Malcolm Edey: Basel III and beyond

Speech by Mr Malcolm Edey, Assistant Governor (Financial System) of the Reserve Bank of Australia, at the Basel III Conference 2011, Sydney, 24 March 2011.

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Thanks very much for the opportunity to speak to you today.

At the end of last year, as you know, the Basel Committee on Banking Supervision released its new set of prudential standards known collectively as Basel III. It was a major re-think of the existing minimum standards for international banking.

Unlike its two forerunners, this was an agreement in which Australia participated.[1] One of the early responses of the international regulatory bodies to the financial crisis was to make their membership structures more representative. In the case of the Basel Committee, the membership was widened in mid 2009 to encompass 27 jurisdictions, a major expansion from the original G10 membership. Australia is represented on the Committee by the Reserve Bank and APRA.

I've been asked to speak today about what might lie beyond Basel III. It's a good question because it recognises that there's more to financial regulation than just the Basel accord.

I'll try to address some of that in a moment, but before I do it's worth recapping why we have a Basel process, why we specifically have a Basel III accord, and what it is intended to achieve.

The origins of the Basel Committee go back to 1974, when regulators from the G10 countries began meeting at the offices of the BIS to share information about their approaches to bank supervision. The original Basel capital accord (what we now call Basel I) was reached in 1988, and it was a relatively simple affair. The main document was a mere 13 pages long[2], compared to the many hundreds of pages that later comprised the second and third Basel packages. The centrepiece of Basel I was the minimum capital standard, set at 8 per cent of risk-weighted assets and calculated on a common basis.

One preliminary question we could ask is: *why was there a need for that kind of agreement, rather than just having a series of national approaches*? Obviously the Australian regulators weren't parties to formulating Basel I, but I think we can see it as having two interrelated rationales.

First, financial stability can be thought of as an international public good. All countries benefit from the stability of the world financial system as a whole, they all experience some cost when the system is unstable, and so they all have an interest in promoting sound minimum standards. That's one important rationale for a coordinated approach.

Secondly, there is the rationale of avoiding a competitive lowering of standards. If we think of this in a domestic context, the principle is well understood. In the long run, we might expect market discipline to ensure that banks maintain high standards of balance-sheet quality and risk control. But in the short run, we know that if a bank tries to expand quickly by lowering its standards, it can be highly destabilising for the system. A bank that tries to do that will either gain market share at the expense of more prudently run banks, or else force the other banks to follow suit, thereby lowering standards for all. To some extent, what is true of individual banks can also be true of jurisdictions. And so the Committee took the view that there was a collective interest in agreeing to a set of minimum standards to be applied by all its members.

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1 That is, Australia participated officially as a member of the committee.

2 There were an additional 12 pages of annexes.

As I said, Basel I was a relatively simple affair. Basel II, which was announced in 2004 and became effective in 2008, was a much more complex and nuanced agreement. In essence, it was intended to broaden the scope of risk coverage, and to bring in some flexibility to accommodate differences in banks' business models and in the sophistication of their risk management. Among other things, Basel II:

- introduced the three-pillar structure into the prudential framework, those pillars being the minimum capital standard, supervisory oversight, and disclosure. So the framework was expanded beyond a simple reliance on the minimum capital ratio;
- it introduced a framework of capital requirements to cover operational and other risks. In that way it recognised that credit quality wasn't the only source of risk that needed to be backed by capital;
- and it allowed flexibility for sophisticated banks to determine some of their capital requirements using model-based inputs rather than fixed weights.

That said, the central principle of having a minimum capital standard for all internationally active banks remained at the core.

When we talk about the Basel standards, it's important to keep in mind that these standards were always conceived of as being only a minimum. Individual jurisdictions have always been free to exceed them, and it's to be expected that a good national regulator would tailor the standards to local conditions and supplement them with effective supervision. In Australia's case, I think we have been well served by our prudential regulator APRA taking a more conservative and hard-headed approach than required by the international minimum.

Clearly, the Basel I and Basel II standards didn't prevent the GFC, and neither did the existing web of nationally-based regulations in the major economies.

So what went wrong?

This isn't the occasion to give a detailed account of what caused the financial crisis. But regulators around the world drew a number of important lessons from it:

- banking systems needed more capital, and better quality capital, to withstand losses;
- they needed to be made more robust to liquidity risk;
- loan underwriting standards needed to be improved;
- governance arrangements for banks and financial regulators needed to be improved;[3]
- various forms of conflict of interest needed to be eliminated or better managed. Examples of that included the originate-and-distribute lending model that went seriously off-track in some countries, and the role of rating agencies in advising on structured securities. It also included badly structured remuneration practices in the industry;
- and there needed to be more scope for regulatory regimes to act against the build-up of financial excess.

Not all of these are matters for the Basel Committee. There are a number of different international bodies working on these things in their different spheres of influence, including the G-20, the Financial Stability Board and the international insurance and securities

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[3] I am referring specifically here to the regulatory systems in the United States and Europe, where there was perceived to be a need for greater coordination among regulatory agencies.

regulators. But since this is a conference about Basel III, I'll focus mainly on the work of the Basel Committee.

Basel III is about applying the lessons learned from the crisis to the way we regulate banks. Its core is a revised set of standards for *capital* and *liquidity*.

On *capital*, the key elements are:

- more and better-quality capital required to meet the basic minimum;
- a capital conservation buffer that sets rules for managing capital above the minimum;
- a time-varying countercyclical buffer, aimed at mitigating the effects of the credit cycle;
- and an unweighted capital ratio (or "leverage ratio") to act as a backstop to all of that.

For the *liquidity* standard, there are two main elements:

- a liquidity coverage ratio, which requires banks to hold enough liquid assets to meet a 30-day stress scenario;
- and a net stable funding ratio, which requires banks' long-term assets to be matched by stable sources of funding.

These were the main elements of the package announced in December last year.

Earlier speakers today will have talked about these things in some detail, and I don't want to repeat that. Instead I'm going to use the remainder of my time to focus on some areas where work still needs to be done.

The first point to make here is that there is a lot of work coming from the international regulatory bodies that's still to be completed. By that, I mean work that groups like the Basel Committee have started but not yet finished, and also areas where the Australian regulators have work to do in determining our response to the new international standards.

Let me go through a few of them.

The liquidity standard

It's well understood now that the liquidity coverage ratio, in the form originally proposed in the Basel process, couldn't have been applied in Australia. Australian governments simply don't have enough debt outstanding for banks to hold to meet the standard in that form. Incidentally, this is a problem that other countries would love to have. The Australian government's gross debt to GDP ratio is not much more than 10 per cent, compared with numbers of the order of 80 to 100 per cent projected in the next few years in the United States and the major European economies. There are some other countries in a similar position to ours, but not many. To accommodate cases like these, the Basel standard allows, among other options, an alternative treatment whereby banks can count a committed facility with their central bank towards meeting the requirement.

I think this is now widely understood and accepted as a sensible solution for the Australian case. But there are still a number of details yet to be worked out. APRA has indicated that it will require banks to make all reasonable use of their own ability to maximise liquidity before relying on the RBA facility. And they've indicated that they will be consulting with banks as to how compliance with that principle will be monitored. The terms of the RBA liquidity commitments haven't yet been determined. That includes the fee. What we have made clear is that, to meet the objectives of the international standard, the fee will need to be market based, and it will be designed to leave banks with broadly the same incentives as exist in other jurisdictions where the alternative treatment is not needed.

Since the international LCR requirement doesn't come into effect until 2015, there's plenty of time to work through these details and to undertake appropriate consultation. There is even more time for that in the case of the stable funding ratio, where implementation isn't scheduled until 2018 and the details of the proposed Basel standard are less well developed. So these are both areas where further work will be ongoing.

The counter-cyclical capital buffer

The Basel III package provides for an additional layer of capital to be set by national regulators based on the state of the credit cycle. The intention is that regulators would adjust the buffer so as to have a countercyclical influence, raising it in good times, and then releasing it to support lending when credit is tight. To avoid regulatory arbitrage, the standard includes a system of mutual recognition, which would have the effect of ensuring that the capital charge is based on the location where the lending occurs, rather than the home jurisdiction of the lender.

The buffer proposal also specifies a standard quantitative indicator to assist in deciding when to activate it. Glossing over the technical detail, this would be based on the ratio of aggregate credit to GDP. When that ratio is sufficiently above trend, it would be a signal to raise the buffer, and when it's below trend, to lower it. In that way, it would allow surplus capital to be released to the system when most needed.

I know there has been some scepticism about this kind of rule-based approach, and it's important to recognise that the Committee's proposal leaves a lot of scope for flexibility and discretion at the national level.

In my view, that's going to be very much needed.

Having worked in the monetary policy area for many years, the indicator approach proposed here reminds me of an analytical device known as the Taylor rule. The economist John Taylor, some years ago, made the observation that a well-designed monetary policy would respond systematically to deviations of inflation and output from their normal values. It's a relationship that can easily be verified in the data. Taylor's work sparked an army of researchers to try to estimate "optimal" Taylor rules for setting the policy interest rate. It's all useful analytical work, but it's not a field that is open to definitive conclusions because the world is simply too complex to be summarised in that way. No-one would think of reducing the actual decision-making process to a mathematical formula, least of all one devised by an international committee.

If that's true for monetary policy, then it's much more true for financial stability policy, where the complexities are even greater. There's nothing in financial stability policy, for example, that corresponds to the core monetary policy objective of a numerical inflation target, or the single instrument of a policy interest rate: financial stability policy has a wide range of instruments at its disposal, and there's no single summary indicator of aggregate financial risk.

So I think we'll need to avoid too much focus in this area on the simple formula.

Having said that, I'm not against the idea of the prudential regulator varying the capital requirement in response to changing circumstances[4], presumably with some co-ordination with the central bank. But I suggest this is an area where it will take some time for national policy approaches to develop, and it's one where too much effort at international standardisation isn't going to be helpful.

4 In fact, the Basel II principles under Pillar II already allow scope for this to occur.

Systemically important banks

Another area of ongoing international work is on systemically important financial institutions, known by the acronym SIFIs. This gets at the question of how to regulate institutions that are too big to fail – or, as some would prefer to call it, too important to fail, or too interconnected to fail. The focus on this question really arose from the experience of the United States, the UK and some other European countries during the crisis, when significant public funds were committed to rescuing failing institutions. Understandably, those countries would like to reduce the risk of that happening again.

One obvious line of approach is that, if an institution is considered too important to fail, then it should be made safer and, therefore, less likely to fail. On that front, it is proposed that institutions judged to be systemically important should be subject to an additional layer of required capital. Work on this is currently being done in both the Basel Committee and the FSB.

Another line of attack (and this isn't mutually exclusive with the first one) is to reduce the prospective impact of failure if it does occur. This leads into proposals for banks to come up with business resolution plans, or so-called "living wills", which are supposed to ensure the orderly continuity of core functions if a bank fails. It's very important, of course, that there should be good preparation for stress events, and I know a number of regulators are now pursuing this with their banks. How far it's possible to push this idea of living wills remains to be seen, but I wouldn't see it as a panacea. And given the differences in national circumstances, I think this is another area where too much effort at international standardisation isn't going to be helpful.

When we talk about having an international approach to regulating systemically important institutions, there's an interesting question as to how that group of institutions should be defined. I am firmly of the view that they should be defined by their global importance, not their relative importance within their own national systems. The purpose of a global SIFI policy (to use a cumbersome expression) is to limit international spillovers, where the failure of a major bank can affect the system as a whole because of its global scale. Individual countries can and do have their own SIFI policies for institutions that are large in domestic terms. APRA for example has a well-articulated framework for calibrating its standards and its intensity of supervision according to the circumstances of each institution.[5] But in my view the international efforts on SIFI regulation need to focus firmly on systemic importance at the world level, and that means focusing on the small number of very large players that can have a global impact if they fail.

Is there too much internationalisation?

So far, I've spoken about things that are already reasonably well advanced on the international regulatory agenda. One big question that I think hasn't got the attention it deserves is: *Is there too much internationalisation in the banking industry?*

When we talk about banks being too interconnected to fail, an important dimension of that is *international* interconnectedness. It's reasonable to ask the question: if banks are too interconnected in that sense, should they be made less interconnected? One way that that might be done is through greater use of subsidiary structures by banks that operate across borders.

I don't want to overstate the case for this because I recognise it's a complex issue. But I can think of a number of advantages for that kind of model from the point of view of financial

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5 See *Probability and Impact Rating System* (APRA November 2010) and *Supervisory Oversight and Response System* (APRA November 2010).

stability. In particular, all of the key policy tools for managing financial distress are located at the domestic level.[6] Liquidity provision to banks is a currency-specific tool, and is the preserve of the national central bank that issues the currency. Bankruptcy laws, resolution powers, bank regulatory regimes, and the fiscal powers that might be needed in a crisis all operate at the domestic level.

The effect of subsidiarisation, at least in principle, would be to ring-fence the national operations of cross-border banks within separate legal entities in the countries where they operate. There's a good argument that that kind of structure would simplify the management of financial stress events. It might also reduce concerns about cross-border arbitrage of differences in capital regulation.

I am aware that there are also arguments on the other side. In some instances, ring-fencing might not be a realistic option, or host countries might prefer foreign banks to enter as branches in order to benefit from the full support of the parent. Some would argue that concerns about cross-border resolution could be better addressed in other ways.

Another point is that the subsidiary structure is likely to be more expensive to operate. But I'm not sure we should view that on its own as a decisive argument against it. A lot of the post-crisis regulatory changes will add to the cost of financial intermediation, but they are being done anyway to reduce systemic risk. The point is that the costs and benefits need to be carefully weighed.

So there are arguments on both sides. I'm not today seeking to present a firm view, but I think it's an area that hasn't been sufficiently debated, and so I simply raise it as one that deserves further attention.[7]

Supervision and lending standards

I started out by saying that there's more to financial regulation than just the Basel Committee. There's also more to financial stability than just having good regulations. The best possible set of regulations won't, on its own, stop the next crisis, for the simple reason that every crisis is different, people innovate around regulations, and you can't regulate against foolish behaviour.

I don't want that to be interpreted as a counsel of despair. Good regulation obviously makes a difference, and the effort to improve our regulatory regimes, and keep them up to date, has to be made. But we also need other things that are hard to convert into rules (and I'm talking about the international scene here): we need bankers and investors who don't take silly risks, supervisors who are prepared to ask tough questions and step in when they see excess, and good-quality implementation of the rules that we already have. I think, by the way, that Australia has been well served by its prudential regulator on this front. But it would be a shame if, in the international debate, those basics got lost in all the focus on re-writing the rules.[8]

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6 This leaves aside the special case of Europe, where the supranational entity operates in some respects as a single jurisdiction.

7 For a more detailed discussion, see Fiechter et al: *Subsidiaries or Branches: Does One Size Fit All?* IMF Staff Discussion Note 11/04, 7 March 2011.

8 International regulatory bodies are clearly aware of the issue. See for example *Intensity and Effectiveness of SIFI Supervision* (FSB 2 November 2010).

End-piece

I want to conclude, if I may, by saying a few words about the current situation. As you know, the Reserve Bank released its half-yearly *Financial Stability Review* earlier today.

As usual, we've given an account of the various uncertainties that exist around the global financial system. The tragic events in Japan are a new element in that picture, as is the instability in North Africa and the Middle East. It's going to take some time before the implications of all that can be assessed.

But, acknowledging the uncertainties, the world financial system over the past half year has generally been improving. Australian banks are in good shape, and they came through the crisis profitable and well capitalised. They have strengthened their liquidity positions and their use of deposit funding. Australian businesses have reduced their gearing. Households have raised their saving rates.

When we think about what the post-crisis environment might look like, it seems unlikely that we'll be going back to the days of consistent double-digit growth in credit that we saw in the pre-crisis years. That growth was driven in part by factors that can't be repeated – the deregulation of the financial system in the 1980s, and the transition to low inflation in the 1990s. In the post-crisis environment, borrowers and investors are more cautious than they were, both at home and abroad. That's likely to mean less demand for leverage and less growth in private balance sheets, even when the economy itself is growing strongly. If those trends continue, I think it will be good for financial stability, but it will also mean that our lending institutions have to get used to lower rates of expansion than were typical in the pre-crisis years.