Remarks of Nout Wellink
Chairman, Basel Committee on Banking Supervision
President, De Nederlandsche Bank

Institute of International Finance 2010 Spring Meeting
Vienna, Austria
11 June 2010

"The Basel Committee and Regulatory Reform"

I. Introduction

I wish to thank Charles Dallara and the Institute for this opportunity to discuss the work of the Basel Committee and its role in reforming the regulatory framework. All of us in the financial community are now at a pivotal junction that will significantly re-shape how banks and supervisors alike conduct their business. In my remarks this morning I would like to explain the rationale for the Basel Committee's reform programme and describe its key elements. I will then detail for you the benefits of our programme and my expectations for finalising our work.

II. Rationale for the Basel Committee's reform programme

I will begin by discussing why we are doing what we are doing. The Basel Committee's reform programme includes the measures finalised by the Committee last summer dealing with stronger trading book capital standards along with higher requirements for complex securitsations and exposures to off-balance-sheet vehicles. In addition, the measures proposed last December represent a fundamental strengthening of the Basel II framework and introduce for the first time minimum global standards for liquidity risk. These reforms are designed to respond to key pre-crisis shortcomings, which became painfully evident during the crisis.

The banking sector entered the crisis with too much leverage and inadequate liquidity buffers. These were accompanied by poor governance and risk management as well as inappropriate incentive structures, especially related to compensation. The combination of these factors was manifest in poor underwriting, the mispricing of credit and liquidity risk, and excess credit growth. When the crisis hit, these shortcomings and weaknesses in the banking sector amplified and deepened the downturn.

You know the outcome: huge, rapid deleveraging; big losses by banks; a deep recession; and massive direct support from the public sector in the form of capital injections, guarantees and liquidity. While not every bank required this direct support, all banks and counterparties benefited indirectly from these efforts and the broader fiscal and economic stimulus of the economy.

Now, in the face of this experience, minimum standards for capital and liquidity need to be raised substantially so that the banking sector can withstand future periods of stress, thus enhancing financial stability and promoting more sustainable growth. The banking sector must serve as a stabilizing force and not as an amplifier of shocks.

It is precisely this mandate that the G20 finance ministers and central bank governors endorsed this past weekend when they met in Korea. They voiced their full support for the work of the Basel Committee, which forms the core of the G20's financial and regulatory reform agenda.

At present, the minimum standard for the highest quality capital is just 2% of common equity to risk weighted assets – it is even less when you factor in necessary deductions from capital.

And with respect to liquidity, no global minimum standard currently exists. Leading up to the crisis, liquidity buffers were inadequate and excessive reliance was placed on short-dated wholesale money to fund long term illiquid assets.

Banks have made progress to strengthen capital levels and liquidity buffers but more needs to be done. In addition, when competitive pressures reassert themselves, there is the risk of a renewed race to the bottom to the unacceptable pre-crisis status quo. Moreover, public sector finances have been stretched and must be consolidated. There is no public sector appetite to engage in the types of banking sector support measures of the past three years. Banks therefore must use their return to profitability – which is due in part to public sector support – to boost capital and liquidity buffers. Significant risks remain in the economy and the financial system, and it would be unacceptable if banks did not use this opportunity to bolster their resilience to future shocks. Finalising the Basel Committee capital and liquidity reforms will raise resilience and provide greater certainty and stability in the markets as to the new standards towards which the sector must move.

It would be unwise to think that this crisis only holds lessons for a limited class of banks, business models or regions. *All* countries need to build bank sector resilience because shocks have originated from all regions of the world, from all types of asset classes, and from all kinds of business models.

III. Key elements of the BCBS reform programme

It is for these reasons that we have proposed our reform programme. Now let me tell you what it is we seek to achieve.

Capturing all the risks

The first objective must be to capture all significant risks in the capital framework. During the initial phase of the financial crisis, the majority of losses and the build up of leverage occurred in the trading book. At the same time, the trading book rules did not adequately capture all of the key risks to which banks were exposed. As a consequence, capital for trading book exposures was distressingly inadequate. In response, the Committee finalised last year a series of enhancements to the trading book rules. These higher capital requirements capture the credit risk of complex trading and derivative activities and require banks to calculate a stressed value-at-risk.

The crisis also exposed weaknesses in banks' risk management and measurement of securitisation and off-balance-sheet exposures. This shortcoming resulted in large, unexpected losses. The Committee's July 2009 enhancements included new rules to strengthen the treatment for certain securitisations in Pillar 1 by introducing higher risk weights for resecuritisation exposures.

Counterparty credit risk is another key risk for which the regulatory capital improvement is needed. The December enhancements proposed by the Committee are meant to strengthen the resilience of individual banking institutions and reduce the risk that shocks are transmitted from one institution to the next through the derivatives and financing channel.

Raising the quality of the capital base

The Committee's efforts to improve risk coverage are a crucial element of the capital adequacy equation but this is only half the story. The other half relates to the quality of the capital base backing banks' risk exposures. The Committee has proposed a series of measures that would overhaul the definition of capital. This is the second objective of our reform programme and it is set out broadly along two lines.

First, the level and the share of the highest quality capital in Tier 1, namely, common equity and retained earnings, will rise substantially. During the crisis, losses came directly out of retained earnings but because of other forms of financial instruments in the capital base, some banks maintained deceptively high Tier 1 capital ratios. Moreover, in the case of many banks, non-common Tier 1 capital instruments ultimately had to be converted into common equity before confidence was restored.

Second, and just as important, our proposal introduces a rigorous set of deductions and exclusions from common equity to arrive at a more transparent, meaningful definition of capital and to restore the credibility of the Tier 1 capital base.

Leverage ratio as a backstop to the risk based requirement

A third objective is the introduction of a leverage ratio to backstop the risk-based system. At the micro, firm-specific level, many firms were too aggressive in gaming the system. The risks that built up in the trading book with inadequate regulatory or economic capital were a case in point. Many firms engaged in hedging strategies where the risk magically disappeared from internal risk reports and capital, only to reappear as basis risk, counterparty credit risk or illiquid positions that could not be sold. Many supervisors did not do enough to prevent this compression of risk-weighted assets.

From a macro prudential perspective, we again saw a cycle of leverage building up in the banking system, which the market forced down in the most destabilizing manner, amplifying procyclicality and the downturn of the real economy. Moreover, market participants piled into what were perceived to be the lowest risk-weighted assets, such as repos, sovereign lending, and triple-A asset backed securities. While these assets may have been viewed as low risk at the bank level, we instead saw the build-up of system wide risks in these asset classes, which ultimately came back to haunt many institutions.

Buffers to withstand shocks

Another objective is the need to build greater buffers into the banking sector to withstand severe shocks. Banks are at the centre of the credit intermediation process, both in bank dominated countries and those where capital markets are more developed. Greater buffers will help prevent the amplification of shocks between the financial and real side of the economy.

These buffers need to take various forms.

First, we need to introduce more forward-looking provisioning. The Committee is promoting stronger provisioning practices through a number of channels. It is working closely with the accounting standard setters to develop a robust and operational expected loss approach for provisioning.

Second, we need to introduce more, prudent valuation practices for financial instruments. The Committee last year issued guidance to banks and banking supervisors to strengthen valuation processes. The Committee also continues to work with the accounting standard setters to develop sound valuation standards. These should provide for valuation adjustments to avoid the misstatement of both initial and subsequent profit and loss recognition when there is significant valuation uncertainty.

Third, there needs to be a capital conservation buffer as proposed in our December reform package. At the onset of the financial crisis, a number of banks continued to make large distributions in the form of dividends, share buy backs and generous compensation payments even though their individual financial condition and the outlook for the sector were deteriorating. More recently, many banks have returned to profitability but have not done enough to rebuild their capital buffers to support new lending activity. This dynamic does not help to make the system more resilient and it amplifies procyclicality. Much of this is due to a collective action problem, which the conservation framework seeks to address. The proposed framework promotes the conservation of capital and the build-up of adequate buffers above the minimum that can be drawn down in periods of stress, subject to appropriate measures that are coordinated with the national supervisor. The approach is not intended to take away freedom from a well-governed board, but rather to provide more clarity regarding the supervisory response.

The Committee is also working on a countercyclical buffer framework to protect the banking sector from excessive credit growth. It will follow up with more detail on the design of this framework. What is clear from history is that the banking sector is most vulnerable during periods of excessive credit growth.

Finally, we need to address the problem of systemic risk arising from excess interconnectedness and the perception that some banks are too big to fail. This is being addressed through a variety of means.

- First, we are introducing capital incentives to use central counterparties for OTC derivatives;
- Second, there will be higher capital for trading and derivative activities, as well as complex securitisations, which are associated with systemic risk and interconnectedness;
- Third, there is a need for more capital for inter-financial sector exposures which are more correlated;
- Fourth, the Committee is reviewing the appropriate capital treatment of systemic banks (in coordination with the FSB); and
- Fifth, the Committee's recent recommendations for cross-border bank resolution provide a practical way to begin addressing the systemic risk issue at cross-border banks.

Liquidity

Strong capital is a necessary but not sufficient condition for banking sector stability. Many banks got into trouble because they were financing long dated, illiquid assets with short-term wholesale funding. Other banks simply did not have an adequate buffer of highly liquid assets to ride out a period of severe stress. Many institutions, in their liquidity planning, assumed that they would experience difficulties, but that this would occur in an overall benign environment.

Our response is to introduce a global liquidity framework which establishes minimum standards for funding liquidity risk, thus preventing another race to the bottom in this area. Banks must hold a stock of high-quality liquid assets that is sufficient to allow them to survive a 30-day period of acute stress. This is complemented by a longer term, structural ratio to promote the funding of activities with more stable sources of funding on an ongoing basis. Banks can meet these standards by changing their funding profile, making them less vulnerable to liquidity shocks.

Better supervision, risk management and transparency

The measures I just outlined will help improve bank and bank system resilience. At the same time, they need to be accompanied by better supervision and risk management. An important lesson from this crisis is the need for better, more rigorous supervision and this key theme pervades the Committee's work. Just a glance at our recently published work would highlight the Committee's drive to raise the bar for both supervision and risk management: last year's supplemental Pillar 2 guidance, our liquidity risk management sound principle, methodology for assessing compensation practices, valuation practices, stress testing and bank resolution are just a few examples. The Committee is putting in place rigorous mechanisms to follow up on its standards to ensure that they are implemented across the membership.

Finally, we need to do a better job at system wide supervision. Most banking crises emerge when there are common vulnerabilities and concentrations across the banking sector and other financial firms. It therefore is critical that we integrate bank level supervision with a broader understanding of financial sector and macroeconomic vulnerabilities.

As we roll out these reforms, it will be important that we ensure the perimeter of regulation keeps up with financial innovation. Activities which combine substantial maturity transformation and liquidity risk should be subject to more bank-like regulation. We also need to be vigilant about major regulatory differences for like activities that could put pressure on the soundness of the regulated sector.

IV. Impact assessment, calibration and implementation and conclusion

Before I conclude let me say a few words about the Basel Committee's process for finalising its reform package. I would like to emphasise three key features of the Committee's work that help ensure that all the parts work together and that the new regulatory package succeeds.

First, there is public consultation. The Committee is conducting a thorough analysis of the nearly 300 comments received covering thousands of pages. We are carefully reviewing the comments and this will help further inform the final design and calibration of the Committee's proposals.

Second, there is calibration. The Committee is conducting a comprehensive quantitative impact study to assess the effect of its reform package on individual banks and on the banking industry as a whole.

The Committee is also conducting a so-called top-down impact assessment, which will complement the bottom-up, firm-specific QIS work. The top-down calibration work will help inform the overall calibration of the capital requirements, minimum and regulatory buffers, factoring in the cumulative impact of the July and December 2009 reform measures and any adjustments to them. Any analysis of appropriate minimum levels must recognise that, to be credible, they need to cover historically severe losses. Buffers need to be sufficiently high to withstand sector wide stress while remaining above a credible minimum. The calibration needs to be set at a level that is appropriate to promoting long term stability. Where there are tradeoffs, these should go in the direction of giving banks the time to reach the new standards instead of watering down the standards themselves. Failure to put in place high quality standards for the long term simply sets the system up for another banking crisis down the road.

Third, we are assessing the benefits and costs of the Basel Committee standards and I think it fitting that I close on this note. The past three years should serve as a strong reminder to us all of the benefits of mitigating banking crises. The costs of a banking crisis include the direct losses borne by security holders, the massive scale and diversity of public sector intervention measures which have strained public finances and will need to be scaled back over time, and the large fall in national and global economic output and employment.

Unfortunately, such episodes are not confined to recent history and occur much more frequently and have much greater economic impact than any of us feel comfortable with. Moreover, the history of crises also shows that some of these costs are persistent.

Raising capital and liquidity standards will reduce the probability and impact of crises, and bring with it large benefits. These benefits include:

- avoiding both the temporary and additional permanent reductions in output and employment that occur during banking crises;
- greater stability of economic output and associated increases in welfare that result from lower output volatility during non-crisis periods;
- a more stable banking system that is able to withstand shocks from outside the banking sector rather than amplifying the effects of such shocks on the real economy;
- lower risk premia; and
- more efficient allocation of resources and the avoidance of excessive credit growth that is often allocated to certain sectors leading up to a crisis.

As with the benefits, the costs of raising capital and liquidity requirements can have both temporary and permanent elements. The temporary costs we believe can be managed through appropriate transition periods – in some cases there has already been very significant adjustment forced by the market and supervisors. The Basel Committee and the FSB are in the process of assessing these temporary costs and the results of this work will help inform the appropriate transition period to the new standards. We will ensure that the banking sector can move to the new standards through earnings retention and reasonable capital raising. We will also ensure that banks can move to the new liquidity standards in an orderly manner.

When it comes to the long term costs, the impact is not clear. On the one hand, higher capital requirements and liquidity standards could increase the cost of funding. On the other hand, more stable, less leveraged banks would raise average ratings, improve the terms on which banks could raise funds, and lower the required return on equity. Moreover, in a competitive market, it is not at all clear that most of the costs of higher capital and liquidity requirements would be passed on to the consumer.

One thing however is clear. Raising minimum capital requirements from their current levels will involve large and permanent net benefits by raising the stability of the system and promoting more sustainable growth. Moreover, these benefits accrue immediately for every additional dollar (or Euro) of capital and liquidity. This is critical in an overall economic and financial environment of continued uncertainty and risk.

It is absolutely essential – indeed it is our duty to shareholders, taxpayers and future generations – to reflect on the lessons of this crisis to safeguard against something like this happening again. We have a common goal and we must work together to achieve it.