Basel Committee on Banking Supervision

BANK FOR INTERNATIONAL SETTLEMENTS

Global adoption of the Basel framework: enhancing financial stability across countries

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9th Islamic Financial Services Board Public Lecture on Financial Policy and Stability

Kuala Lumpur, Malaysia, 5 April 2017

Introduction

Good morning and thank you for the opportunity to participate in the ninth Islamic Financial Services Board Public Lecture on Financial Policy and Stability. It is always a pleasure for me to be in Kuala Lumpur, but in particular for two reasons this time. First, it allows me the opportunity to visit an important participant in the Basel Committee process, as Malaysia, along with Chile and the United Arab Emirates, has been an observer at the Committee since 2014. This reflects the growing geographical reach of the Committee, as well as its recognition of the importance of outreach activities. Second, Malaysia is one of the founding fathers of the Association of Southeast Asian Nations, or ASEAN, which contributes to further banking integration in this region and which celebrates its 50th anniversary this year. I would like to thank the Islamic Financial Services Board (IFSB) not only for inviting me to speak at this event but also for having established a close working relationship with the Basel Committee at the outset. This close relationship is reflected in IFSB's membership in the Committee's Basel Consultative Group and my participation in this week's events.

There is yet one more reason that I am pleased to be here today, and that is because I have the opportunity to discuss something other than reforms to the Basel III framework. My focus this morning is on something no less important – and that is implementation. In banking circles, the term has attracted much attention in recent years as the Basel Committee's post-crisis regulatory reforms were – or will soon be – completed, but this is not at all new. Following the ninth International Conference of Banking Supervisors in Stockholm in 1996, G10 Governors noted the widespread acceptance of Basel standards. One problem, as they saw it, was that of success. Many countries wanted to obtain the Committee's "seal of approval" for adopting its standards but needed assistance to implement them. The Governors wrestled with this issue. How far should the Committee become engaged in implementation? Should it certify compliance?

It took two decades, but I am pleased to say that the Committee has forcefully responded to these questions. The Committee's review of its members' domestic implementation of global standards has become a central element of our work. A central impetus for moving in this direction was important lessons learned from the global financial crisis. The Committee and its governing body, the Group of Governors and Heads of Supervision, places a high priority on the full, timely and effective implementation of Basel standards. In 2013, Basel Committee Chairman Stefan Ingves put it very well when he said, "If we are serious about fixing the problems of the past, then we need to not just look at the policy settings, but also their application. Our efforts on implementation should therefore be seen as an integral part of the reform agenda."[1] It was in this spirit that, in 2012, the Committee launched its comprehensive Regulatory Consistency Assessment Programme (RCAP).

I will focus my remarks this morning on four topics. First, I will emphasise why the implementation of Basel standards is of critical importance. Second, I will outline the key elements of the Basel Committee's implementation programme – the RCAP. I will then describe the success of the programme in increasing the consistency of prudential standards in the Committee's member jurisdictions. Finally, I will say a few words about other efforts under way to facilitate the implementation of new Basel standards and to assess their impact.

The implementation imperative

The Committee's mandate is to strengthen the regulation, supervision and practices of banks worldwide, to enhance global financial stability. Robust global prudential standards, combined with effective bank supervision, are essential to promote the safety and soundness of banks and resilient banking systems. This, in turn, is an essential ingredient of financial stability.

Financial stability is a public good. In an open global financial system, the absence of global prudential standards, or the inconsistent implementation of such standards, produces regulatory fragmentation and an uneven competitive playing field.[2] If global standards are implemented inconsistently or unevenly, large internationally active banks must comply with a patchwork of rules that is both costly and inefficient. This lack of consistency across jurisdictions may also give rise to concerns about the resilience of individual jurisdictions. Therefore, strong global standards not only enhance the resilience of internationally active banks and the financial stability of the individual jurisdictions in which they operate, but also create a level playing field and facilitate the efficient use of capital and other financial resources.

Basel Committee standards are global *minimum* standards. In response to the global financial crisis, the Committee introduced a comprehensive and wide-ranging strengthening of global banking standards, most notably through the Basel III framework. These post-crisis reforms set significantly higher requirements for loss absorption and place greater emphasis on higher-quality capital, while better capturing the full scope of risks that banks face. The framework now includes a leverage ratio requirement, capital buffers to mitigate various sources of systemic risk, and standards limiting excessive liquidity risk and maturity transformation. Broadly speaking, the framework has two complementary objectives: first, to ensure minimum global standards of resilience so that banks are less likely to fail; and second, to reduce the impact on the financial system and the economy in case they do.

Full and consistent implementation of these standards within the internationally agreed time frame is therefore critical to strengthening the resilience of the banking system and promoting a level playing field.

Since the Committee does not possess any formal supranational authority, its decisions do not have legal force. Rather, once the Committee agrees on a standard, it is then the responsibility of its member jurisdictions to convert this standard into law or regulation. The Basel Committee is comprised of

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1 See www.bis.org/review/r130124a.pdf.

2 This calls to mind the "financial trilemma" as described by Professor Dirk Schoenmaker that states that financial stability, financial integration and national financial policies are incompatible. Any two of these three objectives can be combined but not all three; one has to give. See http://personal.vu.nl/d.schoenmaker/Financial_Trilemma.pdf.

27 member countries or 19 jurisdictions if the European Union members are counted as a single bloc. According to our charter,[3] members commit to apply the agreed standards in their domestic jurisdictions within the pre-defined time frame established by the Committee. This is why Committee decisions are taken by consensus among its members.

The Committee's implementation programme (RCAP)

Let me now turn to how the Basel Committee has put these concepts into practice. In 2012, the Committee launched its comprehensive Regulatory Consistency Assessment Programme (RCAP). The RCAP has three objectives. First, it monitors the timely adoption of Basel standards by our members. Second, it conducts peer reviews on the completeness and consistency of the standards adopted by member jurisdictions, including the significance of any deviations from the Basel framework. Third, it seeks to assess outcomes of the application of these standards.

Timeliness

To ensure timely adoption of its standards, the Committee regularly publishes reports on the adoption status of Basel standards by member jurisdictions and large banks. Such disclosure provides an incentive for jurisdictions to align their domestic implementation with the agreed timelines. These reports have been published semiannually since October 2011 and are shared with the Financial Stability Board and G20 Leaders.[4]

The latest monitoring report was issued in October 2016. It shows that member jurisdictions have made good progress in adopting the Basel III standards and are generally on track to implement these standards following the agreed timeline. In particular, it shows that all member jurisdictions have in force final risk-based capital rules, Liquidity Coverage Ratio (LCR) regulations and capital conservation buffers. Also, all member jurisdictions but one have issued final rules for the countercyclical capital buffers, and all but two have issued final or draft rules for their domestic systemically important bank (SIB) framework. In addition, all members that are home jurisdictions to global systemically important banks (G-SIBs) have the final framework in force. The Committee will publish the next monitoring report later this month.

Jurisdictions that are not members of the Basel Committee also report substantial progress in adopting Basel III standards. The Financial Stability Institute (FSI) publishes a regular overview of that progress, which shows that a significant number of these jurisdictions have already brought key elements of Basel III into force or are in the process of doing so, many of which have closely followed the Basel Committee agreed implementation dates.[5] Information obtained from FSI surveys on the implementation of the Basel framework shows that, in 2012, only six non-Basel Committee countries had adopted final rules relating to the new definition of regulatory capital. This number increased to 44 in 2014 and exceeded 60 by the end of 2016. We see similar trends with respect to the LCR. By 2018, around 70 non-Basel Committee member jurisdictions intend to have issued final rules on these two key elements of the Basel III framework.

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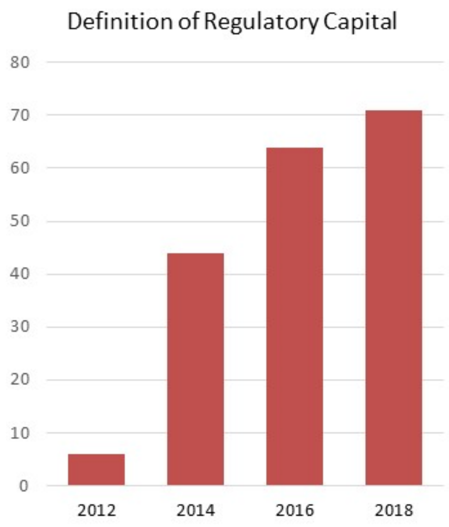
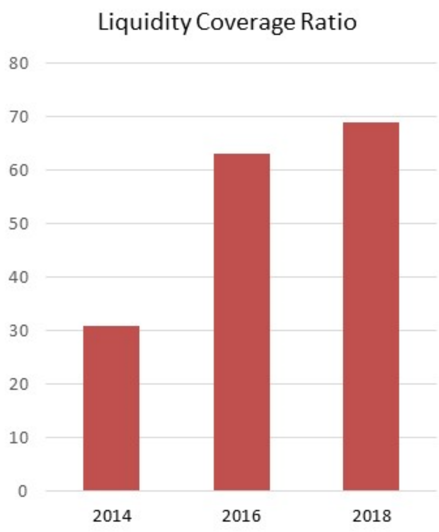
[3] See www.bis.org/bcbs/charter.htm.

[4] The Committee's progress reports on implementation and G20 updates are available on its implementation webpage: www.bis.org/bcbs/implementation.htm.

[5] See www.bis.org/fsi/fsipapers.htm.

Number of non-BCBS member jurisdictions that have implemented Basel III standards





Consistency

Timeliness of implementation is the first step; the next is to build trust in the substance and consistency of what has been implemented. For this, we conduct peer review assessments that examine the consistency and completeness of a jurisdiction's adopted standards.[6] These assessments examine whether the internationally active banks in each member country are held to standards in line with the letter and spirit of the relevant Basel standards. The assessment reports, which are public, provide transparency on cross-jurisdictional differences and their significance in the local context. The programme also allows jurisdictions to initiate corrective measures, as appropriate, to strengthen their regulatory regimes.

The RCAP will in due course review the implementation of all Basel standards. In December 2016, the Committee completed its review of the implementation of the risk-based capital framework in all its members. Further, assessments of the Basel G-SIB framework were published in June 2016, covering the five jurisdictions that are currently home to G-SIBs. By end-2017, the Committee will complete its assessments of the implementation of the LCR. Thereafter, the Committee will review the implementation of the Net Stable Funding Ratio (NSFR), as well as other new standards and updates agreed by the Committee in recent years.

Outcomes

The assessments of regulatory outcomes seek to ensure that the prudential ratios calculated by banks are consistent across banks and jurisdictions. In other words, the ratios should reflect differences in risk rather than in practice. This analysis extends the findings of the Committee's implementation monitoring and

[6] The Committee's jurisdictional assessments are available at www.bis.org/bcbs/implementation/l2.htm.

jurisdictional assessments – both of which focus on domestic rules and regulations – to implementation at the bank level.

The Committee has published five reports on the consistency of risk-weighted assets for similar assets in banks' loan portfolios and trading books.[7] These analyses confirmed that there are material variances in banks' regulatory capital ratios that arise from factors other than differences in the riskiness of banks' portfolios. This motivated the range of ongoing Basel III reforms aimed at reducing excessive variability of risk-weighted assets. These reforms include revisions aimed at enhancing the standardised approaches, constraining the discretion of internally modelled approaches and complementing the risk-weighted framework with a robust leverage ratio and output floor.

Increasing compliance with Basel standards

We are now in the fifth year of the RCAP, and I think it is safe to say that, from an implementation perspective, these have been five very effective years. The RCAP has clearly contributed to improvements in the consistency of banking regulation across Basel Committee members.

As a result of the assessments, most jurisdictions have taken commendable actions to increase compliance with the Basel standards. This is evident from the high number of rectifications made during our peer reviews. The assessments of the capital framework originally identified more than 1,200 "findings", and the majority were rectified during the assessment. Overall, two thirds of Basel Committee members have risk-based capital standards considered compliant or largely compliant with the Basel standards.

With respect to the LCR, the Committee has assessed 12 jurisdictions so far, with a high level of compliance. The assessments identified around 170 findings, and members rectified more than 80% of them during the assessment.

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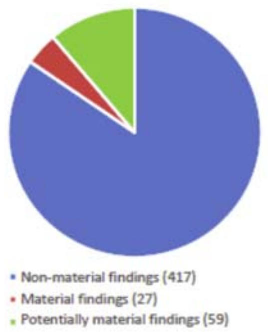
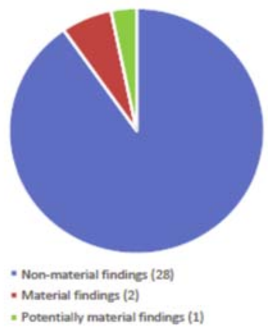
[7] See www.bis.org/bcbs/implementation/l3.htm.

RCAP – capital



RCAP – LCR



C = Compliant
LC = Largely Compliant
MNC = Materially Non Compliant
NC = Non Compliant

We also track a jurisdiction's progress made after the Committee has conducted a peer review. Each year, the Basel Committee publishes reports from its members on actions taken or planned to address findings identified in RCAP assessments.

The current incentive structure of the RCAP relies strongly on public disclosure by the Basel Committee through publication of the detailed assessment reports and an "overall grade". The RCAP reports form a key part of the information provided to G20 Leaders about financial regulatory reforms, and provide jurisdictions, financial markets, bank customers, counterparties and investors with transparency about the extent to which a given jurisdiction complies with the Basel standards.

Supplementing implementation efforts

Implementation is a continuum and not a one-off event. To realise the full benefits, implementation requires a rigorous system of monitoring and analysis as well as a feedback loop to policy work.

The RCAP assessments have uncovered various interpretative issues – around 45 in total – for the implementation of risk-based capital standards, LCR and G-SIB rules. These inform the Committee about areas of the Basel framework that require further clarification. Let me give you a recent example. With regard to Islamic banking, the Basel standard specifies that national supervisors in jurisdictions in which sharia-compliant banks operate have the discretion to define sharia-compliant financial products (eg sukuk) as eligible high-quality liquid assets (HQLA) under the LCR framework. The Basel standard specifies that this supervisory discretion is available in the case of sharia-compliant banks only. When assessing the implementation of the LCR in a member jurisdiction,[8] the team observed that the domestic regulation allows sukuk to be HQLA-eligible for non-sharia banks as well. The supervisory authority then explained that, for sukuk to be eligible, they must comply with all the Basel eligibility requirements that are applicable to other eligible asset types. In addition, the authority explained that sukuk are regular financial instruments, are freely available in the market and can be negotiated by sharia and non-sharia banks without distinction, even when no Islamic financial activity is involved. This was confirmed in a meeting of the RCAP Assessment Team with banks, and the team considered that the domestic regulation was in line with the Basel standard, as it allows banks to include sukuk in HQLA only if such products comply with the operational criteria for HQLA. The team recommended that the Basel Committee clarify the requirements regarding the eligibility of sukuk as HQLA, and specifically to define whether they can be HQLA-eligible also for non-sharia banks. This is an issue under examination by the Committee's Working Group on Liquidity.

The Committee periodically reviews such issues and publishes answers to such questions on how to interpret its standards. These "FAQs" support consistent implementation across member jurisdictions.

The Committee also conducts quantitative impact studies (QIS) on the effect of its standards and any proposed reforms. During the implementation period of Basel standards, the Committee monitors not only the status of adoption in member jurisdictions but also the impact of the revised standards, as well as other metrics, to understand bank responses to regulatory change. Overall, banks have made impressive progress towards meeting Basel III both capital and liquidity requirements. The Committee's latest monitoring exercise shows that virtually all of the 200-odd participating banks meet both the minimum and target risk-weighted Common Equity Tier 1 requirements. In the same vein, around 85% of banks reported a NSFR that met or exceeded 100%.

As explained above, the RCAP focuses on monitoring the timely adoption of Basel standards and assessing the compliance of their implementation in domestic banking regulations. Alongside its standards, the Basel Committee also issues a large number of supporting guidelines, principles and sound practices for both banks and supervisors. While these are not in the scope of RCAP assessments, their adoption and implementation is an important complementary condition for achieving a resilient banking system. This is why the Committee places great emphasis on promoting strong supervision. The Committee will continue to strengthen and supplement the guidance where appropriate and will give greater encouragement to its implementation as a means of improving the quality of supervision in jurisdictions and ensure safety and soundness of banks.

For example, the Committee has been monitoring banks' implementation of the *Principles for effective risk data aggregation and risk reporting* through the Risk Data Network. The most recent progress report – the fourth in this series of follow-ups – was published on 28 March 2017.[9] Another example relates to supervisory colleges. The Committee has been monitoring the implementation of the *Principles for effective supervisory colleges*. The outcome of this monitoring work is published every two years and the first *Progress report on the implementation of principles for effective supervisory colleges* was published in July 2015.[10] The progress report sets out the detailed findings, based on the monitoring initiatives undertaken by the Basel Committee, and highlights challenges faced by supervisors in running effective supervisory colleges as well as the practical approaches taken to address them.

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8 Internal reference only: Singapore's RCAP assessment of the LCR (December 2016).

9 See www.bis.org/bcbs/publ/d399.htm.

10 See www.bis.org/bcbs/publ/d329.htm.

Conclusion

Full, timely and consistent implementation of Basel standards is critical to improving and maintaining the resilience of the global banking system. This will therefore once again be one of the key themes of the Committee's work programme and strategic priorities. We have made a good start in assessing implementation and encouraging improvements. And in the process, our members have also learned more about each other's systems. But I am sure that we still have more to learn, and so I look forward to your questions. Thank you.