Nout Wellink: The importance of banking supervision in financial stability

Keynote address by Dr Nout Wellink, President of the Netherlands Bank and Chairman of the Basel Committee on Banking Supervision, at the High Level Meeting "The Role of Banking and Banking Supervision in Financial Stability", Beijing, 17 November 2008.

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Introduction

I would like to begin by thanking the FSI and EMEAP for organising this very timely event as well as the People's Bank of China for their warm hospitality. I am grateful for the opportunity to discuss the Basel Committee's response to the financial market crisis. This morning I would like to present our strategy for addressing the fundamental weaknesses with respect to the regulation, supervision and risk management of internationally-active banks that have been revealed by the rapidly evolving crisis. Our work programme is well advanced and provides practical responses to the financial stability concerns raised by policy makers related to the banking sector, which is at the core of the global credit intermediation process. Successful implementation of this strategy requires a global effort and the Committee will reach out to countries that are critical to this process.

Background on crisis and emerging lessons

Before I talk about the Committee's response, I think it is important to provide some context as to how we have arrived at where we are today. From a supervisory perspective, the main contributing factors that came together to form a perfect storm include:

- a large amount of pre-crisis, system-wide liquidity, which led to excessive risk taking;
- inadequate measures to contain leverage, maturity mismatches, risk concentrations and the erosion of liquidity buffers over the credit cycle;
- regulatory gaps, which left important segments of the financial system under regulated;
- poor incentives in regulatory frameworks;
- poor underwriting standards;
- outsourcing of the due diligence process to the rating agencies; and
- fundamental shortcomings in financial institution's governance, of which the current risk management shortcomings are just a symptom.

The crisis, which has re-concentrated risk in the banking sector, has resulted in financial market stress and massive deleveraging of historic proportions, with increasing spillover to the real economy. The speed and scale of these developments have been nothing short of astonishing.

The response by the official sector also has been unprecedented, covering a wide range of measures. These are now helping to stabilise the banking sector and financial markets. But it is clear that we continue to face significant challenges as real economic activity slows. The official sector, including supervisory authorities, continues to work nationally and collectively to promote an orderly deleveraging process.

We also need to develop a coordinated strategy to put the banking system on a sound footing over the longer term. Such efforts will further reinforce near term confidence-building measures and provide a long term target around which national and global policy making efforts can converge. They also will provide the basis for an exit strategy from the increased official sector engagement in the banking sector. I would like to focus the remainder of my remarks on how we can go about achieving this longer term strategy.

The Basel Committee's response

The primary objective of the Committee's strategy is to strengthen capital and liquidity buffers and help contain leverage in the system arising from both on- and off-balance sheet activities. It also will promote stronger risk management and governance practices and limit risk concentrations within and across banking institutions, and strengthen market transparency. Ultimately, our goal is to help ensure that the banking sector serves its traditional role as a shock absorber to the financial system, rather than an amplifier of risk between the financial sector and the real economy. The Committee will promote multiple and reinforcing lines of defence in supervisory and risk management frameworks to enhance bank resilience.

Let me discuss in more depth the key building blocks of our strategy.

Strengthening capital buffers

I will start with the Committee's initiatives to strengthen the regulatory capital framework. I would note up front that regulators need to be extremely cautious about adding to the already severe procyclical behaviour in the market place. As such, we do not propose to raise global minimum capital ratios during a crisis. However, banks need to ensure they have adequate buffers above the current regulatory minimum that reflect the nature of their portfolios and their exposure to a plausibly severe economic downturn scenario.

With that background, I will now provide you with more clarity about the Committee's approach to strengthen the capital regime, building on the three pillars of the Basel II framework. Any enhancements will be introduced in a manner that promotes the near term resilience of the banking sector and its ability to provide credit to the economy. Moreover, we cannot set long term capital requirements on the basis of market reactions in the midst of the most severe deleveraging process we have seen in our lifetime. This effort needs to be carried out as part of a considered process that balances the objective of maintaining a vibrant, competitive banking sector in good times against the need to enhance the sector's resilience in future periods of financial and economic stress.

Risk capture

Let me begin with the issue of the risk capture of the Basel II framework. The move to Basel II addresses many of the risks that were not captured under the Basel I framework and helps reduce a number of the perverse incentives that contributed to the crisis. The three pillars of Basel II will help ensure that capital regulation is better positioned to handle periods of rapid innovation and the new products that such periods produce. Moreover, Basel II will ensure that all contractual exposures to off-balance-sheet vehicles are subject to regulatory capital requirements. Non-contractual exposures and implicit support will be addressed through enhancements to the Pillar 2 framework.

Last April, the Committee announced a number of steps to enhance the risk capture of the Basel II capital framework. These measures are an important part of the Financial Stability Forum's response to the crisis that was set out in its April 2008 *Report on Enhancing Market and Institutional Resilience*. For example, the Basel Committee's efforts strengthen the capital treatment for off-balance sheet exposures and securitisations. The Committee expects to issue proposals for the capital treatment of these exposures in early 2009. The proposals are subject to public consultation and we will carefully consider all comments received.

We also have issued a proposal to strengthen the capital framework for the trading book. In particular, we will address the risks of less liquid credit products, which have produced the majority of losses in the banking sector to date. While the proposals reflect the inherent risks already embedded in banks' trading books, they will be phased in over an appropriate period to give the banking sector time to adjust to the new requirements.

We are strengthening the disclosure requirements for banks' risk exposures and the adequacy of capital to support these exposures. We are focusing in particular on trading, securitisation and off-balance sheet activities.

Finally, we will review the role of external ratings in the Basel II framework. I should point out that the use of external ratings is limited to the simple Standardised Approach for credit risk and the Securitisation Framework. Our review will include how any unintended consequences could be mitigated.

Quality of capital

Let me now turn to the issue of the quality of capital. The Committee has been reviewing the key elements of Tier 1 capital and the importance of ensuring strong core capital. A strong, high quality capital base is critical for banks to be able to absorb losses and maintain lending during periods of severe economic and financial stress. The Committee will continue to provide global leadership on what the key elements of a strong capital base should be, reflecting the lessons of recent developments. Such an effort will ensure that both prudential and competitive equity objectives are maintained in the future.

Procyclicality

The crisis shows that banks need to build strong capital buffers and provisions in good times so that they can be drawn upon in periods of stress. This in turn dampens the risk of spillover from the financial sector to the real economy. Reflecting the lessons of the crisis, there are a number of steps the Committee is considering to dampen the potential procyclicality of the Basel II framework. It is important to note that the crisis built up under the Basel I regime, while Basel II only became effective in most countries at the beginning of this year.

We will explore promoting strong capital buffers above the minimum levels and how those can be used during a downturn to dampen shocks and encourage continued lending. The Committee also is assessing ways to strengthen prudential filters, promote through-the-cycle provisioning, and contribute to efforts to strengthen accounting standards for financial instruments. Finally, the introduction of the incremental risk charge in the trading book should help dampen the cyclicality of trading book capital.

Supplemental measures

Supervisors are reviewing the need to supplement risk-based prudential and risk management approaches with simple, transparent gross measures of risk. In combination, such risk-based and gross measures may provide a further check on the build-up of leverage at financial institutions and the underestimation of risk during rapid periods of credit growth or in new business lines that have not experienced a downturn. Moreover, in periods of stress a large gap may open between what the risk-based metric requires, and what the market expects through simpler metrics. I hasten to add that simple metrics alone can and will be gamed, as the recent experience under Basel I has shown, particularly related to the growth of exposures to off-balance sheet vehicles. Both risk-based and simple measures therefore may be needed going forward.

Strengthen liquidity risk management and buffers

A second key building block of our strategy is raising the bar on liquidity risk management and supervision.

The Committee recently issued *Principles for Sound Liquidity Risk Management and Supervision*. This guidance sets a higher soundness standard for banks and supervisors to meet. We will put in place a process to ensure that the principles set out in the paper are implemented in practice. However, we also need to redouble our efforts to develop more consistent benchmarks for sound liquidity at global banks. This includes benchmarks for liquidity cushions, maturity mismatch, funding liquidity diversification, and resilience to stress. The mandate of the Committee's Working Group on Liquidity has been expanded to deal with this next set of issues.

Strengthening risk management practices

A third area of high priority focus is on strengthening governance and risk management practices. Most of the risk management shortcomings revealed by the crisis related to the failure to implement the basics of firm-wide risk management. This points to weaknesses in governance at the top of the firm. What can we do differently in the future?

First and foremost, it remains the responsibility of the private sector to take the lead in strengthening firm-wide governance and risk management frameworks. As far as supervisors are concerned, we are enhancing our supervisory tools and standards to reflect recent lessons, especially in areas like securitisations; management of contractual and non-contractual exposures to off balance sheet vehicles; stress testing and the management of firm-wide concentration; and sound valuations. We will be issuing additional guidance on these topics around the new year. We also need to do a much better job following up on our guidance in a coordinated global manner.

Finally, we can use the leverage of Pillar 2 – the supervisory review process – to promote improvements in firm-wide governance, risk management, and controls, and to establish clear links to the assessment of capital adequacy. Pillar 2 also can be used to promote better alignment between long term risk management and control objectives and the incentives created by compensation schemes. Such coordinated supervisory follow up efforts will be critical to ensure that industry and supervisory sound principles are sustained when competitive pressures reassert themselves.

Strengthening counterparty credit risk

Another building block of the Committee's strategy is strengthening counterparty credit risk practices. The Committee will review the treatment of this risk under the three pillars of Basel II to strengthen minimum capital, risk management, and transparency inside and outside banks. This effort can help individual banks and the system better withstand the failure of one or more major counterparties. It also can help contain leverage outside the banking sector, and it can reinforce efforts to strengthen the infrastructure for OTC derivatives, possibly using Pillars 1 and 2 as inducements. This forms part of a broader effort to assess the scope of regulation and oversight beyond the core banking sector.

Strengthening bank resolution and the supervision of cross-border banks

Let me also say a few words on our work to strengthen bank resolution practices and the supervision of cross border banks. The Committee's Cross-border Bank Resolution Group is assessing key issues and global incompatibilities in the resolutions of global banking groups. This effort should strengthen supervisory understanding of the challenges that can arise when resolving a global banking institution and possible ways to manage through them more effectively.

We also need to deepen the work of the Committee to promote effective supervisory colleges at cross-border banks, building on the extensive work of the Accord Implementation Group in this area. In practice, this means dealing with concrete issues like capital, liquidity and the division of responsibilities between home and host supervisors in good times and in stress.

Strengthening the system-wide approach to supervision

Finally, we need to strengthen the system-wide approach to supervision, another building block for our strategy. It is important that we move to embed institutional level supervision into a broader context that seeks to make the overall financial system more resilient to stress. The Committee, through its central bank and supervisory membership and outreach efforts, is in a unique position to translate broader concerns of central banks, supervisors, and others into concrete, coordinated bank supervisory and regulatory responses at both the national and global level. Focusing resources in this way can help make the regulatory, supervisory and risk management infrastructure more resilient to emerging pockets of stress in an environment of rapid innovation and change.

There are a number of practical ways we can make this link.

- One approach – that I talked about earlier – is the establishment of a capital framework that promotes strong buffers in good times and ways to dip into them in bad times.
- Another is through coordinated global reviews to contain deterioration in global underwriting standards and to address imbalances in risk controls and business growth in competitive environments.
- An assessment of gaps in global regulations and ways to correct them is a third way to strengthen a system-wide approach to supervision.
- Assessing different ways to promote better risk management of participants in major payment systems, derivative markets, and clearing houses is another.
- And finally, establishing stronger links between the objectives of central bank liquidity operations and liquidity regulation and supervision is another way to strengthen system-wide supervision.

Conclusion

Financial markets, individual firms and supervisors have all been severely tested by this financial crisis. We have put in place a comprehensive strategy to address the lessons as they relate to the banking sector, and we are well along in executing on it. Our efforts will strengthen capital and liquidity buffers; improve risk management practices; enhance transparency; and strengthen the supervision of banks and the system-wide approach to supervision. It is important to note that this is a longer term strategy. Some elements need to be tackled now while others will take more time. The Committee is mindful of the need to introduce these enhancements in a manner that promotes both near term confidence and longer term financial stability.