



Basel III: Necessary, but not sufficient

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I am pleased to deliver this keynote address to the Financial Stability Institute's 6th Biennial Conference on Risk Management and Supervision. The Basel Committee regards its continuing partnership with the FSI as both important and highly productive. This conference is a great example of the FSI's ability to bring regulators and supervisors together from around the globe to discuss important regulatory issues. The agenda for today and tomorrow looks extremely interesting, and the range and quality of speakers is impressive. We are very pleased to be able to support this Conference, and I hope you all have an enjoyable stay in Basel.

My main message to you this afternoon is that implementing Basel III is essential, but it must be accompanied by other measures and reforms so that a truly healthy banking system is secured for the future. We need our regulatory and supervisory approaches to work in tandem, as neither is sufficient on its own. We must implement Basel III and the other agreed reforms in a full and timely manner, upgrade our supervisory capabilities, and be responsive to stress and risks as they arise. We cannot guarantee a 'no more crises' era ahead, but we can assure enhanced resilience.

Why is Basel III necessary?

We all know that exercise is good for us, and that fit and healthy people tend to live longer, happier and more fulfilling lives. Yet many of us – and I certainly cannot claim to be any exception to this – struggle to do the amounts of exercise and follow the kind of diet that we know will be good for us.

Changing our habits can be hard. Some people who wish to improve their wellbeing are fortunate enough to have the willpower to resist temptation and change their lifestyle on their own accord. Others who want to make the change struggle on their own, so join a gym, or hire a personal trainer, to help provide additional encouragement and mutual support. Some others, unfortunately, ignore the risks and require a major health crisis before they are capable of changing. And some, of course, do not think about change at all - until it is too late.

If you aspire to a healthier lifestyle, however, there are some common prescriptions to help make changing habits easier and more manageable:

- First, be clear about your objective: know what you are working towards, and why it is important.

- Second, think about a timeframe over which you can achieve your goals, and be reasonable rather than aggressive (it's always nicer to surprise yourself by over-achieving than to become despondent by failing to meet unrealistic targets).
- And then set yourself intermediate goals that allow you to monitor progress and ensure you stay on the right track.

Most importantly, though, get started. Do not put it off for tomorrow, because tomorrow there will always be reasons why it is not a good time to begin.

Why am I telling you all this? Because we need to think about regulatory reform in much the same way. In the pre-crisis years, the financial sector lived life to excess: the good times were difficult to resist, and little restraint was shown. Eat, drink and be merry was the general philosophy and we, as regulatory chaperones, were not sufficiently vigilant. We are all now dealing with the inevitable hangover, and parts of the industry are in ill-health and badly out of shape. A few banks are in intensive care, and some didn't make it. We therefore need to guide the industry through a change of lifestyle. Our goal is a banking sector that can operate in a manner that is competitive and financially sound.

The theme for my presentation today is that Basel III is necessary, but not sufficient, for a healthy financial system. Before I explain why, let me recap the key elements of Basel III:

- Basel III requires banks to maintain higher levels of capital, with minimum common equity holdings at banks increasing from 2% to 7% of risk weighted assets.
- Basel III requires banks to hold higher-quality forms of capital, with common equity at the core of the requirements, and standards to ensure other types of capital instruments are genuinely loss-absorbing.
- The new rules improve risk coverage, particularly for complex, illiquid trading activities and off-balance sheet exposures.
- We've introduced a capital conservation buffer, designed to enforce corrective action when a bank's capital ratio deteriorates, and a countercyclical buffer to require banks to hold more capital in good times to prepare for the inevitable rainy days ahead.
- We've added a leverage ratio as a backstop for the risk-based capital approach, to ensure banks do not become unduly leveraged on a non-risk-weighted basis.
- Lastly, Basel III introduced the first ever international standards for bank liquidity and funding, designed to promote the resilience of a bank's liquidity risk profile to both short and longer-term disruptions.

Over and above these changes, the Committee has agreed additional capital requirements for those banks deemed systemically important at the global or domestic level. These reforms are designed to account for their negative externalities, ie the additional costs their failure would impose on society.

There is a broad consensus that this is a comprehensive response to the lessons of the crisis, and will produce a banking system that is far more resilient, and less prone to excess, than was the case in the past.

Having designed the new framework, we now need to implement it. Often we hear it questioned whether it is really all necessary, particularly in the current economic

environment. And can it be put it off until tomorrow? In response, let me return to my exercise analogy.

First, let's be clear about our goal, and why the full, timely and consistent implementation of Basel III is most definitely important. In setting out why this is the case, we can look to the past, the present and the future.

- First, we would be failing in our duties to the communities we all serve if we did not learn and respond to the lessons of the recent past. With hindsight, it is easy to see that previous international minimum standards for bank capital were too low. Regulations were insufficient to act as a constraint on the natural incentive within banks to increase leverage: not only did they allow leverage to reach very high levels, they also enabled that leverage to be built on a capital base which proved somewhat illusory when needed. This lack of true resilience within the banking system led to widespread and significant financial instability when the music stopped and markets abruptly turned away from risk-taking. *Basel III responds to this experience by substantially raising minimum capital requirements, focused primarily on common equity, and ensuring that other instruments that count as regulatory capital will genuinely be available in times of need.*
- Second, we need to understand the demands of the environment we are presently living in. The decade to 2007 was one in which banks maximised, and were rewarded for, *capital efficiency* – high levels of equity capital were seen as a negative and, without much constraint applied by debt holders, bank management became very focused on finding ways to return capital to shareholders. For the foreseeable future, the priority will be *capital strength*. Of course, shareholders will still want to avoid having excess capital sitting idle, but investors and rating agencies now attach a much greater weight to having a strong capital base, and the risk premia paid by banks in weaker positions will be much higher. Capital strength is a competitive advantage at a time of fragile markets and weak economic conditions. In such an environment, only strong banks have the trust of their counterparties to enable them to borrow without difficulty, and therefore to lend confidently. Weak banks can do neither. *Basel III is the foundation for restoring the financial health of banks, including so that they will willingly and actively deal with one another, which is in turn critical to restoring the functioning of the financial system more generally.*
- And finally, a robust set of international banking standards is critical for the future. At a time when concern is justifiably being expressed about fragmentation of the financial system, preserving the foundation for a competitive international banking landscape in the future has never been more important. In responding to the crisis, it is critical that we avoid a patchwork of diverse national measures which act as a barrier to cross-border banking business. Full, timely and consistent implementation of internationally agreed standards makes it far easier for banks to operate and compete internationally. If we do not continue to work towards this goal, then we only make it harder to reverse the current retraction in international banking activity. *The consistent implementation of Basel III consistently around the world will help provide the foundation on which banks can expand and compete in the international marketplace.*

Given our objective is clear and important, we then need to think about the timetable, and our intermediate goals. We do not want to set unattainable targets, but we want to make sure we can see we are making steady progress towards our objective.

Many people who are not closely involved with Basel III at least know that capital requirements are being substantially raised, and that it is intended to come into force at the beginning of 2013. This can unfortunately lead to a perception that, in less than two months' time, there will be a "big bang" and banks will have the full weight of the new regulatory

framework thrust upon them – whether they are fit enough to deal with it or not. That perception could not be further from the truth:

- The process is graduated and implementation is calibrated such that the full suite of Basel III changes come into force only in 2019 – more than a decade after the onset of the financial crisis, and more than half a decade from now.
- In January 2013, the key changes from the current regime that banks will need to meet are relatively minor:
 - a minimum common equity Tier 1 (CET1) ratio of 3.5%;
 - a minimum Tier 1 ratio of 4.5%;
 - tighter rules for issuing new capital instruments;
 - a haircut of 10% on capital instruments already on issue that no longer meet eligibility requirements; and
 - higher requirements for counterparty credit risk.

Importantly, none of the new deductions from capital, the buffers, the leverage ratio, the systemic add-ons, or the liquidity requirements are to come into force next year. The 2013 requirements are not onerous. Therefore, the arrival of Basel III is more of a “hasten slowly” approach than any kind of “big bang” change.

- In the intervening period out to 2019, higher minimum requirements and tighter definitions of capital will be phased in progressively:
 - the new CET1 ratio of 4.5% does not come into force until 2015;
 - new deductions are phased in beginning from 2014, and only take full effect in 2018;
 - the new buffers – capital conservation and countercyclical – are not being introduced until 2016, and even then are subject to some phasing; and
 - ineligible capital instruments – those that proved of questionable value in the crisis – are being phased out over 10 years.

Phase-in arrangements

(shading indicates transition periods - all dates are as of 1 January)

	2011	2012	2013	2014	2015	2016	2017	2018	As of 1 January 2019
Leverage Ratio		Supervisory monitoring	Parallel run 1 Jan 2013 – 1 Jan 2017 Disclosure starts 1 Jan 2015					Migration to Pillar 1	
Minimum Common Equity Capital Ratio			3.5%	4.0%	4.5%	4.5%	4.5%	4.5%	4.5%
Capital Conservation Buffer						0.625%	1.25%	1.875%	2.50%
Minimum common equity plus capital conservation buffer			3.5%	4.0%	4.5%	5.125%	5.75%	6.375%	7.0%
Phase-in of deductions from CET1 (including amounts exceeding the limit for DTAs, MSRs and financials)				20%	40%	60%	80%	100%	100%
Minimum Tier 1 Capital			4.5%	5.5%	6.0%	6.0%	6.0%	6.0%	6.0%
Minimum Total Capital			8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%
Minimum Total Capital plus conservation buffer			8.0%	8.0%	8.0%	8.625%	9.25%	9.875%	10.5%
Capital instruments that no longer qualify as non-core Tier 1 capital or Tier 2 capital			Phased out over 10 year horizon beginning 2013						

What does our starting point look like?

We have developed a fitness plan that is designed to guide banks towards good financial health in a gradual and, as a result, more manageable and less disruptive manner. The goals are clear, as are the intermediate steps. Now we need to get on with it.

So where are we starting from – what is the current health of the industry? As we all know, it is easy to make the first step if the first step is small enough, even for those that are struggling with the most basic fitness levels.

Our most recent impact study¹ reveals that the vast majority of banks already meet the minimum capital standards set out in Basel III, with smaller banks leading larger banks in their relative capital readiness. We do our calculations on a “fully loaded” basis – that is, based on the rules that will apply at the end of the transition period in 2019. So these numbers understate the readiness of the industry to take the first step. Most obviously, the industry already exceeds, on a weighted average basis, the CET1 minimum required in 2019, let alone in 2013 when the new deductions and buffers aren't applicable and most non-compliant capital instruments will still be allowed to count.

In other words, the steps that banks have already taken to bolster their capital buffers have had a substantial and positive effect, such that the industry will not be disrupted or face financial pressures due to the introduction of Basel III next year. There is some work to be done to get into shape for the minimums that will come into full force in 2019, but equally there is still plenty of time, and a gentle path, to get there. And for those banks that already clearly meet the new standards, they need to only ensure they maintain their current health.

Results of Quantitative Impact Study^(a) (end 2011 data, 208 banks)				
	2013 minimum ^(b)	Group 1 ^(c) (n = 101)	Group 2 ^(c) (n = 107)	2019 minimum ^(d)
CET1	3.5%	7.7% (6.7%-10.9%)	8.8% (7.0%-13.4%)	7.0%
Tier 1	4.5%	8.0% (6.8%-10.9%)	9.2% (7.2%-13.4%)	8.5%
Total	8.0%	9.2% (8.1%-12.1%)	11.0% (8.8%-14.4%)	10.5%

(a) Results show weighted averages for Group 1 and Group 2 banks; figures in parentheses show 25th to 75th percentile range

(b) 2013 minimums do not require full removal of all deductions from capital base, and include 90% of ineligible capital instruments.

(c) Group 1 banks are those that have Tier 1 capital in excess of €3 billion and are internationally active. All other banks are considered Group 2 banks.

(d) 2019 minimums include capital conservation buffer, but do not include any countercyclical buffer, or surcharges (if applicable) for designated G- and D-SIBs.

¹ See *Results of the Basel III monitoring exercise as of 31 December 2011*, published on 20 September 2012.

Why is Basel III not sufficient?

So we have established that Basel III is necessary, and that banks are reasonably well positioned to meet the new capital requirements. But I also made the assertion earlier that Basel III was not sufficient. Why not?

Here, let me offer three reasons why Basel III needs to be complemented by other measures to deliver the sort of financial stability outcomes that the community expects.

First is that we have not yet completed the full set of policy reforms. The Basel Committee still has a very full policy agenda to be completed before we can say the overhaul of the regulatory framework has incorporated all the lessons of the crisis:

- We need to complete the work on liquidity: in the short term, to decide on any revisions to the Liquidity Coverage Ratio (LCR), and then review and refine the Net Stable Funding Ratio (NSFR). We are working towards being able to announce the final form of the LCR in the first part of 2013; the NSFR will take longer. In addition, we need to complete the specifications of the leverage ratio, including associated reporting requirements, ahead of its introduction as a disclosure item in 2015.
- We have embarked on a fundamental review of the trading book rules, given that activity in this area was a major source of the problems that led to the financial crisis. Basel 2.5 was a short-term tactical response designed to shore up capital requirements in the trading book. We are now stepping back to review the trading book rules more generally. As you know, we have already issued a consultative paper and are reviewing the feedback received. We expect to issue more detailed proposals, and undertake an impact study, during 2013.
- For similar reasons, we are reviewing the treatment of securitisation within the Basel framework. Securitisation has an important role to play in the provision of finance, and it is important that the prudential regime does not impede sensible securitisation activities. Equally, the lessons of the past few years have shown us that our regulatory regime did not adequately capture the risks that banks were exposed to from their securitisation activities. Proposals in this area are due out before year-end.
- We are reviewing the large exposures regime, which has been largely untouched for more than a decade. While at face value every jurisdiction has some kind of large exposures regime, and most are founded on a maximum exposure limit of 25% of capital, in practice the rules vary considerably from country to country, and there are a myriad of local rules and interpretations that make it very difficult to assess how robust any individual regime actually is. The Committee is therefore examining the merits of a more consistent approach to large exposures, and will make public some proposals for comment during the course of 2013.
- Finally, the Basel Committee is considering the need to review the standardised approaches to capital adequacy. At the very least, we need to examine the reliance of the standardised approach on external ratings, and to see what can be done to reduce it.

These are all on the agenda because we think there are aspects that need improvement. Basel III helps lift the financial health of the banking system, but we need to make sure there are no remaining weaknesses in the prudential framework that will undermine the substantial improvements we are making elsewhere.

Second, we need to ensure robust implementation. That means more than just having a set of local rules titled 'Basel III'.

At the urging of the G20 Leaders, the Basel Committee and the other standard setters have established implementation programmes to monitor the translation of internationally-agreed reforms into national actions. These initiatives are now beginning to produce their initial reports. For example, the Basel Committee has commenced regular reporting on each member country's progress towards meeting the implementation schedule for Basel III, and has published the first reviews for three jurisdictions. We are also using international teams of supervisors to examine the consistency (or otherwise) of the application of the Basel rules in individual banks. As other Basel standards and policies are completed, the focus on implementation is also expected to rise.

To achieve the goals of policy reform, we need to make sure the reforms are implemented by national authorities in a full, timely and consistent manner. Only then will we see the full benefits of healthier banks and financial systems bear fruit. Alongside our work to finalise the remaining items on the reform agenda, we need everyone to commit to implement the agreed reforms in full and on time, and to use the results of the implementation assessments constructively to fill any identified gaps or deficiencies.

My third, and perhaps most important, reason why Basel III is necessary but not sufficient is that rules alone, no matter how well written and how consistently implemented, will not be enough to deliver the financial health and stability of the banking system that we desire. (If they were, many of you would not be here, since we would not need supervisors to monitor banks day-to-day.) We have designed the fitness regime, and are working to ensure it is correctly translated into local languages, but without supervisors encouraging, coaxing, and cajoling banks to stick to the programme, and occasionally reprimanding the laggards, we will not meet our goals. Indeed, without on-going vigilance, there is always a risk we will return to bad habits of the past.

Therefore, we also need to upgrade supervisory capabilities, demonstrating resolve to act in good times and not simply when faced by impending crisis. Supervisors do their most important work when they are seemingly valued the least. Their job is to be vigilant in monitoring risks when complacency is high and it is presumed nothing can go wrong. Basel III will not change that.

Here I would like to emphasise the fundamental importance of the Basel Committee's revisions to the *Core Principles for Effective Banking Supervision*, which were completed in September this year. A roadmap for strong supervision, the Core Principles represent contributions from a wide range of supervisors and seek to internalise lessons from the crisis before memories fade. Even though it receives far less prominence, this work is at least of equal importance to the Basel III framework in my view – it complements the stronger rules by setting out the necessary conditions for effective supervision to take place.

Those of you familiar with the Core Principles will know that the revised set of 29 Principles was reorganised to highlight the difference between what supervisors do and what they expect banks to do. The first half (Principles 1 to 13) address supervisory powers, responsibilities and functions, focusing on effective risk-based supervision, and the need for early intervention and timely supervisory actions. The remainder (Principles 14 to 29) covers supervisory expectations of banks, emphasising the importance of good corporate governance and risk management, as well as compliance with supervisory standards.

Important enhancements were introduced to the individual Core Principles, particularly in those areas that are necessary to strengthen supervisory practices and risk management. As a result, certain "additional criteria" have been upgraded to "essential criteria", while new assessment criteria were warranted in other instances.

Close attention was given to addressing many of the significant risk management weaknesses and other vulnerabilities highlighted in the financial crisis. In addition, the review took account of several key trends and developments that emerged during the last few years of market turmoil:

- the need for greater supervisory intensity and adequate resources to deal effectively with systemically important banks;
- the importance of applying a system-wide, macro perspective to the micro-prudential supervision of banks to assist in identifying, analysing and pre-emptively addressing systemic risk; and
- the increasing focus on effective crisis management, recovery and resolution measures to reduce both the probability and impact of a bank failure.

In response, the Committee gave added emphasis to these emerging issues by embedding them into the Core Principles, where appropriate, and including specific references under each relevant Principle.

These are significant improvements, deliberately seeking to raise the bar for supervision. Implementing the Core Principles in a meaningful fashion is just as important as implementing Basel III, and just as critical to our ongoing success in maintaining a healthy banking sector.

Concluding remarks

Since the beginning of the financial crisis in 2007/08, an impressive amount of regulatory reform has been enacted – not just by the Basel Committee, but also by the other international standard setters. Of course, it needed to be done: the crisis highlighted the many weaknesses in the regulatory regime that existed at that time. But that does not undermine the tremendous effort that has been put in over the past few years to significantly overhaul the international regulatory architecture.

There is no doubt that the reforms, both those already announced and those still in the pipeline, will make financial institutions more resilient, reduce the reliance of the private sector on central banks, and help tackle the too-big-to-fail problem. That is what the G20 Leaders asked us to do. There is more to be done, but we just need to keep focussed on finishing the job – we shouldn't let up now. This was reiterated in last night's communique from the G20 Finance Ministers and Central Bank Governors, which said "*We remain committed to the full, timely and consistent implementation of the financial regulation agenda ... We agree to take the measures needed to ensure full, timely and effective implementation of Basel II, 2.5 and III and its consistency with the internationally agreed standards.*"² In other words, get on with it.

Perhaps more importantly, however, we always need to remind ourselves that well-functioning financial systems are always built on a high degree of trust. Writing new rules will not be enough, by itself, to restore badly needed faith in the health of the global financial system. International agreements need to be implemented in national markets, and then national rules need to be supported by strong supervision.

² Paragraph 15 of communique issued at the conclusion of the G20 Finance Ministers and Central Bank Governors meeting, Mexico, 4-5 November.

With Basel III, we have laid the foundation with a strong set of minimum standards. But they are exactly that – minimum standards. They are necessary, but not sufficient: Basel III cannot be relied upon to deliver stability on its own. So there is more to be done, and we must push on with the reform agenda to deliver full, timely and consistent implementation.

Of course, we need to be mindful of carefully managing the transition to the new regime so as to reap the benefits without imposing unnecessary costs. Basel III does this, for example, by introducing the new capital requirements gradually. Although they are due to begin in less than two months' time, the new requirements that are meant to be in place next year are modest. Full implementation is still more than half a decade away – and more than a decade after the crisis began – so we cannot be accused of rushing things!

Ultimately, we must remember that to lend confidently, banks must be able to borrow confidently. Weak banks can do neither. Full, timely and consistent implementation of regulatory standards, designed to restore banks to financial health, is therefore essential for a return to a well-functioning financial system. The Basel Committee has designed a fitness regime for banks that is modest at the outset and increases in intensity over time. Like all fitness routines, this will be more difficult for some than others, but faithful adherence will yield positive results for all over the long run. And once we have a healthy banking system, we need to monitor it effectively to minimise the risk of a return to the bad habits of old.

Thank you.