Guy Quaden: Basel III and beyond

Speech by Mr Guy Quaden, Governor of the National Bank of Belgium, at the Eurofi Financial Forum, Brussels, 28 September 2010.

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Ladies and Gentlemen,

I am very pleased to have the opportunity to participate in the Brussels Eurofi conference and to share some thoughts with you at this opening session. It is now just about 3 years after the US subprime crisis triggered world-wide financial turbulence and 2 years after the collapse of Lehman Brothers dramatically escalated the crisis.

The crisis has seriously dented belief in the ability of the markets to regulate themselves. There are currently a lot of items on the agenda of international fora waiting to be dealt with. The Financial Stability Board at the G20 level as well as Ecofin at the EU level have drawn up detailed roadmaps to pave the way for extensive reforms.

The crisis has indeed given rise to a unique momentum for profound reforms of the financial system.

We should not let this momentum slip away. Unfortunately the general public sometimes gets that impression.

Of course many complicated technical issues have had to be resolved. And I admit that it will be important to introduce the new regulations in a timely manner so as not to hamper the smooth flow of credit which will be required to support the nascent recovery. In fact, while there is much discussion as to the design of the ***exit strategy*** from the public support measures, in the monetary and financial fields, we should be equally aware of the need for an ***entry strategy*** for moving over to more comprehensive regulatory requirements.

From this point of view the recent proposal coming from Basel represents a very important contribution.

Two weeks ago, the Group of Governors and Heads of Supervision, the oversight body of the Basel Committee on Banking Supervision, endorsed a broad proposal to strengthen the quality and quantity of regulatory capital held by banks and to institute a global liquidity standard. This proposal, the heart of the new Basel III framework, will be submitted to the approval of the leaders of the G20 countries at their November summit in Seoul.

The proposal represents a major reform of banking regulations, which should substantially improve the resilience of banks to stress conditions, thus reinforcing financial stability and reducing the occurrence of a new crisis with injection of public money. Key elements include not only an increase in the minimum regulatory capital requirement but also an increase in the amount of capital that must be held in the form of common equity, which offers the greatest capacity for loss absorption.

I will not discuss the various proposed ratios in detail, as by now I am sure you know them quite well.

Many in the banking industry complained and argued that these reforms will make lending more expensive and imply a decline in the quantity of credit and, therefore, of GDP. We in the regulatory community believe that the length of the transition periods provided for the implementation of the new rules will significantly diminish the costs, to banks and the economy alike. Consequently, the economic cost of the transition towards the new requirements should be very small in relation to the magnitude of the long-term benefits, derived from reducing the probability of financial crises and the severe loss in GDP and growth that would ensue.

Moreover the banks can use different avenues to reach, if needed, higher capital ratios: raising new funds, retaining a larger part of their profit, reducing some activities that are more risky.

While the current proposal addresses a large part of the G20 global financial reform agenda, work on some crucial, additional elements will have to be completed in the coming months, in particular concerning the modalities of the introduction of a countercyclical buffer and new liquidity ratios.

But I would like to insist in this short statement on a very critical macroprudential issue not yet really addressed: the potential impact of failure of systemically important financial institutions, or SIFIs, and the moral hazard associated with the belief that these institutions are too big to fail, a curiosity and, if I may say so, an extravagance in a market economy.

The Basel Committee is currently working together with the Financial Stability Board to develop a comprehensive, global approach to SIFIs that could involve a potential mix of policies such as capital or liquidity surcharges, large exposure limits, contingent capital, and bail-in debt. The goal is for each jurisdiction to have in place a SIFI policy. Effective resolution regimes, will constitute the basis of the approach, upon which other policies would build. A cornerstone of this foundation should, I think, consist of recovery and resolution plans, or "living wills", formulated by the largest financial institutions. These plans will require institutions to specify the measures they will take in the event of severe stress and will also allow authorities to assess the potential orderly resolvability of these institutions without having recourse to public funds.

The rapid spread of the financial crisis has been a lesson not only to market participants but also to supervisors. It has shown that the root of the problems was the gradual build-up of common risks within the system. It is now widely acknowledged that such crystallisation of risk, linked to major shifts in the correlation between financial products and markets, requires more systemically-focused oversight and regulation. To use the professional jargon, microprudential control, the preserve of the supervisory authorities, must be complemented by macroprudential oversight, resorting to the expertise of central banks. In order to improve the symbiosis between these two approaches, a growing number of countries are adopting the so-called "twin peaks model" where the central bank is in charge of the full range of prudential supervision, in both its micro and macro-dimension, leaving the oversight of market integrity and investor protection to a separate institution. This "twin peaks model" will also be introduced in Belgium next year.

Needless to say, I am well aware that the macro-dimension does not stop at our country's frontiers, while the micro-supervision of cross-border groups also requires close multinational coordination. So, I strongly support the recent decision to set up, at the EU level, a European Systemic Risk Board (ESRB) and a European System of Financial Supervisors (ESFS), which are called on to cooperate closely in order to bring more comprehensiveness and consistency to national and international supervision.

Macroprudential analysis must rely on rapid, direct and comprehensive access to data on individual developments liable to affect global financial stability while, in turn, this analysis must feed into the microprudential supervision. It would be a pity if our efforts to improve this flow of information in our respective countries were to be impeded by hurdles at the international level.

In conclusion, the global nature of the crisis has highlighted the necessity of a holistic, internationally coordinated approach to achieve fundamental reforms in financial regulation. These reforms are under way. It is important that this approach result in consistent, international adherence to measures aimed to raise the capacity of individual institutions to absorb losses, reduce the impact of systemically important institutions on the financial system and the whole economy, limit the buildup of systemic risk, and foster international cooperation in macro-prudential supervision.

Ladies and gentlemen, this week the Eurofi conference will provide ample opportunity to discuss and reflect on the topics and challenges the financial sector and the authorities are facing. I hope you will all have a very successful and rewarding conference and a very pleasant stay in Brussels.

Thank you for your attention.