BASEL COMMITTEE ON BANKING SUPERVISION

BANK FOR INTERNATIONAL SETTLEMENTS

Talk is Cheap – Putting Policies into Practice

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I would like to begin this morning by thanking Josef Tošovský, Chairman of the Financial Stability Institute, which continues to organise these High Level Meetings that serve as an important forum for continued dialogue and outreach. I would also like to thank Uruguay's Jorge Ottavianelli, ASBA's vice chairman, and Marty Gruenberg of the FDIC, for their organisations' leadership and invaluable contributions to banking supervision and regulation.

The theme of this conference is *Strengthening financial sector supervision and regulatory priorities in the Americas*. Basel III, which I believe will play an important role in strengthening supervision and regulation, has been substantially completed. The development process was a difficult one but now the real challenge begins: and that is implementation. The framework addresses the weaknesses that contributed to the global financial crisis. Full, timely, consistent and global *implementation* of the Basel III rules will help avert or mitigate future crises.

This morning I would like to say a few words about some of the lessons that we – as supervisors – have learned from the crisis. This will establish a baseline understanding of what went wrong and why these lessons are relevant for all of the authorities in the room today and how these lessons have been translated into policy responses. I will then talk about the Basel Committee's plans for implementation. This includes a multi-layered peer review process, a first for international standard setters and certainly a new approach for the Committee.

Lessons learned

Let me first turn to some of the lessons learned from the crisis. There is a natural tendency for some supervisors in regions not too badly affected by the crisis to say that Basel III is not relevant in their jurisdiction. After all, the crisis had its roots in the United States and its harmful effects have not spread in a significant way to Latin America, Africa and Asia.

How do I respond? I remind them that they may not feel the effects *yet* but the aftershocks of the crisis continue to reverberate. Even more dangerous, I believe, is that memories are short. This is especially relevant for many emerging markets that were less affected by the crisis and have so far seen relatively stronger economic recovery. To those who question Basel III's relevance, I also remind them of some of the factors that led to or amplified the recent crisis: mispriced liquidity chasing yield, poor underwriting, too much leverage and too little loss absorbing capital, deficient risk management, weak bank governance – these are the common denominators in almost all banking crises. Basel III and other Basel Committee initiatives developed during the crisis are meant to better prepare supervisors and banks for the next inevitable crisis.

Complacency and selective or short memories are particularly corrosive forces that will undermine our efforts and against which we as supervisors have to continuously fight.

New regulations are often criticised for being backward looking, that regulators are always fighting the last war and trying to solve yesterday's problems in an ever-changing world. However, without solving the problems we have already faced, they become today's problems and can persist into the future. It is true that, as the Spanish American philosopher George Santayana famously stated, "Those who cannot remember the past are condemned to repeat it".

I would like to offer a final thought on this issue by highlighting the complex, global and interconnected world in which we live. Much can be understood about the recent crisis simply by its name: it has not been deemed the "American" or "Western" crisis, but rather "the global financial crisis". Seldom, if ever, in history has financial contagion been truly global in scale. The effects were transmitted in ways and to regions that were not previously envisaged. Past regional crises, such as the Asian crisis, were also often far reaching, but never to such a degree. The next crisis may originate in or more heavily impact emerging markets. If so, the effects of globalisation could amplify its contagion and repercussions, and the effects of the next crisis could potentially be greater than this one.

The Committee's response and work ahead

That brings me to the Basel Committee's response that focuses principally on how banks of any size and complexity should manage risk. The Basel III capital and liquidity requirements highlight the necessity that banks not only hold higher levels of better quality capital, but also a sufficient pool of highly liquid assets to be able to weather a liquidity stress. Basel III also introduces principles for enhanced risk coverage in a variety of areas. I would like to touch briefly upon some of these important contributions.

Basel III introduces a global liquidity framework where rules previously did not exist. Beginning in 2007, we learned a quick and painful lesson: a solvent bank is not necessarily a liquid bank. Furthermore, the crisis painfully reminded us that liquidity shocks tend to precipitate insolvency.

It's worth remembering that the recent crisis was initially viewed by many solely as a liquidity crisis. With the clarity of hindsight, we have observed that, in reality, the fundamental problem was related to banks' solvency and not solely liquidity. Basel III addresses this by increasing the minimum capital requirement with a focus on the highest-quality, most loss-absorbing form of capital: common equity. The crisis clearly highlighted that hybrid capital instruments proved inadequate at absorbing losses.

One can also say that levels of common equity were inadequate leading up to and during the crisis. In response, Basel III also introduces capital buffers which banks are expected to build up during good times and to draw on them in times of stress. The buffers, which impose restriction on capital distributions, such as dividends and share buybacks, will allow banks and supervisors to more effectively address solvency issues at an earlier stage.

Another critical element of Basel III is the leverage ratio, which will serve as a backstop to the risk-based capital requirements. Clearly, the build up of leverage and the subsequent deleveraging process has had a significant destabilising factor during the crisis, and currently. The experience of the crisis showed that more highly leverage firms were more likely to fail or require direct government support than firms that were less leveraged.

Basel III was released in December 2010 but the Committee's policy development is not complete. In the last month alone, we have issued:

- FAQs related to Basel III's definition of capital;
- revisions to the Basel regulatory capital adequacy framework related to the treatment of trade finance that will help promote trade with low income countries;
- a consultative paper on capitalisation of bank exposures to a central counterparty (CCP); and
- (last but not least) the Committee's framework to identify global systemically important banks (G-SIBs), the magnitude of required additional loss absorbency for G-SIBs, and the arrangements by which the requirement will be phased in

Further policy work continues, including a fundamental review of the trading book; work related to large exposures; recalibration and redesign of the securitisation framework; and the review of the Core Principles for Effective Banking Supervision. This policy development and standard setting work has traditionally been the Committee's central focus. These days, however, the focus has shifted substantially. The primary focus now centres on implementation.

Implementation

The standards and principles that the Committee has formulated will strengthen the financial system and provide the supervisory community with the necessary tools to respond to a future crisis. But there is an important caveat I must add: the stronger, tougher rules will only achieve their objective if – and only if – they are effectively put into practice globally, consistently and in a timely manner. Internationally consistent implementation is the key to promoting safety and soundness and mitigating the global contagion we witnessed during the crisis. Setting rules without ensuring their implementation is akin to building a lighthouse without ever switching the light on. Moreover, financial systems in different parts of the world are likely to become even more interconnected. There is, therefore, an increased need to ensure that ALL countries implement Basel rules to ensure global financial stability.

The Basel Committee is taking unprecedented steps to ensure that the Basel rules and principles are fully implemented into its members' national regulations, as agreed. It is worth reflecting on how much of the risk management failures we witnessed during the crisis might have been avoided if supervisory sound principles and guidance had been implemented by banks and enforced by supervisors. The Committee's liquidity risk management guidelines issued in 2000 serve as an instructive example: The guiding principles would have effectively addressed many of the issues observed during the crisis if they had been effectively implemented. In an effort to ensure we are not condemned to repeat history's mistakes (as the lessons learned from the crisis begin to fade), the Committee has devoted considerable resources to promote the work of putting these important Basel principles into practice.

How has the Committee responded? It has mandated the Standards Implementation Group, or SIG, to closely monitor the implementation of the Committee's initiatives, including of course Basel III. In just about one year, on 1 January 2013, Basel Committee members have agreed to adopt Basel III into their national laws and regulations. Supervisors must ensure that these rules are implemented in a timely and consistent manner, as was agreed by the Committee. Any efforts to delay or water-down the agreements will jeopardise financial stability, and undermine the long-term robustness of the recovery. Supervisors play the most pivotal role in promoting the Basel agreements.

The work of the SIG to monitor implementation will be conducted along several lines.

- At the most basic level, the SIG will assess members' progress in adopting Basel II, Basel II.5 and Basel III. The first of these progress reports has recently been published. The report details the degree to which jurisdictions have implemented the Basel rules. It is the intention of the Committee that publishing the implementation progress of jurisdictions along these lines will encourage (and, where necessary, pressure) jurisdictions to promptly and effectively take action.
- A second level of review will be to assess the consistency of its members' national or regional regulations with the globally-agreed Basel III rules text. This will entail both off-site and on-site assessments of individual countries and will include a rigorous peer review process and public disclosure of the results.
- The third level of the Committee's approach will be to assess whether the rules are delivering comparable outcomes at banks. This work will initially focus on the measurement of risk-weighted assets across banks and jurisdictions, covering both the banking book and the trading book. Here too, public disclosure of the findings is envisaged.

In the past, the SIG has focused on promoting consistency in the implementation of the Basel standards through sharing information and experiences among supervisors. This has been effective and much has been learnt from this process – supervisory colleges for example were developed by the SIG and much progress was made in addressing home-host issues. Moving ahead, however, the Committee will conduct onsite follow-up and thematic peer reviews to further strengthen the global implementation process. This represents a significant practical and cultural shift in the way international agreements are implemented. The Committee has not previously taken its assessments to the doorsteps of banks or supervisors. However, this is exactly what it seeks to do: global review teams will begin looking at individual countries and banking institutions in a much more detailed manner. Basel Committee members have agreed with this approach to ensure the Basel rules are implemented as agreed and as expected.

These are just a few of the undertakings underway to address implementation. Looking ahead, there are clearly significant risks on the horizon. The implementation of the Basel Committee's reforms will promote a strong and stable global banking system that is able to mitigate individual banking risks as well as global contagion.

Conclusion

In concluding my remarks, I would like to reiterate that the factors that contributed to the recent financial crisis will continue to occur albeit in different forms, triggered by different mechanisms and arising in any part of the world. The corrosive forces of short memories and supervisory complacency, whether due to a false sense that this could not happen in your jurisdiction or because Basel III and other rules will ward off future crises, must be avoided. Moreover, the risk of global contagion that exists today underscores the need for a consistent global regulatory framework. The Basel Committee's response has been to ensure that banks, banking systems and supervisors are better prepared to cope with the next crisis, wherever it arises.

The financial crisis resulted in a bold response by the Committee. The lessons from the crisis and the foundation for better preparing for the next one are enshrined in Basel III. However, these efforts will have been in vain if they are not globally implemented on a consistent and timely basis. The Committee has already embarked on an aggressive programme to help ensure that its rules are indeed implemented as agreed and that they produce the intended results.