Stefan Ingves: Where to next? Priorities and themes for the Basel Committee

Keynote address by Mr Stefan Ingves, Governor of the Sveriges Riksbank and Chairman of the Basel Committee on Banking Supervision to the Third BCBS-FSI High-Level Meeting for Central and Eastern Europe on "Strengthening Financial Sector Supervision and Current Regulatory Priorities", 12 March 2013.

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Good morning. It is my great pleasure to be with you again today. I would like to begin by extending my appreciation to the Financial Stability Institute and the Banking Supervisors from Central and Eastern Europe for their efforts in bringing us together again for another of these High-Level Meetings. Last year, I was pleased to have been able to be a part of what was a very interesting and enjoyable meeting in Warsaw hosted by our Polish colleagues. I hope we can replicate the success of that event this year here in Basel.

I would like to take the opportunity today to reflect a little on what the Basel Committee has been doing since we last met. Then I will outline work currently in train as well as our longer-term strategic priorities. The Committee meets in this building tomorrow, and continues to have a very full agenda. Indeed, the key message I would like to leave you with is that our work, although changing in nature, shows no signs of easing off.

What have we done?

Before I discuss what's left to do, let me recap what has been done over the past year.

The key initiatives completed by the Committee in the past year include:

- reaching agreement on a package of revisions to finalise Basel III's Liquidity Coverage Ratio (LCR);
- revising the *Core Principles for Effective Banking Supervision*;
- developing a policy framework for dealing with domestic systemically important banks;
- establishing disclosure requirements for the new Basel III definition of capital; and
- updating the supervisory guidance for assessing the effectiveness of a bank's internal audit function.

In addition, the Committee established a sound operating framework within which to assess its members' implementation of Basel III. As a result, the Committee produced:

- two regular semiannual reports on Basel III implementation in all member countries (along with two special reports to the G20 on implementation);
- assessments of Basel III implementation in the European Union, Japan and the United States; and
- a report analysing the variability of risk-weighted asset calculations for market risk in individual banks.

Further down the agenda, my colleagues from the Basel Committee Secretariat will provide additional insights on our implementation work. I would like to make the point now, however, that these efforts are critical to delivering on the benefits that Basel III offers. Rules written have no effect if not implemented: we cannot fail on this front, and I will say more about our efforts shortly.

What are we doing?

There is still a great deal of work being done to finish the Basel III framework. The capital standards are now largely settled, with the exception of some technical work on issues like exposures to central counterparties (CCPs). As I noted earlier, the LCR has also been finalised – albeit again with some final technical details to be resolved. But there are other parts of the Basel framework which we are currently working to flesh out and make operational.

Major projects currently under way include:

- finalising the specification of the leverage ratio, and associated disclosure requirements;
- reviewing the Net Stable Funding Ratio (NSFR), which addresses the longer-term structure of bank debt and complements the short-term focus of the LCR;
- completing the review of the trading book capital requirements. This entails an evaluation of the design of the market risk regulatory regime as well as weaknesses in risk measurement under the framework's internal models-based and standardised approaches;
- enhancing the treatment of securitisations to make capital requirements more prudent and risk-sensitive. We are also reviewing ways to reduce mechanistic reliance on external credit ratings and to reduce current cliff effects in capital requirements;
- strengthening standards to limit excessive and opaque risk-taking through over-the-counter (OTC) derivatives and to reduce systemic risk posed by OTC derivatives transactions, markets and practices. Work on margining requirements, counterparty credit risk and capital for banks' exposures to central counterparties are examples of our efforts related to derivatives; and
- revising the supervisory framework for large exposures to complement the Committee's risk-based capital standard and to help improve banks' measurement and control of large exposures.

All of these projects are necessary to ensure that the regulatory framework adequately factors in the lessons from the financial crisis. The challenge, almost five years on from the height of the crisis, is to ensure that we bring closure to these projects and that they are in place before the next stage of the financial cycle begins.

Underpinning the Committee's policy initiatives is an extensive framework for the collection and analysis of data to help us assess the quantitative impact of a particular policy. Quantitative impact studies (QIS) have become a central element of the Committee's work, and we have a full slate of QIS exercises planned for this year. Alongside the semiannual Basel III monitoring reports, almost all of the policy initiatives I have just mentioned have one or more data collections or impact studies planned. While this can be a burden for banks and supervisors, this hopefully makes for well informed policymaking – so is well worth the effort.

In addition to all of the policy and analytical work, the Committee intends to:

- continue to monitor members' commitments to the timely implementation of agreed reforms. To date, this has focused on capital, but will be expanded over the next year to encapsulate local implementation of the LCR, as well as the frameworks for global and domestic systemically important banks (G-SIBs and D-SIBs), since these come into effect over the next couple of years;
- undertake a full set of implementation assessments for 2013. We will conduct reviews of Singapore, Switzerland, China, Australia, Brazil and Canada. Follow-up

reviews of the European Union and the United States are also planned once their Basel III regulations are finalised; and

- publish a report on the initial, detailed review of risk-weighted asset calculations for the banking book; we hope to publish the full results by the summer. Together with the recently published results on the trading book, this analysis identifies the specific drivers that lead to variations in risk weights for similar exposures. The Committee's next step will then be to consider policy responses to reduce any unwarranted variability and to therefore improve the comparability of banks' ratios.

A theme I will be returning to is the importance of this implementation monitoring work for the Committee. While it is a relatively new component of the Committee's mandate, it should not be seen as an adjunct to the Committee's standard-setting role. Rather, it is absolutely critical to successfully delivering desired policy outcomes.

Where to next?

As you can see, the Committee is engaged in a variety of projects that require us to combine the efforts and input of regulators and supervisors across a large number of countries. This is a challenging task. An even greater challenge, however, is prioritising among competing projects to achieve our most pressing objectives. The Committee's response to the financial crisis has been strong, but there is still much to accomplish. So we have recently spent some time identifying our key strategic priorities, to make sure we have a good means of deciding what we really must do. As you may have seen, these priorities were endorsed by the Group of Governors and Heads of Supervision (GHOS) at the same time they endorsed and announced the revisions to the LCR.

The Committee's primary focus in the short and medium term is ***completing and embedding*** the full suite of responses to issues that emerged from the financial crisis. With that in mind, foremost consideration will be given to five priority areas:

1. completing the crisis-initiated reforms of the policy framework;
2. monitoring and reinforcing the implementation of Basel regulatory standards;
3. assessing the impact of, and industry response to, implementation of the regulatory reforms;
4. examining the comparability of model-based internal risk weightings and considering the appropriate balance between the simplicity, comparability and risk sensitivity of the regulatory framework; and
5. enhancing the effectiveness of both micro- and macroprudential supervision.

Completion of the crisis-initiated reforms of the policy framework

As I have already highlighted, the policy reforms initiated in response to the financial crisis are not yet complete. While the basic frameworks for risk-based capital and, more recently, liquidity are now largely settled, many of the other reforms I noted earlier remain very much a work in progress. To ensure that the weaknesses in the regulatory framework brought to light by the financial crisis do not persist for any longer than necessary, the Committee is aiming to have much of this work completed by the end of 2014. This is an ambitious target, but given the importance of these reforms, there is no basis for unnecessary delay.

Our plan is for the leverage ratio work – which is largely devoted to the detailed specification of the exposure measure (ie the denominator) of the ratio – to be largely completed this year, while the NSFR, trading book, securitisation and large exposures policy work will be finalised in 2014. The Committee also has two other major policy initiatives that it plans to launch soon. While not obviously thought of as immediate and essential responses to the financial crisis, they are nevertheless quite important for ensuring that the overall prudential framework remains robust, and existing reforms are effective. These projects are:

- a review of the standardised (credit and operational risk) approaches to capital adequacy, which need to be re-examined in light of calls for greater simplicity and comparability in the regulatory framework as well as the desire to reduce the reliance on credit rating agencies if possible; and
- an examination of the need for a capital framework for interest rate risk in the banking book, particularly given the desire to limit arbitrage opportunities between the trading and banking books.

These last two projects are still at an embryonic stage, so I cannot say too much about what they might entail at this point in time, but they will be the last pieces in what has essentially been a complete overhaul of the regulatory framework since the financial crisis.

Monitoring and reinforcing implementation of Basel regulatory standards

As I have already said, the establishment of the implementation monitoring programme has been a high priority for the Committee; it is critical to the successful delivery of the benefits of the agreed reforms. Starting from scratch at the beginning of 2012, a comprehensive assessment framework has been developed that is growing in its acceptance and credibility, and I am pleased to report that the Committee now has dedicated capacity in the area of implementation work.

The implementation framework is being continuously strengthened through a lessons-learned process. Our goal is to take a more holistic view on the implementation process by focusing not only on the existence of a regulatory framework but also on its functioning. The implementation process is also envisaged to be closely linked to the ongoing policy development process, creating a positive feedback loop that can help strengthen the regulatory regime.

There is no doubt that this new monitoring and assessment initiative has already had a positive impact. As a result of the regular monitoring of how countries are tracking against agreed deadlines, as well as the forthcoming country assessments, member jurisdictions regularly approach the Committee about specific aspects of the Basel framework, actively seeking to ensure that their local adoption of the Basel rules would not be inadvertently out of line with the spirit of the agreement. Jurisdictions have also brought forward the release of their rules to ensure that their progress was captured in the periodic updates that the Committee has provided to the G20 and made public. The self-assessment responses undertaken for the assessment process are also benefiting the implementation process. In addition, the assessments of drivers that lead to variation of banking and trading book risk-weighted assets are continuing and are to likely lead to both more consistent implementation of existing rules, and the development of policy options to address identified areas of weakness.

The priority for the Committee now is to build on these achievements in monitoring regulatory compliance with Basel standards and to continue to enhance the rigour of all aspects of the implementation monitoring and assessment process. There is a very full agenda planned for 2013 and beyond which will deliver quite a number of new monitoring requirements (such as rules relating to liquidity, the leverage ratio and G-SIBs), as well as country and thematic assessment reports. It is a credit to member jurisdictions, and evidence of their commitment to the process, that this work can be undertaken: first, it requires the willingness of each member to be subject to review by their peers, and then a continuing strong commitment, including substantial resourcing of expert staff, from all involved. Nevertheless, the effort will be well worth it if we achieve our objective of consistent implementation of the Basel standards.

Assessing the impact of, and industry response to, the implementation of the regulatory reforms

The major reforms that have been developed by the Committee, coupled with those being introduced at the domestic level, are designed to fundamentally reshape banking. The reforms are intended to generate a more resilient financial system, in which higher levels of capital and liquidity are held, and in which risk is appropriately managed and priced. This will obviously have consequences for the costs of financial intermediation, although studies undertaken suggest that this cost is both relatively small, and considerably outweighed by the benefits of increased financial stability.

Nevertheless, this is not a case of "set and forget". The Committee is mindful of two potential consequences from the programme of reforms.

While a degree of deleveraging and increased risk premia are intended consequences of the reforms, there is always a danger that some unintended consequences may arise. The Committee needs to continue to undertake monitoring exercises to ensure that it responds when truly unintended consequences materialise; we understand fully that, if left unattended, they will serve to undermine support for the reform agenda. However, we also need to avoid using this as an excuse to delay necessary reforms; to the extent there are unintended consequences, we need to see how they can be addressed without losing the reform benefits.

A second potential consequence relates to the incentives that may arise as the banking sector adapts to the reforms by moving into those businesses where risk-adjusted (regulatory) returns are greatest. This reshaping of banking (either within bank balance sheets or outside the regulated banking system) needs to be monitored on an ongoing basis for the Committee to maintain a robust regulatory framework in light of the evolving nature of the banking industry. That does not mean that the regulatory framework should be in a constant state of flux, as there are considerable benefits for financial firms being able to plan in a stable environment. But, equally, we cannot have a regulatory regime that is set in stone, and completely unresponsive to changes in the environment that it is tasked with regulating.

Creating greater simplicity and comparability in the regulatory framework

A vigorous public debate has developed recently as to whether the Basel regulatory framework strikes an appropriate balance among different desirable characteristics: simplicity, comparability and risk sensitivity. The policy development process must take these and several other – often competing – factors into account, and finding the right balance often involves a difficult set of trade-offs.

Nevertheless, it is important to keep this issue under review, and so the Committee established a high-level task force last year with a view to looking at this concern from a broader, strategic perspective. The Committee has already had some discussions on the task force's findings, and will have more in the coming months (including at our meeting that begins tomorrow). The way forward will also be guided by the findings of the reviews of risk-weighted assets that I mentioned earlier, since at the heart of that work is a concern about comparability.

It is too early to say how we will take this work forward. Some issues, such as those in relation to market risk modelling, can be taken up via our existing trading book review. Others might require tweaks to the framework, or supervisory guidance, which can be implemented in the near term. And others might necessitate a deeper, longer-term review before we can decide on any solution. We will publish a discussion paper in the coming months that deals with discusses some of the complex trade-offs that need to be made. But one point I would stress is that whatever we decide upon, it will be designed to strengthen the current framework, and there is nothing that is being proposed that should give reason to hold off on the implementation of Basel III and other recently agreed reforms.

Enhancing the effectiveness of both micro- and macroprudential supervision

Not surprisingly, the Committee's agenda in the past few years has been dominated by policymaking. In 2012, implementation also came to the fore. But it is perhaps stating the obvious that effective supervision is the key to ensuring that regulation, once implemented, continues to work as intended. Only if supervisors are given the tools they need to act can they effectively perform their role. As the policy reform agenda moves towards completion, and the new rules are rolled out by national regulators, the Committee will increasingly turn its attention to enhancing supervisory practices.

Enhancing microprudential supervision

The Committee has a great deal of guidance on supervisory matters already on issue. However, much of this was developed before the financial crisis and will benefit from being updated to reflect lessons learned in recent years. Given the general applicability of much of this material, the benefits of this work will also extend well beyond Basel Committee member countries. As with all multi-year projects, this will require prioritisation. Near-term attention is likely to be given to operational risks (internal controls and information technology), governance, supervisory colleges, stress testing and dealing with weak banks.

Enhancing the practical implementation of macroprudential supervision

The systemically important bank – "SIB" – regimes will continue to be a priority area for the Committee over the coming years. Although the regimes for global SIBs and domestic SIBs have now been published, both will require a certain amount of ongoing maintenance and monitoring. Furthermore, as noted in the G-SIB standard, the methodology, including the indicator-based measurement approach itself and the cutoff/threshold scores, will be subject to periodic review and refinement every three years.

Beyond this work, the Committee will now turn its attention to the *practical implementation* of tools and techniques to deal with systemic risks. This will include two complementary areas of work:

- *Regulatory consequences of SIB classification:* Being a SIB means more than just higher capital. In light of the risks they impose on the financial system, SIBs must be held to a higher standard with respect to supervisory expectations for risk management functions, data aggregation capabilities, risk governance and internal controls, all of which are topics that feature prominently in the Committee's work plan. In addition, given the principles-based nature of the D-SIB framework, the Committee will monitor emerging practice as banking supervisors move towards implementation so as to facilitate cross-border cooperation and mutual understanding.
- *Use of microprudential tools for macroprudential purposes:* The Committee will oversee preparations for the countercyclical buffer, as well as exchange information on the wider range of microprudential tools that have been used for macroprudential purposes (eg sectoral adjustments to risk weights, stress testing requirements, loan-to-value limits or varying margin requirements).

Concluding remarks

Since the financial crisis, the Basel Committee has accomplished a great deal. But we still have work to do to complete the overhaul of the regulatory framework and fully factor in all of the lessons learned. We also need to see whether we have the balance right when it comes to simplicity and risk sensitivity. That work is going to keep the Committee busy for at least the next two years.

But that is far from the end of it, because, as I have noted a number of times today, our policy work will not generate its full benefits if not implemented in a full, timely and consistent manner. So our implementation monitoring work is equally important. And then even when the new standards are implemented, we will need effective supervisors to ensure that they are adhered to. This is an area where the Committee has the potential to do much more, particularly once the policy pipeline begins to slow. In other words, the Basel Committee will continue to provide you with much to talk about – at this meeting and those in the future!