Stefan Ingves: From ideas to implementation

Remarks by Mr Stefan Ingves, Governor of the Sveriges Riksbank and Chairman of the Basel Committee on Banking Supervision, at the 8th High Level Meeting organised by the Basel Committee on Banking Supervision and the Financial Stability Institute and hosted by the South African Reserve Bank, Cape Town, 24 January 2013.

As prepared for delivery.

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Introduction

Let me begin today by thanking Josef Tošovský, Chairman of the Financial Stability Institute, for organising the latest in its series of High Level Meetings. The Basel Committee continues to view these events as extremely important, as they bring together senior policymakers and supervisors in a forum in which we can share thoughts on critical issues of the moment and reflect on long term challenges. Let me also extend my thanks to the South African Reserve Bank for its superb hospitality as the annual host of this High Level Meeting.

Change and reform – new ideas and new ways of doing things – can be challenging in good times. When all is well, the perceived need is low and the costs – including opportunity costs – are difficult to justify. Even small ideas can be difficult to implement. Crises, on the other hand, provide a catalyst for fundamentally rethinking past practices. Many banks have learnt this as a painful lesson in recent years: when times were good, potential operational, risk management and cultural deficiencies were not examined closely enough. When serious problems emerge, however, there is a demand for new ideas and new ways of doing things: the status quo becomes unacceptable.

Of course, the same scenario has applied to the regulatory framework more broadly. Pre-crisis, any call for stronger capital and liquidity rules was generally howled down as burdensome and unnecessary. Post-2008, the costs of a weak regulatory framework have been all too obvious and painful for the banking sector, and as a result the demand for new ideas was immediate and forceful.

My theme for today is that successful regulatory reform is about ideas *and* implementation. Certainly, we needed to rethink the regulatory framework in light of what we have learnt from the past five years – the status quo was not acceptable. But if we want to be successful, the Committee also needs to make sure that the ideas we developed into Basel III are truly put into practice.

From ideas ….

The Basel Committee's response to the financial crisis was to recognise that policy weaknesses contributed to the excesses that built up in the financial sector. A substantial overhaul was necessary: minor adjustments to the framework were not going to be enough. We needed some big, new far-reaching ideas. In summary, we decided that it was necessary to:

- require banks to maintain *substantially higher levels of capital*, with the minimum common equity requirement increasing from 2% to 7% of risk weighted assets;
- require banks to hold *higher quality forms of capital*, with common equity at the core of the requirements, and standards to ensure other types of capital instruments are truly loss-absorbing. It is worthwhile emphasising that these reforms also go a long way to simplifying banks' capital structures, as well as making them more transparent and comparable;

- introduce an *additional capital buffer* (the capital conservation buffer) designed to enforce corrective action when a bank's capital ratio deteriorates. The capital conservation buffer allows banks to dip into their capital reserves, while at the same time providing disincentives for banks to do so due to the restrictions it imposes on dividend and bonus payments;
- add *a macroprudential element* in the form of the countercyclical buffer, which requires banks to hold more capital in good times to prepare for inevitable downturns in the economy;
- supplement the risk-based regime with *a simple backstop* in the form of a (non-risk-based) leverage ratio;
- impose *additional capital requirements on systemically important banks* – both global and domestic – to take account of the externalities their failure would impose on society; and
- introduce the first *international standards for bank liquidity and funding*, designed to promote the resilience of a bank's liquidity risk profile to both short term liquidity shocks (the Liquidity Coverage Ratio – LCR) and longer-term mismatches in funding (the Net Stable Funding Ratio – NSFR).

Of course, there are plenty of other big ideas being floated on how the banking industry should be restructured in the aftermath of the crisis, particularly those related to varying models of structural separation (eg the ideas of Volker, Vickers and Liikanen). But for those that fall within the mandate of the Basel Committee, we believe that the ideas produced by Basel Committee thinking – translated into the Basel III reforms, and subsequently endorsed by the G20 and Financial Stability Board – provide a substantial foundation on which the banking system can be rebuilt to be much more robust and resilient in the future.

Basel III capital requirements are probably well known to all of you, so I do not propose to say much more about them today. What I would instead like to focus on is our thinking in relation to liquidity, and particularly the LCR. As an idea, it is simple: a bank should have enough liquid assets to survive a 30-day period of stress. And perhaps to some, it might seem underwhelming. If you tell your spouse that we have implemented a reform that requires banks to have enough cash to last 30 days, more than likely you will get the same response I did when I tried to explain it to my wife: "what do you mean, *only* 30 days?"

Yet this idea has been one of the most fundamental reforms of the crisis. It also is a classic example of an idea that had been toyed with for a long time, but took a crisis to bring to fruition. A study of Basel Committee history shows liquidity to have been on the agenda almost for the entire existence of the Committee, but we have never come close to an international standard. Basel III has changed that. So even though the LCR is "*only* 30 days of cash", its significance should not be underestimated.

As you would be aware, the focus of the Committee over the past two years has been on refining the formulation of the LCR announced in 2010. Given this is the first time the international community had developed a global liquidity standard, it was agreed that it should be subject to an observation period, during which it could be adjusted as a result of further analysis and assessment. The aim of the observation process was not to further tighten or weaken the standard: the goal was purely to ensure the calibration was more reflective of empirical evidence and appropriate for implementation as a minimum standard, across the Committee's 27 member countries and more broadly.

The changes agreed to by the Committee focus on three main areas:

- High quality liquid assets (HQLA): A diverse and sufficiently large stock of HQLA is essential to help banks withstand liquidity stress. The revised definition now provides limited recognition of additional assets such as a broader range of corporate bonds, a selection of listed equities, and some highly-rated residential

mortgage backed securities (RMBS). Recognising the greater price volatility associated with such assets, their inclusion in the stock of HQLA is subject to a relatively low limit as well as significant "haircuts". The Committee has tried to balance the benefits of greater diversification of the liquidity pool against the cost of including slightly lower quality assets.

- We have also changed some of the assumed inflow and outflow rates that determine the size of the pool of liquid assets that a bank is required to hold.
- As in the case of the capital conservation buffer, the standards now make very clear that liquidity is to be built up and maintained in good times so that it can be used in times of need. In other words, liquidity is not useful if it is frozen.

In addition, in light of the considerable stress facing banking systems in some regions of the world, the Committee revised the implementation plan of the LCR by introducing a phase-in arrangement. The LCR will come into force as planned in 2015, although banks now will have until 1 January 2019 to meet the standard in full. Nevertheless, I expect many banks will choose to move to the higher standard more quickly.

In announcing the revisions to the LCR, many headline writers categorised it as some kind of win for the banking industry over the regulators. This is simplistic. We had an observation period for good reason: to make sure we got the settings right. There was, I think, legitimate concern that, as a *minimum* standard, the 2010 formulation of the LCR may have been calibrated too conservatively overall. For example, the treatment of traditional retail and commercial banking was probably too harsh, and this has been adjusted. Equally the treatment of derivative-related risks was probably too weak, and so that has been adjusted too. Much has been made of the inclusion of RMBS in the definition of high quality liquid assets, but the eligibility criteria are tight and the initial perception that the Committee had granted *carte blanche* to the securitisation sector is well wide of the mark. As the Chairman of the Basel Committee's governing body, Governor King of the Bank of England, said when announcing the full set of changes, they are designed to make the LCR "more realistic". I think this sums it up very well.

Of course, the overall impact of the changes is to improve the reported LCR of the banking system. Based on our most recent data (end June 2012), we estimate that the weighted average LCR for a sample of roughly 200 of the world's largest banks is around 125%, compared with a little over 100% for the previous calibration. This does not mean, however, that all banks are ready and able to meet the standard today. Even though the industry average is well above the minimum, our estimates suggest that roughly one-quarter of our sample could still have an LCR below 100% even with the latest policy changes. So there remains a significant liquidity shortfall that will need to be addressed by a number of banks. One also has to bear in mind that favourable terms from central banks have helped to improve bank funding. Central banks serve as lenders of last resort and, as economic conditions improve, banks will need to become more self-reliant. However, the timetable for the gradual introduction of the ratio ensures that the new liquidity standard will in no way hinder the ability of the global banking system to finance a recovery.

It has taken a lot of time and effort to reach agreement on the LCR. It is, as I said, a deceptively simple idea, but its implications are big and far-reaching. Unsurprisingly, there is much in the detail that required a lot of careful analysis and thought, not to mention a willingness to find a way through differing national perspectives. It is, however, critical that the new ideas such as the LCR (and the other new features of Basel III such as the capital conservation buffer, countercyclical buffer, leverage ratio and NSFR) are implemented if their benefits are to be realised. Against that background, let me now turn to the work we have started to ensure that the Basel III framework is implemented as intended.

…. to implementation

Steady progress is being made. As of January 2013, 11 out of 19 Basel Committee jurisdictions have final Basel III rules in place, including our hosts today, South Africa. A number of non-member countries also implemented Basel III at the beginning of the year, further expanding its coverage. While it would be ideal to have much broader coverage at this time (as at today, around one-third of global banking assets are officially subject to the Basel III requirements), the delays should not be interpreted as any lack of commitment by global regulators to implement the agreed reforms. At recent international gatherings, all members have been asked to reaffirm their commitment to implementing the agreed reforms as soon as possible. And they have given that commitment (subject, of course, to the vagaries of domestic rule-making processes that each must follow). Nevertheless, let me be clear: the question being discussed is *when* the reforms will be implemented, not *if*.

Any setback to implementation is undesirable, since Basel III is a key platform on which to rebuild a stronger global banking system. But the delays are not critical at this point, for two reasons. First, the Basel III capital rules contain a lengthy phase-in period, meaning that in 2013 the new requirements should not be particularly burdensome for banks (eg none of the new deductions from capital are applied this year). Second, many regulators who have been unable to implement the new standards by the beginning of this year are still measuring and monitoring their banks' capacity to meet the new requirements. And, of course, markets are applying similar pressure. In other words, the "force" of the new capital regime is much broader than just those countries that have implemented their domestic regulations.

Nevertheless, to ensure visibility of the implementation of reforms, the Basel Committee has been regularly publishing information about members' adoption of Basel III. We will continue to do this so as to keep all stakeholders and the markets informed, and to maintain peer pressure where necessary. It is especially important that jurisdictions that are home to global systemically important banks (G-SIBs) make every effort to issue final regulations at the earliest possible opportunity.

But simply issuing domestic rules is not enough to achieve what the G20 Leaders asked for: full, timely and consistent implementation of Basel III. In response to this call, in 2012 the Committee initiated what has become known as the Regulatory Consistency Assessment Programme (RCAP). The regular progress reports are simply one part of this programme, which assesses domestic regulations' compliance with the Basel standards, and examines the outcomes at individual banks. The RCAP process will be fundamental to ensuring confidence in regulatory ratios and promoting a level playing field for internationally-operating banks.

It is inevitable that, as the Committee begins to review aspects of the regulatory framework in far more detail than it (or anyone else) has ever done in the past, we will find aspects of implementation that do not meet the G20's aspiration: full, timely and consistent. We are going to find parts of the framework that have been implemented only in part, or late, or inconsistently. The financial crisis identified that, like the standards themselves, implementation of global standards was not as robust as it should have been.

This could be classed as a failure by global standard setters. To some extent, the criticism can be justified – not enough has been done in the past to ensure global agreements have been truly implemented by national authorities. However, just as the Committee has been determined to revise the Basel framework to fix the problems that emerged from the lessons of the crisis, the RCAP should be seen as demonstrating the Committee's determination to also find implementation problems and fix them.

It would be easy to continue to ignore any problems. A fascinating[1] history of the Basel Committee published recently by Professor Charles Goodhart[2] notes that the Committee has on more than one occasion over the past 35 years considered undertaking more detailed analysis of domestic implementation of global standards, but shied away from this as being "too intrusive". However, we have now taken that step, since if we are serious about fixing the problems of the past, then we need to not just look at the policy settings, but also their application. Our efforts on implementation should therefore be seen as an integral part of the reform agenda – not just an adjunct to it.

When it comes to our country-by-country assessments, thus far the Committee has conducted detailed assessments of the final regulations adopted in Japan, and the draft regulations in the European Union and the United States.[3] Follow-up assessments in the European Union and United States will be conducted once final regulations are available. Assessments under the RCAP are currently underway for Singapore and Switzerland. Later this year will follow China, Australia, Brazil and Canada. As with all of the RCAP work, transparency is critical to success – all of these reports will, of course, be published in full when complete.

It is important to note that, in undertaking this work, the Basel Committee has no enforcement power, so it would be meaningless to think we can force jurisdictions to change their local regulations if we find gaps. Our goal is therefore framed more positively: to deepen the implementation process and to *help* jurisdictions identify the gaps and address them. Ideally, the assessments provide a roadmap by which identified gaps can be closed. They also provide stakeholders and markets with a much higher degree of transparency about the extent of any local divergence from agreed international standards, and the importance of these. In this way, we believe we will establish the appropriate incentives for local rule-makers to apply the global standards, and for markets and others to apply appropriate pressure where banks may be subject to weaker-then-expected prudential requirements.

More consistent domestic regulations will be an improvement. But beyond looking at how local regulators have transposed Basel agreements into domestic regulations, the Committee has also begun examining whether the framework(s) are producing consistent *outcomes*. Ultimately, what counts is that the capital ratio calculated and reported by individual banks provides a *meaningful* and *comparable* representation of their capital strength. Differences in regulation, or their application, can undermine the regulatory framework by making it more difficult for bank depositors, counterparties, investors, shareholders and supervisors to have confidence that reported capital ratios serve their intended purpose.

In this context, some concerns have been recently voiced that banks are not calculating risk weighted assets consistently. The Committee has, in fact, been investigating this issue for much of the past year. This work has examined the calculation of risk weights in both the banking and the trading books. As with our country assessments, we will publish the results of both studies.

The preliminary results of the trading book are most advanced, and will be published very shortly. The analysis is based on two sources of data: public disclosures by banks and a hypothetical test portfolio exercise in which 15 large, internationally active banks have participated from nine Basel Committee jurisdictions. I will not pre-release the detailed results today, but the headline messages are that:

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[1] At least, fascinating for regulatory aficionados.

[2] See C Goodhart, *The Basel Committee on Banking Supervision, A History of the Early Years 1974–1997*, Cambridge University Press, 2011

[3] The Level 2 reports on the European Union, Japan and the United States can be found at the website of the Basel Committee (www.bis.org/bcbs/index.htm).

- there is a material variation in risk weights for trading assets across banks (after adjusting for accounting differences and for differences in the riskiness of different bank portfolios);
- certain modelling choices seem to be major drivers of the variation in risk weights; and
- the quality of existing public disclosure is generally insufficient to allow users to determine how much of the variation in reported risk weights is a reflection of underlying risk taking, and how much stems from other factors (eg modelling choices, supervisory discretions).

In thinking about these results, it needs to be borne in mind that the objective is not to achieve zero variation. If we wished to achieve that outcome, we could simply force all banks onto the standardised approach to capital adequacy and remove any modelling options. But the standardised approach – while an ostensibly consistent methodology – would not necessarily guarantee a meaningful measure of risk when applied to the world's largest banks with the biggest and most complex trading portfolios. Modelling necessarily introduces a degree of variability, since Basel standards deliberately allow banks and supervisors flexibility in order to accommodate for differences in risk appetite and local practices, but with the goal of also providing greater accuracy. Further, from a financial stability perspective, it is desirable to have some diversity in risk management practices so as to avoid that all banks act in a similar way. When banks would have identical response functions, economic cyclicality would increase, potentially creating additional instability.

At the same time, excessive variation in risk measurement is clearly undesirable. Finding the right balance is the key. The preliminary work suggests we may not have the balance right in the current set-up. But as with all of our work on implementation, it is necessary to identify problems before we can set about correcting them.

The on-going analysis has generated a wealth of information about risk modelling by banks. This is useful for international policymakers. The Committee has not yet decided what actions it might take in response to the analysis, but some of the possible policy options could comprise improvements in public disclosure practices, limitations in the modelling choices for banks, and further harmonisation of supervisory practices. These ideas will also feed into the current fundamental review of the trading book. In addition, our international study provides national supervisors with a much clearer understanding of how the risk models of their banks compare to those of international peers. This means that national supervisors are much better equipped to discuss the results with their banks and take action where needed.

The Committee will be doing further work on the trading book, in addition to the banking book work, to explore the outcomes in more depth. I am confident that it will generate additional insights in the modelling of risk-weighted assets and to explain better why modelling results differ across banks. It will also allow building quantitative benchmarks against which supervisors can test their banks.

The Committee's work on how banks calculate risk weighted assets also feeds into a broader concern that, in pursuit of risk sensitivity, the Basel III framework has grown too complex. There are many contributory factors to the build-up of complexity, including developments in the financial markets and adoption of sophisticated risk management practices by banks. It is naïve to think banks utilising complex trading strategies and products, across global markets, can be supervised using simple rules (even if calibrated to penal settings). Indeed, an important driver has been the necessity to address perverse incentives that are created by simple rules.

So while seeking appropriate risk sensitivity, care is also being taken to ensure that complexity does not undermine the very benefits it offers. The Basel Committee has also been working during 2012 to review possible areas for simplification, aiming to strike a

careful balance between risk sensitivity/complexity, comparability and simplicity. In the near term, the Committee intends to publish a paper to explain its thinking on the trade-offs that need to be made, and identifying potential ways to make the framework simpler and more comparable.

Conclusion

If there is one message I would like to leave you with it is that, when it comes to reform, ideas and implementation go together.

Much of the Basel Committee's work on big "ideas" that respond to the shortcomings in the regulatory framework identified by the financial crisis is reaching the end stage. The capital rules are set (and, in an increasing number of jurisdictions, coming into force), and the revisions to the LCR have recently been agreed. In 2013, we will seek to set out the specification of the backstop leverage ratio, and the NSFR will be refined between now and the end of 2014. Clearly, we still have work to do, but increasingly it is about getting the technical details correct rather than new far-reaching ideas.

Even when the Committee's policy response to the crisis is complete, much more work will still be needed. Implementation needs to be seen as an integral part of the reform agenda, not a sideline activity. As we examine this issue to a depth that it has not previously been examined, we will inevitably find things that need improvement. Turning a blind eye to these, as may have occurred in the past, is not an option – we need to persevere and find those areas where additional modifications to the regulatory framework are needed to ensure it is effective. If we do not work to improve implementation, we will not embed the reforms into domestic banking systems in the full, timely and consistent manner that is in everyone's interests.