Michael C Bonello: Nexus of Basel II and financial stability

Speech by Mr Michael C Bonello, Governor of the Central Bank of Malta, at the Annual Seminar of the Institute of Financial Services (IFS), Floriana, 14 May 2010.

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I would first like to thank the Institute for inviting me to their Annual Seminar, which this year focuses on the topical, but complex subject of risk, capital and financial stability after the financial crisis. My remarks will concentrate on the lessons learned and on some open questions being addressed by international standard setters.

In the introduction to his recent book *"Good value"*, Stephen Green, the Group Chairman of HSBC Holdings plc, recalls his thoughts one day in April 2008 on the shores of Lake Como against the background of an unfolding global financial crisis. He describes that time as one of those moments in history when it seems as if the tectonic plates are shifting, striking at the roots of what we had taken for granted for a quarter of a century. In his words, "There has been a massive breakdown of trust: trust in the financial system, trust in bankers, trust in business, trust in business leaders, trust in politicians, trust in the media, trust in the whole process of globalization – all have been severely damaged, in rich countries and in poor countries alike."

When I had addressed your annual dinner in November of that same year I expressed the view that the crisis would not be over until confidence and trust were restored and the credit channel started to function again. We are not there yet. We are still confronted by the far-reaching consequences of the sub-prime episode, which now include a full-blown sovereign debt crisis.

It is now clear that risks had been building up over a number of years. Some derived from the fact that corporate governance, risk management, market infrastructures for derivative products as well as supervisory practices and regulatory frameworks had not kept pace with the process of financial innovation. Others have been associated with an overly accommodative monetary policy at the global level, particularly in the United States. There is no doubt, however, that financial regulation and supervision proved inadequate.

The initial trigger of the crisis was the securitisation of sub-prime mortgages and the associated *originate and distribute* model. These products found ready buyers, but there were significant misaligned incentives underlying the model. There were manifest conflicts of interest, originators and brokers had limited interest in ensuring continued monitoring of products and credit ratings were inflated, conveying a false sense of security. A euphoric bubble thus developed, based, in Alan Greenspan's words, on "the complexity of the interactions of asset markets and the economy", and which concealed a massive global under-pricing of risk.

Market participants seem to have been aware of the growing risks but were unwilling to retrench. You might recall Citibank's Chuck Prince's memorable words during the onset of the crisis that "as long as the music is playing, you've got to get up and dance. We're still dancing". Market players failed to appreciate the speed at which demand could evaporate and risk aversion could increase. This soon resulted in record-high risk premia, seized-up interbank markets, acute liquidity and credit shortages, bank failures and a widespread loss of confidence.

Meanwhile the high degree of financial market integration had created the premise for a simultaneous build-up of systemic risk. Financial institutions did not internalise the costs arising from the too-big-to-fail and too-interconnected syndrome. Central banks had been monitoring these trends, but it turned out that the regulatory tools were not designed to address systemic risk. Neither was the strength of the feedback loop between the financial

system and the economy fully anticipated. Unfortunately, these all proved to be critical weaknesses.

In response to the unfolding crisis, Governments and central banks adopted aggressive measures, including fiscal stimulus packages, bank recapitalisations and the provision of government guarantees, and injections of huge amounts of liquidity. It was also important to critically review the legislative and regulatory framework in order to pre-empt the recurrence of, or at least better manage, similar situations. The *de Larosière Report*, mandated by the European Commission (EC) and published in February 2009, set the scenario for reforms at a European level. Similar work was undertaken at the global level by the Financial Stability Board (FSB) and by the Basel Committee on Banking Supervision (BCBS).

This work has clearly showed that the Basel II capital requirements did not ensure an adequate buffer to sustain an institution on a going concern basis. Confidence in regulatory capital waned and the market started to assess bank robustness using other tools. Liquidity measurement, for example, had been largely excluded from Basel II. Some internal risk models were based on short-term statistical horizons that failed to capture periods of stress. The potential of the regime to exert a strong pro-cyclical bias also became manifest.

In its efforts to address identified weaknesses, the BCBS issued two consultation documents in December 2009, one on “Strengthening the resilience of the banking sector” and another on an “International framework for liquidity risk measurement, standards and monitoring”. Concurrently, the EC is proposing amendments to the Capital Requirements Directive (CRD) in order to align it with the recommendations of the BCBS.

According to these proposals the Tier 1 capital base should be sufficiently strong to ensure that banks are in a better position to absorb losses on both a going concern and a gone concern basis. The revised capital framework will strengthen the capital requirements for counterparty credit risk exposures arising from derivatives, repos and securities financing activities. As the existing regulatory ratios did not prevent institutions from taking on excessive leverage, moreover, the proposed leverage ratio should be a welcome addition to the regulatory toolkit. The ongoing deleveraging by banks is indeed having an adverse impact on the flow of credit to the real economy, accentuating the pro-cyclical effect. Financial institutions will, therefore, be required to build-up robust capital buffers during good times, which can be drawn down during periods of stress. The proposals also promote a more forward-looking provisioning to provide for future credit losses, and thus lessen the pro-cyclical effect of the current “incurred loss” method. Finally, the introduction of a global minimum liquidity standard is foreseen that includes a stressed 30-day liquidity coverage ratio requirement as well as a long-term structural liquidity ratio.

Moves are also underway to correct what is considered to be insufficiently transparent and accountable behaviour by credit rating agencies. After having underestimated the risks of mortgage-related bonds in the sub-prime saga, the agencies have recently featured in a perverse dynamic characterised by dysfunctional markets for certain sovereign securities in which prices do not reflect fundamentals, on the one hand, and the predictable rating downgrades, on the other. EU regulations due to take effect later this year will require credit rating agencies seeking to operate in Europe to register and be supervised by the proposed European Securities and Markets Authority (ESMA).

Concurrently with the significant work to strengthen the resilience of the financial system, important changes are also being considered to improve the regulatory and supervisory framework. Of particular significance is the creation, proposed by the *de Larosière Report*, of the European Systemic Risk Board (ESRB), which will exercise macro-prudential supervision and monitor systemic concerns, and, at the micro-prudential level, of the European System of Financial Supervisors (ESFS). This consists of a network of national financial supervisors working with the new European Supervisory Authorities, namely the European Banking Authority, the European Insurance and Occupational Pensions Authority and the European Securities and Markets Authority.

Complementary proposals emerged from the G20 London Summit of April 2009, which launched a global plan for recovery and reform and mandated the FSB to ensure the consistent implementation of the G20 road-map. Ongoing work, which is expected to be completed in the coming months, includes an impact assessment of the BCBS capital and liquidity proposals; the development of tools to reduce the probability and impact of failure of systemically important institutions; measures to reduce the potential of OTC derivatives markets to act as channels of contagion; proposals to restart securitisation on a sound basis; and promoting the full national implementation of the FSB Principles and Standards on compensation.

At the same time, improvements are also being contemplated to the existing crisis management tools. This entails not only ensuring that relevant and timely information is available, through such mechanisms as the colleges of supervisors and the cross-border stability groups, but also a resolution regime that minimises the costs to the taxpayer and the development of internationally consistent firm-specific recovery and resolution plans. The EC is working on a framework for cross-border crisis management covering aspects such as early intervention, the reorganisation of ailing banks and insolvency procedures for winding up failed banks. The possibility of introducing a levy on the financial sector for the creation of a resolution fund, based on the polluter pays principle, is also being discussed in different fora.

Taken together, the numerous proposals currently on the table represent the coming together of an ambitious regulatory reform effort designed to strengthen the resilience of the financial sector that could have far-reaching implications. It has been a commendable example of broad consultation and deep reflection, and consequently deserving support. Going forward, the impact assessment study results, due this summer, should provide useful guidance as to the optimal timing and sequencing of these reforms. In this regard, care must be taken to avoid any risk of undermining the incipient recovery, which is already threatened by the current sovereign debt crisis. It will also be important to aim for a level-playing field and to minimise the potential for arbitrage through harmonization, particularly in the case of the proposed bank levy.

At the same time, we must ensure that banks, especially the larger ones, go back to their core business of extending credit to the real economy and refrain from engaging in the kind of risk-taking that gave rise to the recent crisis. Priority must, therefore, be given to the one measure that is most likely to influence the banks' ability to take risk, that is the BCBS proposals on bank capital. Capital buffers must henceforth be commensurate with the degree of risk undertaken. It is no longer acceptable that profits are privatised and losses socialised. In a broader context, another important challenge is to ensure that systemic risks are addressed without unduly constraining financial innovation and integration. Finally, the opportunity provided by the current period of reflection should also be used to examine the possible consequences of some of the reform proposals for the functioning of financial markets and for the implementation of monetary policy, and by extension also for the real economy.

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