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FSI High-Level Meeting on the New Framework to Strengthen Financial Stability and Regulatory Priorities

St. Petersburg, Russia, 24 May 2011

"Basel III: a roadmap to better banking regulation and supervision"

Introduction

First of all, I would like to thank Josef Tošovský, Chairman Ignatiev and the Central Bank of the Russian Federation for hosting this high-level meeting. Since becoming Basel Committee chairman in 2006, I have participated in as many as 10 of these events in all parts of the world. We have discussed topics such as Basel II and Basel III; the Core Principles; "back to basics" and the future of supervision; and, of course, the financial crisis and the Committee's response. I have always been impressed by the quality of discussions and exchange of information that take place among the senior officials that participate in these meetings. These are the cornerstones of supervisory cooperation and coordination.

Since 2006, it has been a long five years – a challenging five years – and, for both good and bad reasons, a memorable five years. On the regulatory side, much has been achieved. These policy responses to the crisis must now be implemented fully, consistently and globally. This is going to require much more work. Much of this work now shifts to the supervisory side and, as I will discuss this morning, I think we are moving in the right direction.

So this morning I would like to first have a look back on where we have been and what have we learned as regulators and supervisors. Then I will examine where we are today and, finally, where we are going.

Where have we been?

Let us go back to 2007. What were some of the topics that were on the minds of bankers and supervisors? We were hearing quite a bit about the benefits of:

- Light touch regulation,
- The originate-to-distribute business model,
- Capital efficiency and optimisation, and
- Financial engineering and innovation.

Contrary to the view held by many that this was the dawning of a new era – the great moderation – at the macro level there were a few people leaning against the wind. They warned of unsustainable credit growth, for instance, but their voices were drowned out by the euphoria of the times. At the micro level, few people had put together the pieces of the puzzle. Prior to the crisis, the Basel Committee had already begun work on a range of issues that would prove to be central elements to Basel III: They include stronger capital requirements for the trading book, a review of the definition of capital, a review of global liquidity supervision, stress testing, valuations and counterparty credit risk.

We were also discussing other – but less apparent – risks to the global banking system. In a speech I gave at the Annual Risk Conference of GARP – the Global Association of Risk Professionals – in February 2007, I highlighted a variety of growing risks that were causing concern among Basel Committee members. This included the originate-to-distribute model and the need to assess the pressure points that might arise if risk appetites were to reverse and liquidity conditions to deteriorate. I noted that these pressure points could take different forms and the Committee's discussions gave us a good head start in developing concrete responses to them. For instance, a few of the pressure points I noted that were already on the Committee's radar included:

- Securitisation pipeline risk and the adequacy of risk transfers,
- The growth of illiquid and structured risks in the trading book,
- Growing risk concentrations,
- Off-balance-sheet conduits that some day might require additional support from sponsoring banks,
- Trading counterparties that might demand additional financing, and
- The risk that market liquidity could spill over to funding liquidity.

On each of these topics, the Committee subsequently revised the Basel II rules and developed supervisory guidance. So what lesson do I draw from this experience? That it is of critical importance for supervisors to be ahead of the curve – to take a *proactive* rather than a *reactive* approach. Developing regulatory policy must be done on a comprehensive, well-informed and inclusive basis. But there is also a time dimension. This was another lesson of the crisis: good regulation must be supplemented with strong and timely supervision and enforcement.

The crisis also taught us – or painfully reminded us of – a third lesson, and that is the primacy of high quality capital. Strong capital regulation provides necessary incentives and limits on bank risk taking. But a strong capital base must be accompanied by adequate risk coverage. If a meaningful segment of a bank's risks are not supported by capital, the bank remains exposed. Unfortunately, during the crisis, many banks were not protected against risks, such as complex, illiquid trading activities and off-balance sheet exposures.

Strong capital and comprehensive risk coverage are not supervisory silver bullets that can cover up deficiencies in risk management or substitute for effective market discipline. The Committee, through the three pillars of Basel II, laid the foundation for the regulatory model that promotes safer banks. This framework remains valid today. Basel III is an extension of it – but with critical additions, such as a leverage ratio, a macroprudential overlay and the liquidity framework.

Where are we today?

The Committee's response to the crisis was primarily a regulatory one, although we also upgraded Pillar 2 and Pillar 3 of the capital framework. Now what is required to implement these new rules is strong supervision. And that brings us to the present. We have come a long way in a short amount of time. But the benefits of Basel III will fall short if the framework is not implemented fully and in a consistent manner. The Committee is increasing the already substantial resources dedicated to implementation issues. In the past, the Committee's Standards Implementation Group (SIG), which is chaired by José María Roldán, focused on promoting consistency in implementation of Basel II through sharing information and experiences among supervisors. Going forward, this approach will be supplemented with supervisory peer reviews and thematic reviews, to strengthen the global implementation process. It represents a significant practical and cultural shift in the way international agreements are implemented.

Two years ago in South Africa, I addressed a high level conference of bank supervisors on the issue of the future of supervision. The theme of my remarks was "Back to Basics". Back to basics means a focus on the core principles and other fundamental standards. This focus continues today. The crisis reminded us not only of the importance of sound standards, but also underscored that these must be accompanied by stronger implementation and rigorous supervisory follow-up. Strong regulations – like Basel III – are only the starting point, and even this becomes ineffective without strong supervision. We have come a long way from light touch regulation to what some like to call "intrusive" supervision. And this means that supervisors sometimes need to take actions that are unpopular with individual banks or with prevailing public opinions.

Another essential element of effective supervision is cooperation and coordination with other supervisors. Meetings like this one help promote regional communication. Let me say a few words about the global dimension of this. The Basel Committee has long been aware that some of the biggest challenges facing the banking industry relate to global, cross-border activities and the implications for global financial stability. In fact, the Committee was founded on this basis. One way we approach this challenge is through outreach with *all* supervisors – not just Basel Committee members. At an early point during the current crisis, the Committee agreed to formalise the global dimension of its work by expanding – doubling – its membership. The benefits of this expansion have been immense: among others, it brings a tremendous amount of additional expertise and new perspectives to the Committee's table and its working groups. It has also reinforced the legitimacy of the Committee as a truly global body. These benefits help promote goals of global financial stability. In addition, through the work of our Basel Consultative Group, we share information and ask for input on Basel Committee initiatives. This further broadens the global dialogue on supervisory issues; it also helps promote the Committee's standards in a wide range of countries.

Where are we going?

The importance of supervisory cooperation to address global risk naturally leads me to my next topic: where are we – as supervisors – going? I will start with saying a few words about our work on global systemically important financial institutions – or G-SIFIs. Basel III is a significant step in helping to improve the resilience and soundness of G-SIFIs. But it does not fully address the externalities or spill-over effects that these firms impose. More must be done and the Committee has already made a proposal to the Financial Stability Board on how to identify G-SIFIs. At its June meeting the Committee will discuss the magnitude of additional loss absorbency and, in coordination with the FSB, will issue a consultative document on this important issue later this summer.

Basel III also introduced a global framework for liquidity requirements, which was a major achievement of the Committee. Unlike capital requirements, we do not have extensive experience with global liquidity standards nor do we have as high quality data on bank liquidity profiles. For these reasons, we are taking a cautious approach in implementing the new requirements. We are reviewing their implications for individual banks, the banking sector, and financial markets, addressing any unintended consequences as necessary.

In this regard, the Committee's focus is ensuring that the calibration of the framework is appropriate. Certain aspects of the calibration will be examined and this will involve regular data collection from banks. Any adjustments should be based on additional information and rigorous analyses. Moreover, relying just on banks' experiences from the crisis is not sufficient as banks and markets received massive government support. Hence, the analysis will need to include *both* quantitative bank experience and additional qualitative judgment.

Finally, a measure of the effectiveness of Basel III might be the development of so called "shadow banking". By this I mean credit intermediation that takes place outside of the traditional banking system and that involves liquidity or maturity transformation. While shadow banks perform useful functions, they can also introduce a number of risks to the broader financial system, including to banks. Clearly, it is important to address issues in the shadow banking sector but its existence should not detract from the need to strengthen the resilience of the banking system.

The banking sector remains at the centre of the credit and liquidity intermediation process. This is true even in economies that are more reliant on capital markets. Moreover, significant parts of shadow banking were created, sponsored or financed by the banking sector. These include SIVs, conduits, money market mutual funds, parts of the securitisation chain, and hedge funds. Finally, much of the shadow banking sector depends on the financing and liquidity support of the banking sector. Basel III goes a long way to closing the gaps in exposure to shadow banking. Thus, stronger, consolidated banking regulation and supervision will go a significant way towards containing the risks of the shadow banking sector.

These are just a few of the agenda items for the coming year. Looking ahead, there are clearly significant risks on the horizon. Promoting a strong and stable banking system that is able to act as a shock absorber rather than an amplifier of risks is essential. That, in my view, is the fundamental philosophy underlying the Basel III reforms.

Conclusion

Let me now bring my remarks to a close. The recent financial crisis resulted in a strong and – some say – a bold regulatory response. But it also taught us some valuable lessons, such as the need for supervisors to get ahead of the curve through strong risk analysis and assessment. But we also know that once a regulatory response is formulated, it must be implemented in a full and timely manner. We also were reminded of the unassailable importance of strong capital and liquidity buffers in the face of rapid financial innovation and uncertainty.

The regulatory response to the crisis has been developed. Now we as supervisors must ensure that Basel III and all relevant standards are implemented. We will be judged on our capacity to meet this objective. This process will sometimes require unpopular actions and decisions but we must press on with resolution and determination. It will also require even more cooperation and coordination with our supervisory counterparts in other jurisdictions. As regulators and supervisors, it is our responsibility to ensure that the standards are implemented both in form and in the spirit in which they were intended.

Looking to the future, we are well on our way to developing a framework to address the risks arising from G-SIFIs. The Committee is also carefully monitoring a variety of aspects related to the Basel III liquidity framework and will adjust the standards if necessary. Shadow banking is another important risk area that warrants careful analysis.

Finally, I would like to take this opportunity to personally thank Stefan Walter, the Basel Committee's Secretary General, and the Secretariat for their outstanding work over the past five years. As you may know, Stefan will be stepping down from his role as Secretary General later this year. I am grateful for both the tremendous effort and outstanding level of service that he and his small team have provided to me and the Basel Committee over the past five years.