Nout Wellink: Basel Committee initiatives in response to the financial crisis

Remarks by Dr Nout Wellink, President of the Netherlands Bank and Chairman of the Basel Committee on Banking Supervision, before the Committee on Economic and Monetary Affairs of the European Parliament (ECON), Brussels, 30 March 2009.

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Thank you, Madame Chairwoman and members of the Econ Committee, for this opportunity to share with you the Basel Committee's strategy and initiatives to respond to the present financial crisis as it relates to the regulation, supervision and risk management of the banking sector. The work of the Basel Committee is consistent with and supports the initiatives of the Financial Stability Forum and the Leaders of the G20.

In formulating responses to the financial crisis, it is necessary to address both the *near term* challenges related to the weakening economic and financial situation and the *long term* regulatory structure issues. The two are linked and we need to manage carefully the transition from current measures to a more sustainable long term framework.

With regard to the near term situation, it is clear that the banking sector has been at the heart of the adverse feedback loop between the financial and real side. We have moved from what I would call the mark-to-market and illiquidity phase of the crisis related to legacy assets to the fundamental credit cycle part of the crisis. This is associated with large write downs from corporate and retail lending books, and I believe this phase will continue to play out over the medium term.

It is critical that supervisors have a comprehensive strategy to deal with both phases of the crisis and their associated impact on banks. That is essential if we are to restore stability to our financial systems and economies. When it comes to the long term, we need to establish a clear target for the future regulatory system which substantially reduces both the probability and severity of a crisis like the one we currently are working though. By providing clarity about the future regulatory framework, we will help re-establish near term confidence, reduce the risk of competitive distortions and limit the degrees of uncertainty for the public and private sector. Also, by emphasising that these reforms will be phased in over an appropriate horizon, we reduce the risk that our own actions contribute to procyclicality in the system. In this regard our plans are closely aligned with the views expressed in the de Larosière Group's report. This group's report has been strongly appreciated by the Basel Committee.

Let me now say a few words about the steps the Basel Committee has and will be undertaking to produce a more robust supervisory and regulatory framework for the banking sector. Such a framework needs to have four key components:

1. Strong regulatory capital,
2. Robust standards for bank liquidity,
3. Enhanced risk management, governance and supervision, and
4. Better transparency

I would like to say a few words about each of these components.

Regulatory capital

The Basel Committee, in a press release issued on March 12th following its recent quarterly meeting, underscored the importance of a strong capital base as a necessary condition for a strong banking sector. It stated that the level of capital in the banking system needs to be strengthened to raise its resilience to future episodes of economic and financial stress. The

Committee will do this through a combination of initiatives, which I will describe momentarily. Our press release also noted that the Committee will review the regulatory minimum level of capital, taking account of these initiatives. Our objective will be to arrive at a total level and quality of capital that is higher than the current Basel I and Basel II frameworks and appropriate to promote the stability of the banking sector over the long run. This effort will be phased in over a time frame that will not aggravate the current stress.

Building on the three pillars of the Basel II framework, we need to develop a more resilient capital framework that has multiple safeguards built into it.

First, we need to improve risk coverage.

One of the most procyclical dynamics has been the failure of risk management and capital frameworks to capture key exposures in advance of the crisis. For example, risks arising from securitisation activities – especially so-called resecuritisations – as well as certain trading book exposures were not sufficiently captured. I could also point to exposures to complex financial instruments that experienced severe declines in value because of impaired liquidity. The Basel Committee's response therefore is to enhance the Basel II framework so that risks are more comprehensively and more accurately covered.

Second, there needs to be a solid capital base backing these risks.

We will achieve this by strengthening the quality, consistency, and transparency of the highest forms of Tier 1 capital. It must be based on a clear definition of capital that needs to be transparent and it must be global to ensure competitive equality. The Basel Committee already has a strong foundation for such a definition, namely common equity and reserves. We now need to deal with the many differences related to definitional issues, such as deductions from capital and the treatment of prudential filters.

Third, we need to address procyclicality.

Procyclicality is a complex issue and it is the product of many factors. At the most basic level, it is the result of animal spirits, which produce exuberant behaviour in the upswing of the cycle, and fear during the downturn. We cannot change this behaviour, but we can seek to dampen the channels through which it manifests itself. These include accounting and capital frameworks, liquidity regimes, risk management and compensation, margining, basic infrastructure, transparency, and the way supervision is carried out. In the case of the regulatory capital regime, we need to address any excess cyclicality in minimum requirements over the credit cycle while maintaining appropriate risk coverage and sensitivity. The Basel Committee has put in place a process to systematically assess the quantitative impact of Basel II on the level and cyclicality of capital. We will take appropriate steps if the results of our capital monitoring suggest the capital framework is unduly procyclical.

But even more importantly, we need to build countercyclical buffers into capital frameworks and provisioning practices. This will help ensure that reserves and capital are built up during periods of earnings growth, so that they can be drawn down during periods of stress. The Committee is working to translate this important principle into a concrete proposal. The approach needs to have robust standards that can be applied at the global level and translated into national contexts.

Finally, the capital framework needs to be underpinned by a non-risk based supplementary measure. This is particularly important as the Basel I-based floors are phased out. Just like we expect banks to manage to a variety of measures when they assess risk (such as net and gross exposures, VAR and stress tests), we as supervisors also must not constrain ourselves by evaluating risk through the lens of a single, risk based measure. We need the risk based measure to interact with a simple metric that can act as a floor and help contain the build up of excessive leverage in the banking system, one of the key sources of the current crisis. The Basel Committee is working to develop by year end a specific proposal in this area. Key principles guiding this work are that the measure must be simple and transparent, and it must address issues related to accounting differences and off-balance sheet exposures, among others. Finally, it needs to interact with the risk based measure in a prudent but sensible manner.

Once these different streams of work are further advanced, taken together they will form the basis for the Committee's assessment of the appropriate level of minimum capital that should be put in place over the long term.

But whatever we do – and this gets back to my link between the near and long term – we must not raise global capital requirements in the middle of this crisis. Capital buffers are there to be used and we must provide a clear road map where we are headed.

Liquidity

Let me now say a few words about our work on liquidity. Capital is a necessary condition for banking system soundness but by itself is not sufficient. Of equal importance is a strong liquidity base. Many banks that had adequate capital levels got into trouble because they did not manage their liquidity in a prudent manner.

In response to these shortcomings, the Basel Committee last September issued its *Principles of Sound Liquidity Risk Management and Supervision*. This was a significant step toward setting a new global soundness standard for what constitutes robust liquidity risk measurement, management and supervision. But this was only the first step. The next step is to monitor implementation of the principles and we have put in place a process to do just that. We also are developing benchmarks, tools and metrics that supervisors can use to promote more consistent liquidity standards for cross-border banks.

Better risk management and supervision

I have discussed the importance of having stronger global standards for capital and liquidity, but this is not enough. If firms have poor governance and risk management cultures or if supervision is weak, then we could again find ourselves with the types of problems we are now facing.

We propose to build on Basel II's supervisory review process – Pillar 2 – to raise the bar for risk management and supervision practices. This past January, the Basel Committee published for comment supplemental Pillar 2 guidance. The purpose of this guidance is to address the flaws in risk management practices revealed by the crisis, which in many cases were symptoms of more fundamental shortcomings in governance structures at financial institutions. The Committee will strengthen its supervisory guidance and the links to the Pillar 2 review process. It is focusing on firm-wide governance and risk management; capturing the risk of off-balance sheet exposures and securitisation activities; more effectively managing risk concentrations; and providing incentives to better manage risk and returns over the long-term, including compensation practices.

Moreover, we need to move towards a macroprudential approach to supervision. What does this mean? In our discussions in the Basel Committee, we have emphasised the need to focus supervision not just on the soundness of individual banks but on broader financial stability objectives. This should inform where we focus our limited supervisory resources and how we develop our supervisory and regulatory tools.

Transparency

One of the main amplifiers of the crisis was the lack of transparency regarding the risk profile of institutions and structured products. Moreover, the process by which these products are valued often lacks rigour. Lack of transparency about the risk profile of products and financial institutions caused a massive retrenchment by investors and counterparties further amplifying the deleveraging process.

To help mitigate this behaviour, the third pillar of the Basel II framework – market discipline – sets out a series of required disclosures that are intended to complement the other two pillars of the Basel II framework. This should allow market participants to assess capital adequacy of a bank through key pieces of information on the scope of application, capital, risk exposure and the risk assessment process. The Committee's January proposals for enhancing Pillar 3 are focused on disclosures related to securitisation, off-balance-sheet exposures and trading activities. We believe that these proposed enhanced disclosure requirements will help to avoid a recurrence of market uncertainties about the strength of banks' balance sheets related to their capital market activities.

Conclusion

Taken together, the recent and planned initiatives of the Basel Committee should promote a more robust banking sector and limit the risk that weaknesses in banks amplify shocks between the financial and real sectors. Because our measures are far reaching and ambitious, they will need to be phased in over a reasonable timeframe.

I should also note the invitation to join the Basel Committee that we have extended recently to the BRIC countries – Brazil, Russia, India and China – as well as Australia, Korea and Mexico. The expansion of our membership will help enhance the global reach and acceptance of our standards.

The efforts of the Basel Committee need to occur in a broader context of achieving the right balance between the scope and depth of regulation. Failure to produce adequate regulation for other "bank like" activities means that we in the banking sector will just be "pushing on a string", and the activity will simply migrate elsewhere. I therefore strongly welcome the activities of other bodies like the G20, the Financial Stability Forum and the Joint Forum to ensure that all sectors are subject to an appropriate degree of regulation, oversight or transparency commensurate with their systemic significance. The Committee will actively contribute to these other efforts

Finally, Madame Chairwoman, I would like to thank you and the ECON Committee for holding this important meeting. The official sector is at a critical juncture and the actions we take in response will have a far-reaching and long-lasting effect.