Consistent with the mandate of the AIG, the AIG operational risk working group has been looking at ways to enhance coordination and cooperation in the oversight of operational risk within internationally active banking groups. The group is also exchanging views on and approaches to the supervisory assessment of operational risk, especially related to the AMA. In addition to beginning to tackle some of the implementation issues raised by the hybrid approach, the working group has discussed a number of other outstanding implementation issues which can be loosely grouped into three categories.

The first category is internal governance with respect to operational risk. Work on internal governance will focus on those practical challenges facing boards and senior management in the oversight of operational risk, including:

- how to ensure the independence of risk management over operational risk;
- the role of internal and external audit;
- the content and frequency of board reports; and
- the level of detail of operational risk policies approved by the board.

The second category consists of data issues. This includes issues related to the collection of internal loss data as well as the use of external data in an AMA. These are an extremely important and diverse set of issues, ranging from the recognition of loss events, to “boundary” issues between operational, credit and market risks, to the validation of operational risk data integrity.

The third group of issues relate to the quantification or modeling of operational risk exposures within an AMA. As you know, the Basel framework permits a significant degree of flexibility in permissible modeling techniques underlying an AMA. With that said, there are still important implementation issues warranting additional discussion between banks and supervisors, including acceptable ways for banks to demonstrate that expected operational risk losses are adequately covered and that correlation estimates included within an AMA are reasonable.

All of these issues are being discussed by the AIGOR, but given the underlying flexibility incorporated in the AMA, the AIGOR does not anticipate identifying single solutions to any of them. Rather the AIGOR expects that it will develop a range of acceptable practices, taking into account industry and supervisor experience.

QIS and Parallel Run Policies

I want to talk a bit about how we are going about implementing Basel II in Canada. But before doing so, I want to acknowledge concerns that have been raised by the industry about QIS 4 and 5 and the planned parallel run. QIS stands for quantitative impact study. The Basel Committee has already undertaken three such studies. Certain jurisdictions will complete a so-called national QIS4, and the Committee is planning on conducting a fifth quantitative impact study by the end of 2005. The purpose of these studies is to evaluate the impact Basel II will have - in other words, quantify if there will be the same, more or less overall capital in the system for the risks taken. There were several reasons for conducting more than one study. These include:

- proposals were modified,
- banks’ abilities to provide information improved, and
- results varied based on the strength of the economy.

The results of these studies are used to recalibrate, as necessary, factors set out in the credit risk section of the new framework. We will also be using these studies to collect information on operational risk, similar to what was done in the previous exercises. We are trying to complete all of the studies by the end of 2005, as this is our last opportunity to make changes to the framework before some banks begin implementing it. We recognize that these are time-consuming exercises but I think everyone can agree that it is better to resolve the calibration issue now than after implementation. It is an important exercise and it is worth spending the time to get it right.

Implementation in Canada

OSFI will apply the new Basel framework to all banks incorporated in Canada. OSFI expects large internationally active domestic banks to implement an advanced IRB approach for all “material” portfolios and credit businesses in Canada and in the U.S.

starting on November 1, 2007. OSFI will make available the IRB and Standardized approaches to all other banks incorporated in Canada but anticipates that most will adopt the Standardized Approach for measuring credit risk. A Canadian subsidiary of a foreign or domestic bank will be permitted to use its parent's IRB methodology subject to OSFI approval. OSFI's approval will consider, among other things, the appropriateness for the Canadian marketplace of the data and experience used to calculate the subsidiary's IRB capital requirement.

To measure operational risk, OSFI will permit banks incorporated in Canada to implement any one of the three approaches: the Basic Indicator Approach, the Standardized Approach or an AMA. OSFI anticipates that banks that plan to implement an IRB approach for credit risk will, over time, implement an AMA for operational risk as they improve their systems and processes to the point where they are able to meet the qualifying criteria. OSFI will consider under what circumstances it will allow an allocation methodology for AMA for small subsidiaries in Canada. Clearly, in considering this issue, we would want to be satisfied that the board of directors and senior management of the banks understand the risks and agree that the methodology of capital allocation was consistent with the risks undertaken in their operations.

OSFI takes its responsibilities as home supervisor seriously and is striving to develop informal, but effective, relationships with host supervisors. In fact, OSFI has been in contact with host country supervisory authorities that regulate significant foreign subsidiaries of Canadian banks and arranged a "college of supervisors" scheduled for May of this year where we will discuss information-sharing possibilities and hopefully lay the groundwork for establishing a level of reliance on each other's work. OSFI believes home-host relations will be most effective where reliance is built in large part on trust and goodwill.

I believe that OSFI is well positioned to implement Basel II, as it is consistent with the risk-based supervisory framework we adopted in the mid-90s.

Conclusion

I hope this has given you a flavour of the work we are undertaking in implementing Basel II, particularly the operational risk component.

As we approach each issue of implementing Basel II, I think it is important to keep in mind not only the challenges, but also the benefits. Better relating capital to risk, promoting enhanced risk measurement and management practices in internationally active banks, and further enhancing supervisory focus all present huge opportunities --for banks, for supervisors, and for our markets and economies.

While there are challenges, and while implementation won't be perfect, I believe that with a combination of a practical and realistic approach, good feedback and ongoing communication, Basel II can be implemented well.

I look forward to that result.

Thank you