Stefan Ingves: Strengthening bank capital – Basel III and beyond

Keynote address by Mr Stefan Ingves, Governor of the Sveriges Riksbank and Chairman of the Basel Committee on Banking Supervision, at the Ninth High Level Meeting for the Middle East & North Africa Region, jointly organised by the Basel Committee on Banking Supervision, the Financial Stability Institute and the Arab Monetary Fund (AMF), Abu Dhabi, United Arab Emirates, 18 November 2013.

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As prepared for delivery

Good morning everyone, and thank you for the opportunity to speak about what – among the myriad of recent regulatory initiatives – has probably been the most important: strengthening bank capital.

Strengthening bank capital is not simply about asking banks to hold more capital. Rather, it is a broader objective that involves ensuring the functioning of the entire capital regime. The Basel Committee's approach has therefore been to work extensively on the consistent implementation of the regulatory capital framework. The ultimate goal is to implement Basel III so that it strengthens the *quantity, quality, consistency and reliability* of bank capital ratios around the world.

Quantity and quality of capital

As you know, a set of requirements designed to raise the quantity and quality of bank capital lies at the heart of the Basel III reforms. Not only were minimum capital requirements raised, but the increases in capital requirements were focused on where they were needed most: in going-concern loss-absorbing capital, or Common Equity Tier 1. The requirement for higher-quality capital was just as important as the increases in the headline minimum capital ratios, if not more so.

Given the challenge posed by the new requirements to a banking industry still in recovery, Basel III provides for a transitional period out to 2019 so that banks will have ample time to build their capital bases in an orderly and sustainable fashion. The good news is that the global banking industry is responding well to the new requirements and, for large parts of the industry, the transitional time may not be needed. For the 101 large internationally active banks (the so-called Group 1 banks)[1] that we survey every six months, the story is one of an industry that already on average meets the 2019 requirements. The average CET1 ratio at end-December 2012 was 9.2%, well above the basic 7% minimum. Of course, there are variations between banks, and some still have work to do, but even for those with a shortfall against the 2019 requirements, that shortfall has now fallen to €115 billion, sharply down from almost €400 billion just a year previously.[2]

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1 These banks are internationally active and have Tier 1 capital in excess of €3 billion.

2 These shortfalls include, where relevant, any additional capital surcharge for those banks identified as systemically important on a global basis. As a point of reference, the sum of after-tax profits prior to distributions across the same sample of Group 1 banks during 2012 was €420 billion.

Chart 1: CET1 Capital Ratio (%), Group 1 banks

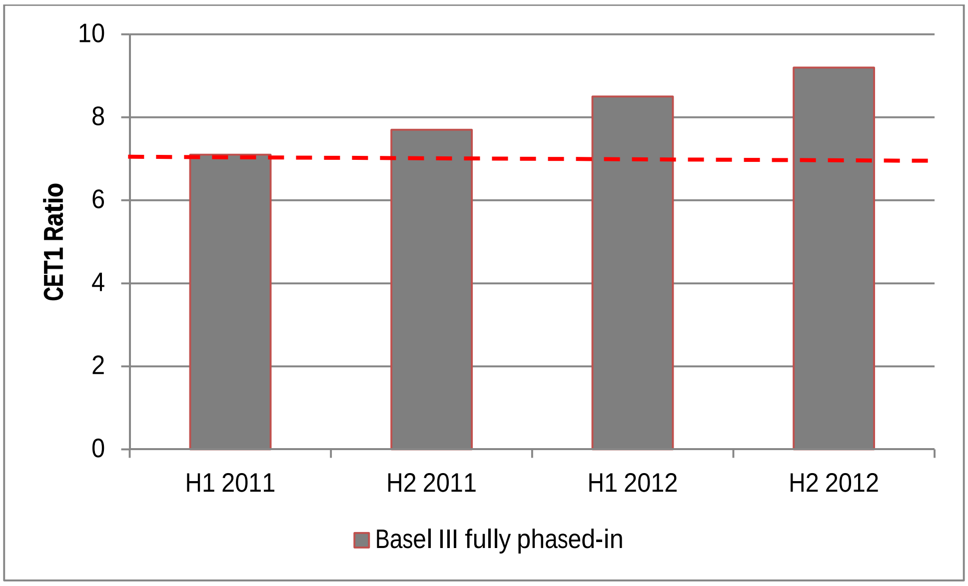
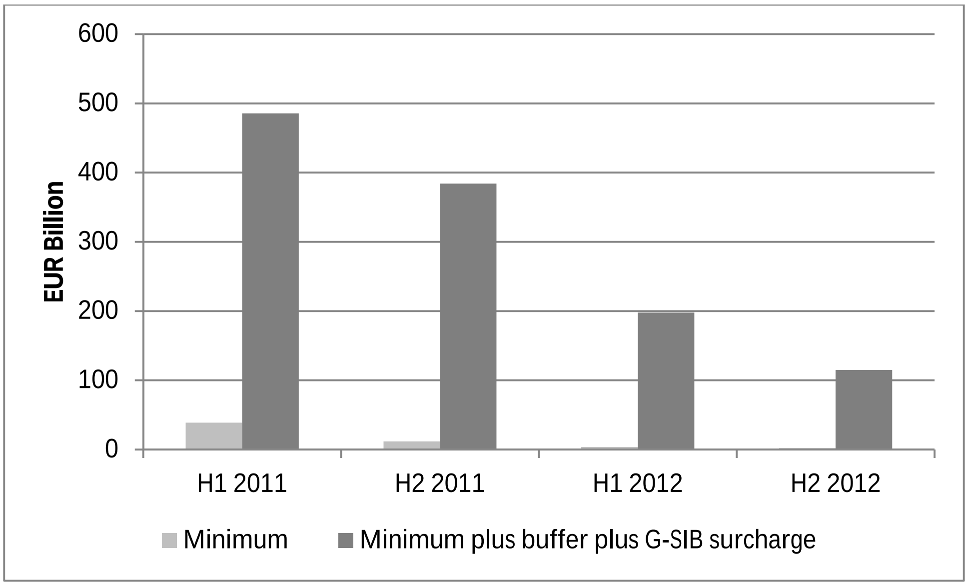


Chart 2: CET1 Shortfall (€ bn), Group 1 banks



Consistency of bank capital regulation

An important new mandate for the Committee is to be more active in monitoring the implementation of the international minimum standards within individual member jurisdictions. This stems from the G20 Leaders' desire that Basel III be implemented in a "full, timely and consistent" manner. Consistent implementation is critical if there is to be a level playing field for international banks.

Implementation is more than issuing new rules and regulations. Durable and consistent implementation also requires monitoring, evaluation and analysis of intended prudential outcomes. To this end, the Committee last year instituted the Regulatory Consistency Assessment Programme (RCAP). A key feature is the jurisdiction-specific peer assessment in which a small team of experienced supervisors and regulatory policy experts reviews a member country's Basel III regulations across all its components and sub-elements. The purpose is to find any divergences from the agreed standards and to weigh the current and potential materiality of any weaknesses. To foster transparency, the resulting assessments are made public, together with an overall review of compliance with the Basel standards.

Some comment that this effort, well intended as it is, will ultimately be fairly limited in its impact because the Committee has no enforcement power and cannot override the sovereign regulatory power of national authorities. It is true that the Committee does not have this power, and nor should it. But that does not mean that the peer reviews and the RCAP process as a whole lack impact. We have thus far published five monitoring reports, and completed assessments on the final Basel III rules in Japan, Singapore, Switzerland and China. In all cases, the implementation of Basel III was deemed compliant with the international standards. But importantly, in all cases the assessment process also generated a number of changes to the domestic regulatory framework to fill gaps and improve the alignment with the international standards. This shows that a peer review programme, coupled with transparency, can make an impact even without a suite of legal powers to back it up.

Overview of assessment outcomes — Table 1

Assessed member jurisdiction	Publication date of assessment	Number of regulatory changes, amendments, and clarifications made by a member jurisdiction during the assessment	Overall assessment grade
Japan	October 2012	5	Compliant
Singapore	March 2013	15	Compliant
Switzerland	June 2013	22	Compliant
China	September 2013	90	Compliant

Comparability of bank capital ratios

Over time, the consistent national implementation of Basel III standards will help ensure greater “truth in advertising” when comparing bank capital ratios. It is important that, when a bank publishes what purports to be a Basel III capital ratio, investors and counterparties can be reasonably sure that the ratio has been consistently calculated and that, if there are differences, those differences are transparent and some measure of their materiality is available.

But there is more to bank capital calculation than just following national regulations. The current framework makes use of internal models – these were introduced in 1996 for market risk, and in 2006 for credit and operational risk. The rationale was clear: to provide incentives for improved risk measurement, and reduce arbitrage via greater risk sensitivity. The Basel I framework, established in 1988, had grown outdated and was increasingly subject to arbitrage. Given its limited risk sensitivity, it provided banks with incentives to accumulate risk, as the build-up of many risks would not be visible in banks’ capital ratios. In the current framework, internal models provide an important means of generating the increased risk sensitivity that is regarded as essential.

Making capital adequacy ratios more risk-sensitive should, in theory, also make them more comparable. Capital adequacy assessments are about measuring the adequacy of capital relative to the risks a bank is taking. Measuring capital, ie the numerator, is relatively easy. The denominator, ie risk, is a much more slippery concept, and a certain degree of sophistication and complexity is needed to measure it. But by enhancing the accuracy of risk measurement, we should be making capital adequacy ratios more comparable and reliable, both over time and between banks.

As an aside, let me clarify that this is no criticism of the leverage ratio as a regulatory tool. It is simply that capital adequacy and leverage are two different concepts, and measure different things. The risk-based capital framework is not ideal for placing an absolute constraint on leverage, just as a leverage ratio is not ideal for assessing whether capital is adequate to cover the risks undertaken. This is why Basel III adopts a "belt and braces" approach, using the leverage ratio as an important backstop for the risk-based capital adequacy regime.

Returning to the rationale for using internal models to measure risk, it is important to remember that a key premise was that banks' risk-based capital ratios should consistently reflect banks' risk-taking. That was why Basel II provided not only for the use of internal models in Pillar 1 of the regulatory framework, but also for the Pillar 2 and 3 requirements so as to provide a second view on banks' solvency (Pillar 2), including one based on stress tests and performance measurement, and to facilitate market discipline via disclosure (Pillar 3).

Unfortunately, the financial crisis and subsequent analysis have shown that bank and supervisory practices are not as consistent as they could be. For example, the risk weights of some banks that introduced internal models under Basel II have been trending downwards in recent years, when experience and intuition say they should have been moving in the opposite direction. Many people worried that Basel II would be procyclical. It would seem that those fears are largely unfounded, but for reasons that may be far from satisfactory! Increasingly, this has led to questions about the credibility of internal model-based capital ratios.

Therefore, alongside the assessment of national regulations, the RCAP has also started studying the consistency of outcomes at individual banks. As with the introduction of a rigorous peer review programme, the significance of this initiative should not be underestimated. Never before have we had *international* teams of supervisors looking at the modelling practices at individual international banks. I think this is a quite telling example of the regulatory community's commitment to improving the consistency, comparability and reliability of bank capital ratios.

The Basel Committee's two recently published studies on RWA variability have compared banks' estimates of risk-weighted assets on hypothetical portfolios of financial instruments (for the trading book) and credit counterparties (for the banking book). To give you an idea of the size of the task, in the case of the banking book, for example, the Committee collected banks' probability of default (PD) and loss-given-default (LGD) estimates for 46 sovereigns, 77 banks, and more than 1,200 large corporates.

Both reports suggest that the underlying differences in risk remain the core driver of differences in risk weights and capital requirements, as intended. However, there are also supervisory and practice-based variations, and they are material. While it is difficult to be precise on how much variation is "too much", the observed range of practice-based variations analysed by the two studies appears too wide. To give you a flavour of that: just taking the banking book results alone, two banks with exactly the same assets could report capital ratios that differ by 4 percentage points – the most conservative bank would report a regulatory capital ratio of 8% when the least conservative one would report 12%. Of course, this simply compares the extremes in the sample – many banks were much closer to the average. But if outsiders have no way of identifying who is "average" and who is an "outlier", this variance is clearly too wide to underpin confidence in the measurement of bank capital.

So what are we doing about it?

Building upon these initial studies, the Committee has started *extending its analysis* to establish a comprehensive picture: for the trading book, the initial analysis has been extended to more complex portfolios, with results expected in the next few months. In parallel, the work on the banking book will extend to the other remaining core asset classes, especially retail portfolios, SMEs and so-called "partial use" exposures (ie exposures that have not been migrated to the internal models). The Committee also foresees extending its work to operational risk, the third core risk type. And once the Committee has done an initial round of assessment, we will need to *repeat the exercise periodically* to see whether the policy measures that I will discuss shortly are having the desired impact.

Further analysis to establish a comprehensive picture will take us into 2015, but this does not, of course, prevent us from taking action in the meantime. It is clear that a problem exists and the Committee is considering a range of supervisory and policy responses – without, I must add, settling on anything definitive just yet. Given the multi-faceted nature of the problem, it is also clear that we will need a multi-faceted response. As there is no silver bullet, we will likely end up with a series of incremental policy and supervisory changes, drawing from the following list:

- Most immediately, we will see *supervisory action*. Our benchmarking work has, for the first time, given supervisors meaningful information on international benchmarks against which they can compare their domestic banks. Many supervisors are responsible for only a handful of IRB banks, and it can be difficult to generate reliable benchmarks from a small sample. But our studies have provided supervisors with a much clearer picture of how their banks stack up against their international peers, and supervisory action is already being taken against a number of the outlier banks that are on the low side.
- Similarly, the Committee's *RCAP jurisdictional assessments* are having an impact by reducing variability due to undesirable differences in national regulations. These may often seem to be small issues of technical detail, but they can have a material impact on capital outcomes. To the extent these differences are removed, they can add to the consistency of outcomes. The Committee is also looking at the issue of *national discretions and Pillar 2*, and it is investigating whether more can be done to reduce variability from these sources by elinimating discretion where possible, and strengthening supervisory guidance on model validation, review and approval.
- Since transparency (or lack thereof) of bank modelling practices is at the heart of the problem, during 2014 the Committee plans to propose *enhancements to Pillar 3*. The aim is to provide banks' external stakeholders with information to better understand banks' risk profiles and risk-weighted asset differences. But it is unlikely that disclosure can be the sole response, and, thus, this initiative will have to be flanked by other measures targeted specifically at practice-based deviations.
- Our latest policy proposals stemming from the fundamental *review of the trading book* were released at end-October, and incorporate a number of proposals that flow directly from the findings on practice-based variation in the trading book. For example, certain modelling choices with respect to the choice of stressed periods and the scaling of short-horizon estimates to longer horizons have been constrained in the latest proposals, along with more gudiance on expected supervisory practices.
- More generally, within the policy framework, we are looking at how far greater *constraints on the modelling practices* of banks are needed. This could involve enhancing the data requirements on which models are built, limiting certain modelling assumptions or techniques, and/or strengthening validation requirements.
- To make a more direct impact, we are also examining the role of *floors and benchmarks* within the regulatory framework. Floors are not a new phenomenom in the capital framework, but we need to look at whether existing floors are effective, and whether there is a case for their greater use, particularly for products and markets where data are limited, or other characteristics that make them hard to model reliably.

- Finally, as I mentioned earlier, we also intend to ensure that the *leverage ratio* fulfils its intended role as a backstop to the risk-based regime. Despite the case for its inclusion in the regulatory regime that I made earlier, some people have questioned the merits of a leverage ratio. But given the very high levels of leverage that could be generated under the risk-based regime, it is a sensible measure to include as a backstop in the regulatory framework. And the case for a leverage ratio will only grow further if risk-weight variability is not adequately dealt with.

In sifting through these potential actions and trying to find the preferred policy mix, it is important that supervisors and the industry engage in a constructive dialogue on the best way forward. Banks have a keen interest in ensuring that their risk measurement methods are seen as robust and credible: not only does this affect confidence in the reliability of their capital ratios, but any doubts also call into question their stress-testing results and their risk management systems more generally, since these are invariably all built on the same foundations. Thus the Committee is keen to hear from banks and other interested parties what their preferred course of action is. Recent initiatives by the industry groups, such as the International Institute of Finance (IIF) and by the Global Association of Risk Professionals (GARP), to foster improved understanding of these issues, are therefore very welcome.

Concluding remarks

Let me sum up some of the key points I have made this morning. First, it is important that bank capital is seen to be of sufficient *quantity, quality, consistency and reliability*. These four characteristics are critical to the long-run credibility and success of the international capital adequacy framework.

In Basel III itself, the Committee has made substantial enhancements to the quantity and quality of capital. By agreeing to be part of the Committee's RCAP initiative, and by responding to it, national authorities have made clear their commitment to fulfilling the G20's call for consistency in implementing the reforms. And we are now, for the first time, delving into the capital calculation practices of individual banks from an international perspective, to see what needs to be done so that the results are sufficiently comparable and reliable.

The Committee is well aware that any changes to bank and supervisory practices will have costs. The potential side effects of materially narrowing down modelling choices could include a reduction in risk-sensitivity and a corresponding increase in the potential for arbitrage. If not done well, it could also reduce banks' incentives to invest in risk management models, especially their attempts to continuously broaden and deepen their understanding of risk. As always in regulation, we need to find the right balance: we need to reduce material practice-based differences in RWA variation, while limiting the adverse effects from doing so.

Resolving this issue will also take time: there is no quick fix. It will be a significant undertaking, and we need to carefully study the right mix of regulatory and supervisory responses. But given the importance of the issue, we have to move ahead because the consensus is building that the status quo cannot be maintained, as it helps neither banks nor supervisors.

Hence the title of my speech today: *Strengthening bank capital: Basel III and beyond*. The Basel III reforms themselves deliver two of the four characteristics that I said were essential – higher quantity and quality of capital. They are important, but not enough on their own. It is the Committee's current and future work programme on implementation and consistency that will ensure that the full benefits of the regulatory reforms of bank capital can be achieved.