

**Cross border implementation of Basel II:
BaFin/Bundesbank approach towards home/host
cooperation¹**

1. Introduction

The implementation of Basel II causes substantial effort for both, credit institutions and supervisory authorities. This is especially true for internationally active banking groups that are planning to implement advanced risk measurement approaches in cross border locations. In order to reduce the implementation burdens for these banking groups and their supervisory authorities, redundant work on both sides has to be avoided as far as possible. This objective can only be achieved if home supervisors and host supervisors of internationally active banking groups work closely together.

Keeping this in mind, this paper explores practical ways of cross border coordination and cooperation between supervisory authorities. Given the importance of this issue, the Basel Committee on Banking Supervision and its Accord Implementation Group developed helpful High Level Principles for cross border cooperation. These principles together with the current draft for the recast of EU directives 2000/12/EC and 93/6/EEC form the basis of the considerations in this paper.

¹ In the context of the AIG's work on home/host issues, BaFin/Bundesbank as the relevant home supervisors carry out a real case study on a major internationally active German banking group. In addition, BaFin/Bundesbank participate as host supervisors of subsidiaries of foreign banking groups in real case studies conducted by the home supervisory authorities of these banking groups. In the course of these case studies, BaFin/Bundesbank took part in several bilateral meetings with other supervisory authorities and attended several supervisory colleges.

The contemplations in this paper are based on the experience BaFin/Bundesbank gained in the course of these real case studies. They represent BaFin/Bundesbank's current thinking on home/host cooperation, subject to further elaboration in the course of the dialogue with host supervisory authorities.

2. Guidance from Basel and Brussels

The Basel Committee established main guidelines ("High-Level Principles") for the cross border implementation of the new Accord in August 2003. The six High-Level Principles (HLPs) constitute the basis of a general framework for the coordination and cooperation of the home and host country supervisors. Since a huge portion of the home/host cooperation approach in this paper is based on these HLPs, they are reiterated below supplemented by considerations about how they translate into practical supervisory cooperation.

Principle 1: The New Accord will not change the legal responsibilities of national supervisors for the regulation of their domestic institutions or the arrangements for consolidated supervision already put in place by the Basel Committee on Banking Supervision.

Principle 2: The home country supervisor is responsible for the oversight of the implementation of the New Accord for a banking group on a consolidated basis.

Principle 3: Host country supervisors, particularly where banks operate in subsidiary form, have requirements that need to be understood and recognised.

The three HLPs demonstrate where the need for supervisory cooperation results from: Legal responsibility of home and host supervisors remains unchanged and the new rules continue to be applied at each level of the banking group. This may require banking groups to obtain approval for their use of certain approaches from relevant host country supervisors on an individual or sub-consolidated basis, as well as from their home country supervisor in respect of consolidated supervision. But oftentimes, these banking groups are managed along business lines rather than along entities. In many cases, functions like the risk management function of a banking group are partly or completely centralised at one location and risk measurement approaches are commonly used by different group entities. In these cases, the banking groups' function and/or business line oriented structure that ignores country borders deviates from the supervisory structure which is lined up along the borders of jurisdictions. To the extent supervisors are able to align supervisory cooperation arrangements to the respective banking groups' conditions, undue burden for banking groups could be avoided.

Nevertheless, legal responsibilities for the supervision of banking entities do exist at different levels of the banking group. Foreign subsidiaries of a banking group that apply an advanced approach on a group-wide basis still need the approval from their competent host supervisory authority for the local use of that approach. This legitimates the performance of own supervisory approval work by each of the legally responsible supervisory authorities. In order to reduce multiple approval work, any cross border cooperation arrangement has to take this into consideration. Therefore, cross border cooperation should be designed in a way that ensures that supervisory work is reduced while the competent supervisory authorities are still involved in a way that allows them to fulfil their legal supervisory obligations. Consequently, cooperation agreements between competent authorities should aim at addressing two crucial elements: agreements about mutual recognition of approval work in order to reduce redundant supervisory work on the one hand and an effective exchange of information between competent authorities on the other hand in order to ensure that the competent authorities fulfil their legal obligation of a prudent supervision of the banking entities without conducting all supervisory work by themselves.

It is BaFin/Bundesbank's objective to arrange home/host cooperation in a way that allows for reliance of host supervisors on the work of BaFin/Bundesbank and vice versa to the greatest possible extent.

Principle 4: There will need to be enhanced and pragmatic cooperation among supervisors with legitimate interests. The home country supervisor should lead this coordination effort.

Principle 5: Wherever possible, supervisors should avoid performing redundant and uncoordinated approval and validation work in order to reduce the implementation burden on banks, and conserve supervisory resources.

Principle 6: In implementing the New Accord, supervisors should communicate the respective roles of home country and host country supervisors as clearly as possible to banking groups with significant cross-border operations in multiple jurisdictions. The home country supervisor would lead this coordination effort in cooperation with the host country supervisors.

At its May 2004 meeting, the Basel Committee reiterated its commitment to push forward the development of supervisory cooperation plans between home and

major host countries for banking groups with major international operations, focusing on practical home/host cooperation for more advanced approaches.

In line with the Basel Committee's HLPs, the current draft for the re-casting of Directives 2000/12/EC of the European Parliament and Council Directive 93/6/EEC assigns a leading role to the home supervisor with respect to information gathering and disseminating as well as planning and coordination of supervisory activities. Furthermore, the draft supports the idea of close cooperation between home and host supervisory authorities with regard to the approval of banking groups' IRBA and AMA applications.²

A basic rule that has to be followed if a true reduction of supervisory approval work shall be reached is that the home supervisor's needs and requirements have to be recognised as well as the host supervisors'. This simple rule translates into a basic division of supervisory approval work: The home supervisor should be responsible for approval work relevant to the banking group as a whole and the group's entities in the home country whereas the host country supervisor should be responsible for the banking group's Basel II implementation relevant to the group's entities under his supervision. The significant overlap of responsibilities and a potential way to reduce it are the central elements of cross border cooperation to be dealt with later in this paper.

At this point, the important role shall be underlined which host supervisors - depending on their significance - should play with regard to the approval process. If their interests are not reflected sufficiently in the approval process for advanced approaches in banking groups, they could potentially jeopardise pillar 1 cooperation efforts by performing redundant supervisory work according to their own approval conditions or by requiring capital add-ons from the banking entities they supervise under pillar 2. Given the fact that the host supervisor is legally responsible for the supervision of these banking entities and therefore might have to support them in the case of a crisis, this outcome would be understandable from the host supervisor's perspective although it would be unfavourable from the cooperation perspective.

² This paper does not discuss Art 129 (2) of the EU draft directives, which in the current form would change legal responsibilities of EU supervisory authorities. Once the directives have come into force a section contemplating the practical implications of 129 (2) will be added to this document.

The competition argument is another aspect to be considered. If the host supervisor's approval requirements are not reflected sufficiently in the approval process of a foreign banking group's entities within its jurisdiction, then these entities might have to meet different supervisory requirements than those banking entities with parent institutions in other home countries as well as those domestic banking entities that do not belong to a banking group.

These considerations show that any supervisory cooperation agreement should reflect the important role of host supervisors. On the other hand, supervisory arbitrage within banking groups needs to be considered. If each host supervisor decides on the approval of IRBA or AMA applications on its own, international banking groups could be tempted to relocate their business within the banking group to the host country with the lowest level of supervisory requirements. This outcome would interfere with the legal responsibility and legitimate interest of the home supervisor to conduct the prudential supervision over the banking group as a whole.

The conclusion of these considerations for the practical cross border cooperation is that cooperation arrangements should not jeopardise the level playing field within host jurisdictions while they should at the same time provide for the supervisory needs of the home supervisor. In order to avoid adverse supervisory effects on both the banking group and the involved supervisory authorities, home and host supervisors should both aim at supervisory arrangements that sufficiently reflect their respective interests while taking into account the banking group's concerns.

3. BaFin/Bundesbank cooperation framework

3.1 Supervisory cooperation - General remarks

As a basic principle, cross border supervisory cooperation should always reflect the individual conditions of each banking group. Therefore, a thorough analysis of the banking group is an important initial step towards the development of a well suited and hence efficient supervisory plan detailing as far as possible the

practical arrangements between the home country supervisor and relevant host country supervisors.

This analysis should cover the group's structural and organisational features like the locations and legal status of group entities, the relevance of these entities with respect to the group as well as with respect to the host countries' financial systems, the business conducted within these entities, the degree of integration of these entities' risk management function within the group, etc. Another key element of this analysis is the detailed rollout plan of the banking group. This should not only contain information about when the bank intends to implement what approach for which portfolio. But it should also include information about the methods for minimum capital calculation the bank is going to utilise. It is of special interest with regard to these methods where they were developed: in Germany or in host countries. In addition, it is important to find out where the different models are managed (i.e. where the ongoing enhancement takes place) and whether they are used locally only or commonly by different entities of the banking group.

Ideally, supervisory responsibility could follow the responsibility within the banking group. Therefore, in the case of centrally developed models that are consistently applied across the banking group, the home supervisor would lead approval work. Conversely, the approval work of locally developed models would be led by the supervisory authority of the entity of the banking group that developed these methods.

As mentioned above, the design of most efficient home/host cooperation depends on the individual conditions of the banking groups. In each single case, home and host supervisors will have to determine bilaterally what form of cooperation suits best the situation of the banking group. Therefore, it is not possible to answer this question in form of a simple rule. Rather, the following set of criteria may give an idea of what may be important factors to consider when determining the most efficient form of cooperation:

- degree of mutual trust between BaFin/Bundesbank and host supervisor

- legal status of foreign banking entity relative to the banking group: subsidiary or branch?
- legal framework: is host country a member of EU (because of European passport, new EU directive)?
- National legal restraints (Does host country law require own accomplishment of supervisory review actions? What risk measurement approaches are available in host country?)
- importance of foreign entity to banking group: share of business volume, share of credit volume, share of risk (risk weighted assets, credit risk, operational risk, share of earnings); legal obligations of parent company for liabilities of foreign entity, impact to parent bank's balance sheet, importance of functions conducted by foreign entity for banking group
- roll out plan of banking group: what risk measurement approach is planned for foreign entity? Are risk measurement methods developed/managed/internally validated centrally or locally within the banking group?
- special interests of host supervisor (e.g. importance of foreign entity for host country's financial stability: share of local market, exercise of systemically important functions by foreign entity, degree of integration with host countries financial market))
- special interests of home supervisor

In conjunction with the remarks about the "division of work" in the next section, this set of criteria gives an impression of what home and host supervisors will take into consideration when they decide about the appropriate form of supervisory cooperation. In order to determine the respective roles home and host supervisors should play with regard to approval work and the exchange of information concerning a certain banking group, it makes sense to define cooperation categories depending on the extent and form of involvement in the supervisory work³.

³ Note: BaFin/Bundesbank emphasise that the determination of cooperation categories is strictly limited to the role of a host supervisor in the cooperation process regarding a certain banking group. The cooperation category of a host supervisor is neither a statement of the overall importance of a host supervisory authority nor does it reflect an assessment of this host supervisor's quality. Accordingly, the same host supervisory authority that belongs to cooperation category 1 with regard to the banking entities of a certain German banking group within its jurisdiction can at the same time belong to cooperation category 5 with regard to a different German banking group.

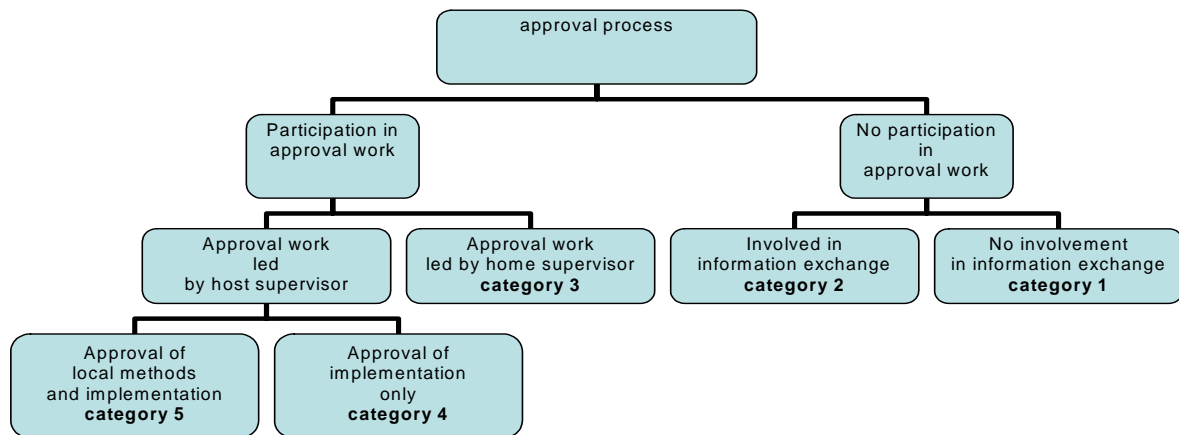
All roles host supervisors can play with respect to a certain banking group can be divided up into two main groups: one participating⁴ in the approval work of a banking entity within its jurisdiction, the other one not. The main group of host supervisors that do not participate in the supervisory work with regard to Basel II implementation can be subdivided into host supervisors that are involved in the exchange of information and those who are not. Without prejudice to the actual outcome, one could for example think of the host supervisor of a small banking branch of an EU banking group as a typical host supervisor that is neither involved in the actual Basel II supervisory work nor in the respective information stream. On the other hand, the host supervisor of a major foreign subsidiary of a banking group that is important for the stability of the host country's financial system might see itself in the group of host supervisors that participate in the Basel II approval work, especially if the respective subsidiary employs locally developed risk measurement methods. Of course, this host supervisor will also be involved in the information exchange process.

The main group of host supervisors that participate in the supervisory work can be subdivided into the group of host supervisors that lead approval work themselves (model and/or implementation) and therefore play an important role in the joint home/host approval process of IRBA and AMA applications and those who participate in approval work led by the home supervisor or other host supervisors. All in all, there are five different roles host supervisors can play with regard to the approval process:

1. no participation in approval work, no involvement in information exchange
2. no participation in approval work, involvement in information exchange
3. participation in approval work led by BaFin/Bundesbank, involvement in information exchange
4. participation in method approval work under the lead of BaFin/Bundesbank, leading of local approval of method implementation, involvement in information exchange

⁴ The term "participation" covers a variety of forms of supervisory cooperation that ranges from physical participation in on-site examinations to an update on information regarding the supervisory approval work. In practice, the mutual physical participation in supervisory approval work will probably be rather rare because different languages are spoken in home and host countries. The language for communication between supervisory authorities as well as the communication with the banking groups is an issue that needs to be resolved.

5. leading of approval of local methods and leading of local approval work on method implementation, involvement in information exchange



Each host supervisor should think about the role he wants to perform with respect to a certain banking group. BaFin/BBK will develop their own ideas on this. In a next step, they will decide in consultation with the respective host supervisor on the most beneficial role this host supervisor should play with regard to supervisory cross border cooperation on Basel II implementation regarding a certain banking group.

Question to attending host supervisors:

Do you agree with the definition of roles of host supervisors in this section? Which role do you think you would play with regard to Dresdner BANK group? Why?

3.2 Division of responsibilities in initial approval process

3.2.1 Approval of risk measurement methods

Given the high priority of the initial approval process with regard to AMA and IRBA applications, this paper focuses on this area of cooperation. BaFin/Bundesbank's current thinking on this topic is that the basic principles with regard to division of work, information sharing and communication should be followed in the ongoing supervision of Basel-II compliance similarly to the way described in this paper.

The initial approval process of IRBA and AMA applications covers two areas that should be distinguished: the supervisory work regarding the supervisory evaluation of the bank's risk measurement methods on the one hand and the approval work regarding the implementation of these models in the bank's entities on the other hand. It is BaFin/Bundesbank's view that the approval work with regard to centrally (usually in the German parent institution) developed risk measurement methods should be led by BaFin/Bundesbank. "Centrally" in this context means that these methods are developed/managed/continuously enhanced at a single banking entity while they are commonly used by different entities throughout the banking group. These central methods may for example comprise rating methods for bank exposures, sovereign exposures and exposures to large corporates for the measurement of credit risk and AMA models for the measurement of operational risk.

Depending on a banking group's structure, it may often be found that some of the centrally developed methods or parts of them are used in the group's foreign banking entities, too. If that is the case, the host supervisors of these foreign entities should try to avoid the performance of own approval work of these methods and should aim at relying on the results of the supervisory approval work led by BaFin/Bundesbank as far as possible in order to avoid multiple supervisory work regarding the same methods.

As these central methods are used for capital calculation to comply with their supervisory requirements, these host supervisors have a legitimate interest in learning about these methods, especially if the entities supervised are material to the host supervisor's financial system. Therefore, some of these host supervisors will participate actively in BaFin/Bundesbank's approval work of centrally developed methods (cooperation categories 3 to 5) while others will receive detailed information about the joint approval workteam's findings (cooperation category 2). BaFin/Bundesbank should - upon consultation with the respective host supervisors - decide on a case by case basis on the form of host supervisor's involvement in approval work on centrally developed methods, depending on the materiality/cooperation category of these host supervisors.

If a risk measurement method is developed locally by a foreign banking entity, the respective approval work on this method should be led by the host supervisor legally responsible for the supervision of this entity (cooperation category 5). In practice, these locally developed methods will probably comprise credit risk methods for retail exposures or exposures to small and medium enterprises. As the host supervisor has much more knowledge of the local market conditions covered by these methods it will usually be more competent to judge the appropriateness of the banking entity's risk measurement methods. This is one reason why the approval work of these local methods should be accomplished by the host supervisor.

In order for BaFin/Bundesbank to allow them to meet their responsibility for the Basel-II Implementation of the banking group as a whole, they will at least need to maintain a sufficient level of information about the host supervisor's findings. Depending on the materiality of the banking group's operations covered by local methods, BaFin/Bundesbank will in some cases ask for active participation in the approval work led by the host supervisor.

According to BaFin/Bundesbank's understanding, the mutual participation in supervisory approval of risk measurement methods is an important element of supervisory cooperation. Active participation allows supervisors to have a very close look at the methods judged. Besides gaining unfiltered helpful information for their further supervisory approval process, they can also influence the approval work to a certain extent in order to meet their own supervisory needs. In addition, mutual participation in approval work promotes the convergence of supervisory approval activities. All in all, the participation feature will supposedly strengthen the mutual reliance on the supervisory approval work led by other supervisors. It will hence promote unanimous decisions on banking group's IRBA and AMA applications.

Nevertheless, it has to be stressed that a participation of host supervisors in the approval of central methods is not intended to lead to a hidden multiple supervisory approval work. Supervisory cooperation does not mean that everybody does everything together instead of doing it on his own. It rather means that the overall amount of work is being reduced because some

supervisors accomplish the work for others. This approach will always require mutual reliance between supervisory authorities. In addition, it has to be decided on the question “who does what?” with regard to supervisory approval work. These considerations emphasise the importance of the materiality/cooperation-categorisation concept sketched in this paper.

Returning to the division of local and central methods, it is obvious that in practice it will not be easy to draw a line between these two methods in each particular case. Central methods may be altered or supplemented by local elements and vice versa. In those cases an efficient approval process has to be found via bilateral contacts. This means that on the one hand the sketched central/local concept with the respective roles of home and host supervisors should be followed while on the other hand it may be beneficial to deviate from this concept in certain constellations.

3.2.2 Approval of implementation of risk measurement methods

The second element in the initial approval process is the implementation of risk measurement methods (both: locally and centrally developed) within the banks. In this regard, BaFin and Bundesbank think that in general the respective legally responsible host supervisor should lead the supervisory approval work. This basic principle takes into account the fact that the legally responsible supervisory authority is in charge of the ongoing supervision of this banking entity and therefore has a legitimate interest in knowing the entity in-depth. In addition, this host supervisor (the home supervisor in the case of the parent institution) is permanently watching this banking entity and therefore can more easily decide whether the risk measurement methods are implemented appropriately. Furthermore, the competition argument promotes this concept since the host supervisor also is responsible for examining the implementation of risk measurement methods in the domestic banks that do not have foreign parent companies.

The supervisory approval of the implementation of risk measurement methods in a bank comprises mainly the bank’s use test, the integration of methods in the processes of the bank, its support by the bank’s IT infrastructure, the control

environment, the adaptation of central models to local conditions (where applicable), the appropriateness and quality of data, the overall consistency of methods used, etc.

While the relevant host supervisor will usually lead the supervisory approval work (cooperation categories 4 and 5) of all these areas, BaFin/Bundesbank would always have an interest in actively participating in this work, especially if issues are concerned that are important from a group's perspective.

3.3 Information sharing

Note: the information sharing strategy depicted here exclusively refers to information concerning a banking group's implementation of Basel II methods under pillar 1 and the approval hereof. It does not refer to information sharing in the context of ongoing prudential supervision.

Information sharing is a central element in home/host cooperation. As stated earlier, the permanent exchange of relevant information between the supervisory authorities involved is an important measure to promote mutual reliance and therefore it is a key element for promoting efficiency of supervision.

In line with the guidance from Basel and Brussels, BaFin/Bundesbank think that the scope of information shared between supervisors involved in the supervision of a banking group should be linked to the cooperation category of these supervisors. If information sharing surpasses a certain level it does not increase efficiency of supervision any further but rather leads to a decrease. Therefore, an information sharing arrangement has to be found that reflects this fact. Consequently, depending on their roles, not all host supervisors are likely to stay involved in the permanent information exchange. This does not mean that host supervisors of cooperation category 1 will not receive any information at all. Instead, BaFin/Bundesbank intend to provide these host supervisors either regularly or upon request with aggregated information about the current status of the approval work.

In accordance with the Basel/Brussels guidance, BaFin/Bundesbank think that they should play a leading role with regard to the collection and distribution of information about the Basel II implementation efforts of both the banking group and its supervisory authorities. In order to reduce supervisory burden on the banking group resulting from multiple information requests, host supervisors should ask BaFin/Bundesbank for information before they approach banking entities.

BaFin/Bundesbank and host supervisors should also start sharing information about the banking group's rollout plan that constitutes the basis for the planning of supervisory cooperation. Also, it would be of great benefit to efficient cooperation if all relevant supervisors provided BaFin/Bundesbank with information about approval work planned or already accomplished. In addition, information about the supervisor's implementation approach towards Basel II, like timelines, application packages, etc. are of interest for all supervisors involved and should therefore be disseminated by BaFin/Bundesbank.

Question to attending host supervisors:

To what extent do involved host supervisors think the ideas described in sections 3.2.1, 3.2.2. and 3.3. should be applied in supervisory practice? Can involved host supervisors think of cases that are not covered by this concept?

4. Additional issues

- BaFin/Bundesbank think that in cases where home/host cooperation is documented in written form, this written documentation should not take the form of MoUs because of their very formal nature. Negotiating an MoU with every host supervisor would simply be too time consuming in the cooperation context and it cannot be adapted quickly to changing conditions, either. Rather than MoUs, minutes of supervisory meetings could form the basis for supervisory cooperation. If the supervisory authorities involved agrees on the minutes of the meetings they would be binding for the supervisors involved while still remaining a flexible tool to react promptly to new situations.

- Host supervisors of the categories 4 and 5 should provide BaFin/Bundesbank with a list of their requirements with regard to the approval work they will lead. BaFin/Bundesbank will then submit these requirements together with their own application package requirements to the bank. Once the banking group submits an application, a copy of this application will be sent to the respective host supervisor. It can then check compliance with its requirements in order to determine whether the quality of the application package is sufficient to be accepted.
- It is BaFin/Bundesbank's view that it is not possible to determine in detail beforehand which particular authority will perform what kind of supervisory activity throughout the whole approval process. These details will rather be finally decided in the course of the actual approval process. Nonetheless, supervisory authorities should start working out their cooperation arrangements in as detailed as possible and adjust them in the course of time to the changing conditions and the increasing level of detail.