Basel II and Revisions to the Capital Requirements Directive

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European Parliament
Committee on Economic and Monetary Affairs

3 May 2010

Introduction

The primary objective of the Basel Committee on Banking Supervision (BCBS) reform program is to raise the resilience of the banking sector, thus promoting more sustainable growth, both in the near term and over the long run. The over-riding objective of the Committee's reform agenda, as endorsed by the G20 and the FSB, is to deliver a banking and financial system that acts as a stabilising force on the real economy. As we now know, this clearly was not the case leading up to the recent financial crisis.

The pre-crisis financial system was characterised by the following weaknesses:

- too much leverage in the banking and financial system and not enough high quality capital to absorb losses;
- excessive credit growth based on weak underwriting standards and under pricing of liquidity and credit risk;
- insufficient liquidity buffers and overly aggressive maturity transformation, both direct and indirect (for example, through the shadow banking system);
- inadequate risk governance and poor incentives to manage risks towards prudent long term outcomes, including through poorly designed compensation systems;
- inadequate cushions in banks to mitigate the inherent procyclicality of financial markets and its participants;
- too much systemic risk, interconnectedness among financial players as well as common exposures to similar shocks, and inadequate oversight that should have served to mitigate the too-big-to fail problem.

In particular, the depth and severity of the crisis was amplified by a financial system that entered the crisis with too much leverage, insufficient liquidity buffers and capital levels, and poor incentives for risk taking. The banking sector therefore was too vulnerable to shocks, whatever their source. During the most severe episode of the crisis, the market lost confidence in the solvency and liquidity of many banking institutions. The weaknesses in the banking sector were transmitted to the rest of the financial system and the real economy, resulting in a massive contraction of liquidity and credit availability. I feel certain that had regulatory standards been higher, as the BCBS is now proposing, the crisis would have been less severe and the burden on the public sector and taxpayers would have been lower.

Key elements of the BCBS reform programme

To remedy these fundamental shortcomings, the BCBS reforms promote the following objectives, which link directly to my analysis of pre-crisis shortcomings:

- ensure that all material risks are adequately integrated into and covered in computing the level of required capital (especially those related to trading activities, complex securitisations, and derivatives);
- assure that high quality capital is present to absorb losses arising from all risk exposures;
- introduce additional checks and balances into regulatory, supervisory and risk management frameworks. This includes strong emphasis on the three pillars of the Basel II framework, as well as moving over time to a credible Pillar 1 leverage ratio that serves as a backstop to the risk-based requirement and helps contain the build-up of banking sector wide leverage;
- promote forward looking provisioning and countercyclical capital buffers that raise the ability of the banking sector to absorb shocks when they inevitably come;
- introduce minimum global standards for measuring and controlling liquidity risk;
- assure that regulation and supervision of systemically important banks is strong, forcing them to internalise the risks they create for the public at large;
- strengthen risk governance and management, building on the Pillar 2 supervisory review process;
- improve market discipline by enhancing Pillar 3 disclosure of firms' risk profile and capital adequacy; and
- promote practical approaches to improve the management of cross border bank resolutions.

The BCBS reforms, integrating microprudential and macroprudential elements, are designed to be proportionate to the risks of individual banks' business models, as well as the broader risks that certain activities and institutions pose to the system.

A significant proportion of the reforms are targeted at those firms and activities that are systemic in nature. In particular, capital requirements have been increased for trading book activities, counterparty credit risk, and complex securitisations and resecuritisations. Thus, under the newly proposed BCBS standards, systemically important banks will be subject to tougher standards.

The BCBS has also put forward a set of proposals aimed at the systemic risks posed by derivative activities. Under these revisions, OTC derivative exposures will be subject to higher capital requirements based on stressed inputs and longer margining periods that reflect the liquidity. Moreover, derivatives exposures that are not cleared through central counterparties that meet the revised CPSS/IOSCO standards will be subject to higher capital requirements, thus increasing incentives to use such central counterparties. Also, exposures among major, interconnected financial institutions have a higher degree of correlation compared to exposures to the corporate sector and would therefore require relatively higher capital.

Once the risk coverage of the capital framework has been improved to reflect different business models and different degrees of systemic risk, all banks need to back these exposures with higher quality capital that can absorb losses on a going and "gone concern" basis. In developing its proposals, the BCBS has paid particular attention to the unique circumstances of non-joint stock companies, including cooperatives and savings banks.

Moreover, it is the expectation of the Committee that all banks will build buffers above the minimum in good times that can be used in times of stress. Having these countercyclical buffers will make the system more resilient to shocks and reduce the risk of spillover from the financial to the real economy.

Impact assessment, calibration, and implementation

In fashioning the reforms, the BCBS is paying close attention to the impact on the industry and the economy as a whole both during the transition and in the long run. This means putting in place a path to a safer and stronger financial system that keeps growth on track – enhancing welfare in the long run, while at the same time minimising the economic costs in the short run.

Banks have returned to pre-crisis levels of profitability. To a significant extent this is due to the unprecedented public support measures put in place during the crisis. With this in mind, it seems reasonable to expect that these profits will now be used to build capital and liquidity buffers, and not feed excessive bonuses, dividends, and leverage. The BCBS reforms, which the G20 has asked to be finalised by the end of this year, will provide clarity on the new resilience standards that banks should achieve. Moving towards these standards will increase confidence in the system. As history has shown time and again, a weak, undercapitalised banking sector cannot support sound, long-term real economic growth.

Current minimum regulatory requirements remain unacceptably low and will not deter a renewed race to the bottom in which financial institutions end up undercapitalised, over-leveraged, and illiquid. For example, the current effective minimum capital requirement is just 2 percent common equity to risk-based assets. This is equivalent to risk-weighted leverage of at least 50:1. However, it is based on a diluted definition of bank capital. If one were to use a more robust definition based on tangible common equity – which has become common practice among market participants – the leverage permissible under the current minimum would be even higher. In addition, there is no minimum global standard for liquidity whatsoever, even though poor liquidity at banks was one of the key amplifiers of the crisis. In response, the Committee has proposed internationally harmonised minimum liquidity standards to help ensure that banks can withstand a one-month period of acute stress and to promote banks' resilience over the longer term through incentives to support their activities with more stable sources of funding.

The BCBS has put in place a rigorous process to assess the overall impact of its reforms with a view to ensuring that the new standards achieve the objective of greater banking sector resilience while they simultaneously promote maximum sustainable growth. These processes include the following:

- ***Public consultation:*** The December capital and liquidity reforms have been subject to rigorous public consultation. The Committee is now reviewing nearly 300 comments with an eye toward identifying any unintended consequences in either the design or calibration of the proposals. It is important to note that in many cases, higher requirements are being introduced – by design – which will affect those business lines and activities that posed substantial risk to banks and the system. The BCBS wants to make sure that it considers all major consequences of its reforms and the incentives they create.
- ***Impact assessment:*** The BCBS is conducting a comprehensive quantitative impact study to assess the impact of the reform package on individual banks and on the banking industry. The impact study will inform the calibration of the capital requirements and ensure an appropriate set of minimum standards across banks,

countries, and business models. Similarly, the liquidity standards will be calibrated so that they promote sound liquidity buffers while allowing for prudently managed business models and sustainable maturity transformation in the banking system.

- ***Overall calibration:*** The Committee is engaging in an analysis to determine the calibration of the overall capital and liquidity requirements, factoring in the cumulative impact of all the individual reform measures, as well as what is necessary to achieve the resilience of the banking sector while ensuring prudent long term availability of credit.
- ***Macroeconomic impact assessment over the transition period:*** The FSB and the BCBS, in close collaboration with the BIS and IMF, are assessing the impact of the reforms over different possible transition periods to ensure that there is no threat to the economic recovery. Moreover, national macroeconomic models (subject to a common set of protocols) are being used to assess the link between higher capital standards, credit availability and costs, and broader economic growth. This framework therefore can accommodate differences in the role of the banking sector in national economies, where some are much more bank driven than others.

Based on these four initiatives, by the end of this year the BCBS will develop a balanced set of reforms that promote greater banking sector resilience and maximum sustainable economic growth.

The market and bank supervisors have already forced banks to raise their capital and liquidity buffers. However, when competitive pressures reassert themselves, significantly higher minimum requirements will help contain any return to the unacceptably low capital and liquidity levels which made the system so vulnerable to shocks the last time around. It therefore is critical that the calibration of the new standards be based on what is necessary to promote balanced and sustainable banking in the long run. Appropriate implementation time lines and transition arrangements will be used to make the transition to the new standards in a manner that does not jeopardise near term growth. Failure to set the right long run levels will undermine near-term confidence and jeopardise long-term financial stability.

The BCBS is comprised of 27 countries and it conducts its work under the review of its oversight body, the Group of Central Bank Governors and Heads of Supervision of its member jurisdictions. The work of the Committee also is being reviewed closely by the Financial Stability Board. In addition to monitoring the consistency with the G20 reform mandates and the broader economic implications of the transition to the new standards, the FSB process will ensure that the BCBS reforms are integrated into a coherent overall set of reforms to strengthen global financial regulations.

Consistent with the G-20’s mandate, rigorous processes have been put in place to ensure that all countries implement the full set of international prudential standards. Consistent and timely implementation of standards by all jurisdictions is critical to promoting a global level playing field.

Conclusion

The Basel Committee is on schedule to deliver a fully calibrated package of global standards for capital and liquidity by the end of this year. It is conducting a wide range of analyses to ensure that the design of the reforms is appropriate and that they produce a more stable financial system and economy over the long run without jeopardising growth in the near term.

The BCBS reforms are intended to be forward looking, making the system more resilient to future crises, whatever their source. While certain banks and countries may not have “caused” the current crisis, everyone was affected. All countries and financial institutions

benefited from the public sector interventions to stabilise the economy, the functioning of markets, and the resilience of counterparties. Moreover, past crises have emerged from all regions of the world, covering a wide range of products, and affecting all types of business models and asset classes (retail, commercial real estate, sovereign lending, corporate lending, trading activities, securitisations, and underwriting). While we cannot with certainty predict the source of the next crisis, we can however lay the groundwork to help mitigate or minimise the impact. It is therefore critical that all banks and countries strengthen banking sector resilience, particularly given the global and diverse nature of financial markets and the speed with which shocks are transmitted across countries. This and previous crises have shown that the deepest and most prolonged downturns arise when the banking sector gets into serious trouble and no longer has the capacity to perform its core credit intermediation function.