

Nout Wellink: A new regulatory landscape

Remarks by Mr Nout Wellink, President of the Netherlands Bank and Chairman of the Basel Committee on Banking Supervision, at the 16th International Conference of Banking Supervisors, Singapore, 22 September 2010.

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Introduction and background

Good morning and welcome to the 2010 International Conference of Banking Supervisors. I will start by thanking our host – the Monetary Authority of Singapore. I would like to thank in particular MAS Managing Director Heng Swee Keat and his deputy, Teo Swee Lian, and the staff of MAS for doing a marvellous job of organising and hosting this ICBS.

It has been two short years since we last met in Brussels at the 2008 ICBS. In my opening remarks at that conference, I used the occurrence of storms and the need to build strong dikes as metaphors for the financial crisis and the need for a strong supervisory response. This morning I will reflect on our response to the recent financial storm, which is designed to protect against future crises.

Consider the extraordinary financial landscape around the time of the last ICBS. In September 2008 alone:

- Lehman Brothers declared bankruptcy,
- the other large US investment banks converted to bank holding companies,
- Fannie Mae and Freddie Mac were nationalised,
- AIG was brought back from the brink of collapse,
- Fortis, the financial conglomerate, was broken up and sold,
- Iceland's largest commercial bank – and subsequently the banking system – collapsed, and
- many countries had to step in to provide massive support to their banks.

This was the height of the crisis. Since then, the financial and banking system have been stabilised and we are on the road to recovery. But this has come at a high cost: many government budgets have been stretched due to massive amounts of official sector support. There was a fundamental spillover from the financial crisis to the real economy. This resulted in lost wealth and a loss of jobs. It is not yet over and risks remain.

While painful and costly, the crisis has nonetheless presented an opportunity to put in place longer term reforms that are needed to make banks and the financial system more resilient to future periods of stress. The Basel Committee has been at the core of this reform agenda, which was crystallised at the G20 Leaders summit last year in Pittsburgh.

Last year we also expanded our membership by doubling in size to 27 jurisdictions. We have benefited immensely from this broadened membership, both in terms of wisdom and legitimacy.

This morning I would like to describe ways in which the Committee has responded to this financial storm and to prepare for the next storm. I will start first by talking about the Committee's *bank-specific reforms*, the goal of which is to make banks more resilient to shocks. But a bank-specific approach is not enough. The Committee is also addressing system wide risks and I will also say a few words about this.

Making the banking system more resilient

The core of our bank-specific reforms is stronger capital and liquidity regulation. The Basel II framework was bolstered significantly in July 2009 and the Committee's December 2009 proposals, which were signed off on in September, will further strengthen existing Basel II capital treatments. In other respects, the December 2009 proposals introduced global standards where none currently exist (eg a leverage ratio and liquidity requirements). Collectively, the revised Basel II capital framework and the new global standards have been commonly referred to as "Basel III".

With the benefit of hindsight, pre-crisis capital standards were too weak for the types of risks that were building up in the system. Keep in mind that the effects of the crisis became manifest in 2007 and built-up prior to the implementation of Basel II. Many countries that have adopted Basel II did so in 2008 or later. So this was not a Basel II crisis.

The deficiencies leading to the crisis were numerous and attributable to many. This includes bankers, investors, rating agencies and supervisors. From the regulatory perspective, the main inadequacy related to the level and quality of capital. Instead of 8% of hard capital backing risks, many banks typically held 2%. And if you consider that regulatory adjustments, such as goodwill, are deducted from Tier 1 or Tier 2 capital, then it was possible for banks to have even lower levels of tangible common equity.

The set of capital rules governing trading book exposures was another regulatory deficiency. Banks had built up massive illiquid credit exposures in these portfolios. The VAR-based capital regime, with its 10-day liquidity horizon was not designed for this. Banks abused this regime, and warehoused highly illiquid, structured credit assets in the trading book for which there was no market, which were impossible to value when liquidity broke down, and for which too little capital was held to protect against risks. This is where the first wave of losses hit.

These were two important deficiencies but there were others, like liquidity. Many banks relied excessively on wholesale funding to finance securitised, illiquid assets. In addition, there were poor incentives and governance at the firm level along with a lack of transparency, which made it nearly impossible to understand a bank's exposures or the quality of the capital backing them.

So what has the Committee done in response? First, we have strengthened the capital base. Raising the quality, consistency and transparency of the capital base has been one of the primary objectives of the Committee's reform programme. Overall, these rules that will govern the capital structure represent a substantial strengthening of the definition of capital. By itself, the new definition of capital is a significant improvement to the global capital regime, which will be enhanced further by better risk coverage, the introduction of buffers and higher minimum capital requirements. On top of this comes the higher level of capital.

In addition to raising the quality of the capital base, the Committee has improved risk coverage of the regulatory framework and more improvements are on the way. Our goal is to ensure that all material risks are captured. During the crisis, many risks were not reflected in the risk-based regime. The Committee has substantially strengthened the rules that govern capital requirements for trading book exposures as well as for complex securitisations and exposures to off-balance-sheet vehicles. The revised trading book framework, on average, requires banks to hold around three to four times the old capital requirements. We are now finalising rules that will strengthen the capital requirements and risk management standards for counterparty credit risk.

An additional element to the regulatory capital framework is a leverage ratio, which will serve as a backstop to the risk-based capital requirement. In the lead-up to the crisis, many banks reported very strong Tier 1 risk-based ratios while, at the same time, managed to build up high levels of on- and off-balance sheet leverage. The use of a supplementary leverage ratio will help contain the build-up of excessive leverage in the system. It will also serve as an

additional safeguard against attempts to “game” the risk-based requirements and will help address model risk.

In July, the Committee’s oversight body of Governors and Heads of Supervision agreed on an indicative calibration of 3% as a minimum for the leverage ratio to be tested during the parallel run period, with a view to be implemented on January 1st, 2015. For global banks with significant capital markets activities, this 3% calibration is likely to be more conservative than the current measures of leverage in place in some countries. The new definition of capital and the inclusion of off-balance-sheet items in the calculation of the leverage ratio are the main factors.

The reform measures described above radically transform the regulatory capital framework. The Committee’s proposed liquidity framework will have as profound an effect since a global liquidity standard does not currently exist.

During the crisis, funding remained in short supply for an extended period. In response, the Committee has proposed global minimum liquidity standards to make banks more resilient to potential short-term disruptions in access to funding and to address longer-term structural liquidity mismatches in their balance sheets. The Liquidity Coverage Ratio (LCR) will require banks to have sufficient high-quality liquid assets to withstand a 30-day stressed funding scenario that is specified by supervisors. This is complemented by the Net Stable Funding Ratio (NSFR), which is a longer-term structural ratio designed to address liquidity mismatches.

Introducing a new set of standards is a complex process. Unlike the capital framework, for which extensive experience and data help inform calibration, there is no similar track record for liquidity standards. The Committee is therefore taking a carefully considered approach to the design and calibration and will review the impact of these changes to ensure that they deliver a rigorous overall liquidity standard. It will introduce the LCR as a minimum standard in 2015 after thoroughly assessing its behaviour. In a similar way, the Committee will also carry out an “observation phase” to address any unintended consequences across business models or funding structures before finalising and introducing the revised NSFR as a minimum standard by 1 January 2018. The Committee will revise the NSFR by the end of this year and will test it during the observation phase.

These initiatives – higher and better quality capital, improved risk coverage, introduction of a leverage ratio and new global liquidity standards – are the foundation for the Basel Committee’s response to the crisis. But they are not the whole story. The Committee has also developed supervisory guidance on other important bank-specific initiatives. These include stress testing, valuation, corporate governance, compensation, supervisory colleges, and high level principles for financial instruments accounting.

Addressing systemwide risks

While stronger individual banks typically lead to a stronger banking system, this firm-specific approach by itself may not be sufficient. Broader macroprudential measures to address procyclicality and to strengthen the resilience of the entire banking system are equally important. A systemwide focus addresses problems related to interconnectedness and the perception that some banks are too big to fail.

An essential element in addressing systemwide risk is the build up of buffers in good times that can be drawn down in periods of stress. To help achieve this, the Committee has introduced a capital conservation buffer. As a bank’s capital levels move closer to minimum requirements, the conservation buffer will impose a constraint on its discretionary distributions. These include dividend payments, share buybacks and bonuses. Retaining a bigger proportion of earnings during a downturn will help ensure that capital remains available to support the bank’s ongoing business operations and lending during the period of

stress. This buffer of 2.5% will be comprised of common equity and will be fully phased in by the end of 2018.

In addition, the Committee in July 2010 issued a proposal for a countercyclical buffer which would be imposed when, in the view of national authorities, excess aggregate credit growth is judged to be associated with an excessive build-up of system-wide risk. The countercyclical buffer would increase the conservation buffer range by up to an additional 2.5 percentage points during such periods of excess credit growth. Conversely, the buffer would be released when, in the judgment of the authorities, the released capital would help absorb losses in the banking system that pose a risk to financial stability. This would help reduce the risk that available credit is constrained by regulatory capital requirements. Taken together, this framework of buffers is intended to increase banking sector resilience and mitigate procyclicality.

The use of “gone concern” contingent capital would increase the contribution of the private sector to resolve future banking crises, thereby reducing moral hazard. The Committee recently published a proposal for consultation based on a requirement that the contractual terms of capital instruments will allow them – at the option of the relevant authority – to be written off or converted to common shares if the bank is judged to be non-viable by the relevant authority. The potential role of “going concern” contingent capital in the capital framework is also currently under review. The objective here is to decrease the probability of banks, or the banking system as a whole, reaching the point of non-viability.

Several initiatives discussed above will help reduce procyclicality. These include the leverage ratio, capital conservation buffer and countercyclical capital buffer. In addition, the Committee is reviewing different approaches to address any excess cyclicality of the minimum capital requirements. It has also developed a concrete proposal to operationalise an expected loss approach to provisioning that was proposed by the IASB.

While procyclicality amplified shocks over the time dimension, excessive interconnectedness and the too-big-to-fail issue also transmitted shocks across the financial system and economy. Work on this topic is ongoing. The Committee and the Financial Stability Board are developing a well integrated approach to systemically important financial institutions. This could include combinations of a capital surcharge, bail-in debt and contingent capital.

Many of the Committee’s reform measures also help address risks that originate or concentrate outside of the banking sector. For example, the Committee’s July 2009 Basel II enhancements specifically addressed risks related to securitisations, resecuritisations and off-balance-sheet exposures (eg structured investment vehicles). In addition, the limitation established by the leverage ratio, which takes account of off-balance-sheet exposures, and the measures to improve both the risk management and capitalisation of counterparty credit risk, will also play important roles. Moreover, a heightened sensitivity to financial innovation and the regulatory perimeter, a renewed focus on consistent and timely implementation, as well as more rigorous supervision will help safeguard against risks arising from or concentrating in a non-banking sector.

Conclusion and the road ahead

In all, the Committee has taken major steps to move the banking system to a much higher level of resilience. If, prior to the crisis, banks had the levels of capital we are asking for, we likely would not have experienced such a deep crisis.

Let me be clear, the current standards are extremely demanding. Before we even raise the level of capital, we have introduced a much stricter definition of capital. This is equivalent to a substantial increase in the minimum requirement by itself. In addition, we have raised the capital requirement for trading, derivatives, and interbank exposures by a substantial amount. Finally, we have increased the amount of common equity that banks need to hold from 2% to 7%. To help illustrate this point, for many global banks, a 7% requirement is

substantially higher than the same number under the old standard, as one must factor in both the effect of regulatory adjustments to common equity and the higher risk-weighted asset requirements for trading and counterparty exposures.

This is a *fundamental* improvement in addition to the other improvements I have mentioned and the Committee has taken full account of the potential impact. It has conducted a comprehensive quantitative impact study and other analyses to assess the impact of its regulatory reforms. In August, the Committee and the FSB published a report on the macroeconomic implications of the proposed higher regulatory standards during the transition to these new standards. This report concluded that the transition to stronger capital and liquidity standards is likely to have only a modest impact on economic growth. This report was accompanied by an additional study conducted by the Committee on the long-term economic impact of the new standards, which concluded that there are clear economic benefits from increasing the minimum capital and liquidity requirements from their current levels. These benefits accrue from reducing the probability of financial crises and the output losses associated with such crises.

Indeed, in recognition of this more stringent regime and to support the ongoing recovery, the Committee is keen to provide for a smooth transition. As of 2013 the standards rise each year to their final level at the end of 2018. Over the same period, the leverage ratio and the liquidity standards will also be phased in.

These are minimum requirements. We have said that countries should move faster if their banking systems are profitable and able to do so without having to restrict credit. Banks should not be permitted to increase their distributions if they are still below the ultimate target but feel they can take their time to get there. Banks can meet the new standards through earnings retention, capital raising, or reducing their riskier exposures that are not necessarily associated with the granting of credit to ultimate borrowers.

Will our response to the recent financial crisis be adequate? The answer to this is “yes” but a qualified “yes” as there is much more to be done and the crucial second step of the policy-making process has yet to take place. I refer here to implementation and rigorous supervisory follow up.

We must remember that memories fade quickly. Regardless of how tough the new standards are and how we expect them to increase the resilience of bank and banking systems, they must be effectively implemented and enforced. Moreover, our standards need to keep pace with financial innovation.

We have provided a road to a much safer banking system. When we meet again in two years, it is my hope that the banking sector and broader economy will be well along towards greater resilience.

Thank you very much for your attention.