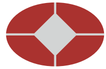 BANK FOR INTERNATIONAL SETTLEMENTS

Banking regulation and supervision after the crisis – where are we now, and what lies ahead?

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Introduction

I would like to begin by thanking the Research Center on Regulation and Supervision of the Financial Sector (CIRSF) and especially Professor Silva Morais, its founder and Chair, for the kind invitation to address this distinguished and diverse audience. It is a pleasure to participate in this conference.

While I am not as familiar as I would like to be with the work of the Center, I understand that it brings together various stakeholders in the financial services sector – ranging from regulators and practitioners to lawyers, consultants and academics, all of whom are represented here today – with a view to enhancing the regulatory framework, supervisory practices, corporate governance and risk management. This spirit of cooperation is essential to the development and implementation of sound global prudential standards, and these will be the focus of my remarks today.

This conference is taking place at an interesting juncture for the global financial system. We will soon mark the 10th anniversary of the subprime mortgage crisis that triggered the global financial crisis, one of the longest and most severe economic episodes ever experienced. And while economic activity and employment have gradually recovered in most economies, reaching pre-crisis levels in many of them, much more time will pass before the resulting output gap is closed.

The Basel Committee on Banking Supervision (BCBS) estimates that its member countries alone lost output worth more than $76 trillion as a result of the crisis, up to the end of 2015.[2] We must also be mindful of the large social costs that the crisis inflicted and the heavy burden on public finances that will affect future generations in many advanced economies.

While the subprime crisis was the trigger, the financial crisis was rooted in the imperfect functioning of the global financial system. Banks were not following sufficiently sound risk management strategies and lacked adequate loss absorption capacity. Moreover, the global system was highly vulnerable to adverse shocks because of the role played by large and interconnected financial groups that were considered too big to fail. And there were significant shortcomings both in the prudential standards for banks and in how they had been implemented.

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[1] I am grateful to Jeff Miller for his assistance in preparing these remarks.

[2] S Ingves, "Finalising Basel III: Coherence, calibration and complexity", speech at the second Conference on Banking Development, Stability and Sustainability, Santiago, 2 December 2016.

Given the financial nature of the crisis, authorities worldwide were clearly obliged to deliver a package of regulatory reforms that would substantially lessen the probability of a similar event in the future and mitigate its impact on the real economy if it should occur.

I think it's fair to say that the international regulatory community has largely delivered on this obligation, thanks to unprecedented cooperation among national authorities. But it is also true that the job is not yet complete. The ultimate goal of enhanced financial stability requires continued work in specific areas and the ongoing vigilance of regulators and supervisors, accompanied by renewed emphasis on international cooperation given the strong interlinkages among national financial systems.

I would like to take advantage of this opportunity to take stock of what has been accomplished and, more importantly, comment on the remaining pieces of the post-crisis regulatory reform package and the main supervisory challenges as we move forward.

The achievements

As everyone in this room knows, the crisis had no single cause. It resulted from a complex combination of economic and financial developments linked to unsound behaviour by private agents that was aided and abetted by policy mistakes. But one thing is now abundantly clear to even the most casual observer, which is that imperfections in regulatory and supervisory frameworks at the turn of the century contributed to the severity of the crisis. In particular, the prudential rules at the time did not suffice to ensure the resilience of banks whose failure could generate systemic instability. Further, the authorities lacked the means to manage the crisis effectively without the direct involvement of governments, whose finances were in some cases already stretched.

As I have noted, the regulatory community has responded. In particular, prudential standards have been substantially reformed under the leadership of the Basel Committee. Time won't permit me to cover the full range of reforms, but I would like to highlight a few of them.

On the capital front, we now have a tighter definition of what constitutes regulatory capital, higher risk-weighted minimum requirements, a new minimum leverage ratio and a capital conservation buffer. The market risk framework has been largely overhauled, with improvements that include increased granularity and the introduction of the "expected shortfall" concept in the Standardised Approach, and more comprehensive risk capture and a more granular model approval process in the Internal Models Approach. The Basel III package also incorporates a new macroprudential overlay comprising a countercyclical capital buffer and frameworks for both global and domestic systemically important banks. And the Basel framework now includes the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR), standards aimed at ensuring banks' resilience to liquidity stress.

In the crisis management domain, the Financial Stability Board (FSB) has put in place a comprehensive set of principles to help ensure the orderly resolution of systemically important banks (SIBs) along with minimum loss absorption requirements for global SIBs. Together, they represent considerable progress in mitigating the too-big-to-fail problem.

The adoption of the new standards has already contributed to marked improvements in the underlying solvency and liquidity positions of banks worldwide. For example, according to the Basel Committee's latest Basel III monitoring report,[3] total Common Equity Tier 1 (CET1), the highest-quality form of capital, increased by more than 70% (about €1.5 trillion) in a sample of 89 of the largest internationally active banks in the five-year period to mid-2016. At the end of that period, every one of

[3] Basel Committee on Banking Supervision, "Basel III Monitoring Report", February 2017.

these banks met the minimum and target CET1 ratios of 4.5% and 7%, respectively, on a fully phased-in basis. Similar improvements can also be seen in banks' liquidity profiles. As of mid-2016, 88% of all banks that participated in the monitoring exercise already met or exceeded the final LCR requirement of 100%, which isn't mandatory until 2019. Some 84% of those banks already met or exceeded the 100% NSFR requirement, which doesn't become a minimum standard until next year.

The remaining steps in the regulatory reform journey

It is clear, then, that the post-crisis reforms have already accomplished several elements at the core of the Basel Committee's objective to strengthen the global financial system. However, there are a few remaining issues on the agenda of the Basel Committee which it hopes to complete soon.

As you know, the Committee has made considerable progress in developing a revised standardised approach for credit risk, which will substantially increase its granularity and improve its risk sensitivity. It has also consulted on a revised standardised approach for operational risk and the introduction of a leverage ratio surcharge for G-SIBs. As importantly, the Committee has been exploring options to limit the variability in risk-weighted assets for banks that use the internal ratings-based (IRB) approach for credit risk. The options include tighter restrictions on the parameters used in internal models (input floors) and on the extent to which risk-weighted assets calculated by the model can be lower than they would be if the standardised approach were used (an output floor).

In finalising these reforms, the Committee has made it clear that it will not be significantly increasing overall capital requirements – but this does not mean avoiding any increase for any bank. Indeed, some of the remaining reforms may well have a non-negligible impact on some banks. The Committee and its governing body, the Group of Central Bank Governors and Heads of Supervision (GHOS), are now in the process of calibrating the final parameters and determining appropriate transitional arrangements that are capable of achieving a broad consensus.

Once these final details of the Basel III reforms are finalised, the Committee's regulatory work will focus on completing a few existing policy initiatives. Key among them is its review of the regulatory treatment of sovereign exposures. Such a review is a worthwhile endeavour in a world in which a bank's exposures to sovereigns are arguably not riskless. At the same time, before any changes in the related global standards are considered, all the implications will need to be weighed, not only for banks but also for national economies and the functioning of capital markets.

The Committee is also considering the longer-term regulatory treatment of loan loss provisions following the adoption of an expected loss approach by accounting standard setters. The expected loss approach will soon replace the incurred loss approach in the current accounting standards.

In the Basel framework, the treatment of provisions is different depending on whether a bank follows an IRB or the standardised approach for credit risk. The main difference is that IRB banks must first estimate expected losses in accordance with the requirements of the Basel framework, and then deduct from CET1 any shortfall in those estimated expected losses relative to accounting provisions. For those banks, therefore, the role of regulatory capital is to cover unexpected losses. While this is also true for non-IRB banks, the same mechanism does not exist for deducting any possible provisioning shortfall from regulatory capital.

While the longer-term approach is still under review, the Committee has confirmed that the current regulatory treatment of provisions entailing different requirements for IRB and non-IRB Banks, will be retained as an interim measure. Arguably, this is pragmatic given the limited time before the effective date of the new international accounting standard and the potentially significant impact of the change for

some banks. It also avoids introducing new changes at a time when both banks and supervisors are fully occupied with other regulatory reforms.

In any case, given the importance of provisioning practices for a meaningful assessment of solvency, regulators should retain, and where possible, enhance their ability to monitor provisions and require adjustments to a bank's CET1 when appropriate. Conceptually, at least, there is no compelling reason to confine this supervisory intervention to more sophisticated banks on the IRB approach. Indeed, in a number of jurisdictions – most notably in Asia – national rules go beyond the minimum requirements of the Basel framework and contemplate deductions from CET1 when provisions do not cover expected losses in the case of standardised banks, as well as IRB banks.

So, notwithstanding these and a few other policy-related initiatives currently being addressed by the Basel Committee, it is clear that the so-called post-crisis regulatory reforms are approaching completion. The general consensus within both the private and official sectors is that it is now time to allow the new standards become embedded in day-to-day practices and provide for a period of stability in the regulatory framework.

This presents a good opportunity to evaluate the combined effect of all reforms. Although the standard-setting work incorporated a careful process of public consultation and extensive studies to assess the quantitative impact of the proposals, there is scope to conduct a more comprehensive analysis of the interactions between the various regulatory pieces introduced in both the prudential and resolution domains.

The task of developing a framework for the post-implementation assessment of the reforms broadly is being addressed by the FSB in close collaboration with the standard-setting bodies. The framework will help identify whether any regulatory gaps remain and point to possible unintended consequences of the reforms. However, it is important to stress that the first priority of this work is to see whether the reforms have actually met their overall objectives in terms of crisis prevention and management. Therefore, this work should not mislead stakeholders into expecting any significant backtracking from the substantial progress that has been made.

The new priority: policy implementation

The completion of the regulatory reform package also allows the international regulatory community to focus its attention more closely on ensuring the timely and effective implementation of the reforms and, more generally, facilitating the generalised adoption of sound supervisory practices.

So far, the progress made in adopting the Basel standards in Basel Committee member jurisdictions has been reassuring. The Committee's latest report on the adoption of the Basel regulatory framework[4] shows that, as of end-March 2017, all 27 member jurisdictions have final risk-based capital rules, LCR regulations and capital conservation buffers in force. Also, almost all have issued final rules for the countercyclical capital buffers and final or draft rules for D-SIB frameworks. With regard to the G-SIB framework, all members that are home jurisdictions to G-SIBs have final rules in force.

As for non-Basel Committee member jurisdictions, surveys conducted by the FSI[5] show 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. For instance, our survey results indicate that, while only six non-member

[4] Basel Committee on Banking Supervision, "Twelfth progress report on adoption of the Basel regulatory framework", April 2017.

[5] The FSI's Basel implementation surveys are available at www.bis.org/fsi/fsipapers.htm

jurisdictions had adopted final rules relating to the new definition of regulatory capital in 2012, 63 of them intended to have issued final rules relating to both the new definition of regulatory capital and the LCR framework by the end of 2016. Moreover, around 70 non-member jurisdictions were expecting to have implemented these key elements of the Basel III framework by 2018, at the latest.

But compliance with the Basel framework requires only that the standards be applied to internationally active banking groups, the definition of which is left largely to national discretion.

At present, the scope of banks subject to national rules based on the Basel standards varies significantly across jurisdictions. Examples of the extremes include the European Union, where the same Basel-inspired regulations are applied to essentially all banks, and the United States and Japan, where the full Basel rules are only enforced for the relatively few banks considered to be internationally active.

Given the additional complexity that Basel III introduces in the prudential standards, a debate is under way in several jurisdictions whether and how to adjust the requirements for a subset of smaller, non-internationally active banks in order to mitigate the compliance burden. This is generally referred to as the application of the proportionality principle in banking regulation.

The debate is legitimate to the extent that the new standards have been designed, at least in part, to mitigate the systemic risk generated by institutions with complex business models and balance sheets. Although Basel already embeds a certain degree of proportionality, it could be argued that a direct and general application of some of the new standards (for example, those relating to liquidity risk, market risk, disclosure and large exposures) may sometimes generate excessive compliance and reporting costs for smaller and less complex banks without providing substantive prudential advantages.

At the same time, applying a proportional approach is likely to materially affect the competitive environment and, if not properly designed, could reduce the risk sensitivity of capital requirements, thereby creating incentives for unsound behaviour. Consequently, authorities should seek to reduce these distortions by ensuring, at a minimum, that the (simpler) rules applied to smaller institutions in an effort to reduce compliance costs do not imply an effective relaxation of solvency requirements.

It is also clear that a rigorous application of the new prudential standards will achieve little if it is not accompanied by sound supervisory practices to tackle the important challenges that the banking industry and authorities currently face. Such issues as the banking industry's low profitability and potential overcapacity, the level of non-performing loans in some advanced economies, the increasingly relevant cyber-security risks, the challenges posed by fintech and the need to reinforce corporate governance and culture can only be addressed by determined policy and supervisory action, whether or not those actions are derived directly from international standards.

International cooperation is also essential in these areas in order to benefit from shared experience and expand the catalogue of best practices that is such a powerful tool for national supervisors.

Concluding remarks

In conclusion, I would like to briefly return to the efforts currently under way to finalise the post-crisis regulatory reforms, of which Basel III is a significant component. This is certainly not the first time the Basel Committee has gone through difficult negotiations to reach an agreement, and I'm sure it won't be the last. But I am confident that the Committee will once again achieve a successful outcome.

Indeed, having recently experienced an extremely costly financial crisis and the attendant disturbances in the functioning of the international financial system, the need for robust international regulatory standards is more evident now than ever before. In a world in which internationally active financial groups transmit risks seamlessly across borders, there should be a shared interest across all

jurisdictions that such groups meet sufficiently stringent standards of solvency and liquidity. Moreover, to the extent that an integrated global financial system contributes to effective risk-sharing across jurisdictions and regions and amplifies investment and funding opportunities for firms and households wherever they are located, it is vital that we do what we can to facilitate the operations of international players and promote a level playing field through the harmonisation of both prudential requirements and, ideally, supervisory practices.

As I mentioned before, however, globally harmonised standards and practices need not be applied to all banks in all jurisdictions. It may be appropriate to apply simpler rules and less intrusive practices in the case of smaller, less sophisticated banks, as is the case now in many jurisdictions. But at the same time, we need to keep in mind that the application of the proportionality principle should not compromise the stringency of the prudential requirements. It should also carefully weigh potential distortions in the normal functioning of market forces.

In any event, notwithstanding the current emphasis on finalising the last few pieces in the post-crisis reforms, I anticipate that the focus of the international regulatory community will soon shift from standard setting to policy implementation matters. For its part, the Basel Committee signalled this shift in its recently published 2017–18 workplan, which has the Committee paying greater attention to supervisory matters. And let me just mention that, through its various activities, the Financial Stability Institute will support authorities' renewed focus on implementation. I would be happy to provide more information about our work in this area in the discussion that follows, or on the sidelines of the meeting.

Thank you for your kind attention.