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Finalising Basel III

VII Expansión-KPMG Financial Meeting: "Transformation of the banking business model"

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Allow me to begin by expressing my gratitude for the invitation to inaugurate this VII edition of the Expansión-KPMG Financial Meeting.

Last year we met, around these same dates, to analyse the move from “restructuring” to “transformation” of the banking sector. Today, the focus of the discussion is on “transformation”; and this is positive, as it shows that banks are already immersed in a process of change, enabling them to face the new landscape in the wake of the crisis.

The conference programme identifies three areas that are key to the complex setting in which banks are now pursuing their activity.

First, the search for profitability, which in a context of very low interest rates is a fundamental challenge for European and Spanish banks alike.

Second, how to address the challenges and opportunities arising from growing technological innovation, a question to which the banking sector cannot remain immune.

Third, adaptation to the regulatory changes that have come about as a response to the weaknesses identified in the wake of the international crisis that began in 2008.

Regarding this latter area, I shall devote my address to the changes in the global solvency framework, not only because of their significance but also because of the timeliness of the matter.

The Governors and Heads of Supervision comprising the body overseeing the Basel Committee on Banking Supervision met on 11 September. At that meeting we reiterated our aim to conclude by the end of this year the reforms outstanding and thereby finalise the new capital framework known as Basel III.

Basel III: lessons from the crisis and regulatory response

The fundamental aim of the Basel framework is to offer, at the global level, minimum regulatory capital rules that ensure the solvency of internationally active banks. This is essential to preserve financial stability and to provide security to investors and depositors as to banks’ capacity to withstand risks, such as those arising, for example, from adverse economic scenarios, from inappropriate management decisions or, in general, from unexpected circumstances.

The international financial crisis in 2008 highlighted the fact that these objectives have not been met, or not to the extent necessary. Although there were various causes behind the crisis, in the banking sector a series of grave weaknesses came to light. These included most notably excessive leveraging and credit growth; banks’ high exposure to systemic risks; and the absence of sufficient tools to properly address liquidity and funding problems.

The Basel Committee’s response to these vulnerabilities was the approval, in 2010, of the new framework known as Basel III. Focusing initially on the numerator of the solvency ratio and its value, the framework substantially increased the minimum capital levels required and the quality of this capital.

But there is more to Basel III than this: there has been a move from a framework turning on a single metric, the risk-based capital ratio, to another comprising a set of requirements that should interact in a complementary fashion. As a result, a leverage ratio has been introduced which not only limits indebtedness, but also constitutes a non-risk-based capital requirement; two liquidity ratios have been incorporated (one short-term, and another that seeks to ensure a more stable funding structure); limits on large exposures have been set in place; and, finally, macroprudential capital surcharges have been included to prevent and mitigate both the risks derived from globally systemic institutions and those associated with excessive credit growth at the aggregate level.

Risk sensitivity, complexity and comparability

Given all these changes and regulatory innovations, was there anything left to do?

The answer is yes, since following the onset of the global financial crisis in 2008, the soundness of the Basel framework was called into question, as was – more specifically – its risk measurement methodology.

Almost 30 years ago, in 1988, the Basel regulations introduced the concept of risk sensitivity, assigning greater capital consumption to those exposures deemed to be of most risk. Under Basel I, this risk measurement was very simple, such that very few asset categories (those considered to be of least risk) had weightings lower than 100%.

In 2004, the Basel II accord established a new capital framework aimed at improving risk measurement, enabling banks to use their own models while providing a more detailed and risk-sensitive method than that of Basel I. The in-house measurement models, which were assumed to be more advanced, were under supervisory authorisation, available to the banks with the greatest internal risk management capacity. These models were deemed to reflect best market practices and the shared objective was to promote their use. The search for risk sensitivity prevailed over other considerations of simplicity and comparability.

That said, following the international financial crisis that broke in 2008 and the lessons drawn from it, shortcomings have been identified in the Basel II framework relating to the ability of the models to correctly measure risks. Moreover, questions have been raised about the actions of banks, which might have been able to benefit from incentives to develop new models that tended to reduce the risk calculated and, therefore, the capital consumed. And this not to mention the doubts raised about supervisors' capacity to validate increasingly more complex models. In sum, the validity of risk-adjusted capital ratios as a measure of banks' solvency has, in some cases, been questioned, along with the usefulness of this metric to compare the relative position of each bank.

To illustrate this problem we can cite certain analyses published in 2012 which concluded that around half of all investors did not believe banks' RWA figures, while 80% considered that the risk measurement framework should be simplified in order to be more credible.

The Basel Committee conducted various studies attempting to cast light on this matter. Work on the credit and market risk areas was carried out. While this type of study should be viewed with all due caution, it is worth recalling some of the conclusions reached.

For instance, according to a study by the Committee published in July 2013, when different banks applied their own internal models to a single portfolio selected for the purposes of the study, there was seen to be high variation among the resulting RWAs. Only a portion of this variation was due to genuine factors, i.e. to risk factors, and to methodological differences permitted by the supervisors (and which were, therefore, in principle, acceptable or relevant differences). What was most interesting, or worrying, depending on one's standpoint, was the fact that 25% of the variation could not be explained by either of the factors I have just mentioned.

Market criticism and doubts, combined with the findings of the studies, led the Basel Committee to launch a far-reaching internal debate.

At the risk of excessive simplification, at one extreme are those who have lost confidence in banks' capacity to properly use their own models, and also in supervisors' ability to validate and oversee increasingly complex models. And at the other extreme are those who consider that the evidence available is not sufficiently conclusive as to do away with internal models, since, from their standpoint, the differences in RWAs would essentially be in response to the different levels of risk assumed under different business models.

In our view at the Banco de España, risk sensitivity should continue to be at the heart of the capital framework: if a bank assumes more risk, more regulatory capital should be required of it. If this nexus were to disappear, there would then be a disconnect between the bank's internal risk management and regulatory requirements; and perverse incentives might arise, potentially leading banks to take on greater risks than they could properly manage.

That said, internal risk management models undoubtedly pose problems that need to be analysed and resolved.

First, their growing complexity means there is a risk they may ultimately become black boxes accessible to only a handful of experts. Second, the elements integrated into models (such as probability of default or loss given default) are difficult to estimate, especially in certain cases characterised, for example, by the absence of sufficient data. And finally, given that the higher the risk calculated by the model, the greater the capital required, banks might be tempted to underestimate the risks in order to save on capital.

To sum up, we believe it is necessary to continue to use the internal models, insofar as they provide for credible and consistent risk measurement. But we also believe that the quality and credibility of the regulations would be reinforced by the possibility of including certain limits, such as those currently being considered by the Basel Committee, to overcome the shortcomings and doubts mentioned.

Arguably, the best way to achieve this aim is by converging the estimation methodologies used by institutions and supervisory practices in respect of model validation. However, under the Basel framework, considering the significant national differences, this is a very difficult task. Accordingly, we believe that setting certain explicit, verifiable and uniform limits on the models, without this resulting in excessive standardisation, would be a realistic and desirable goal.

Striking a good balance between risk sensitivity on the one hand and simplicity and comparability on the other is the aim of the negotiations and reconciliation of positions under way on the Basel Committee so as to shape the final design, thus bringing the reform of Basel III to a close.

Issues outstanding for conclusion of the reform of the capital framework

In January this year, the Basel Committee's Group of Governors and Heads of Supervision formulated the two objectives of the reform: to address the issue of unjustified variation in risk-weighted assets, avoiding any significant across-the-board increase in capital requirements.

The Committee has already published for public consultation a first proposal on ending the use of internal models to calculate operational risk, which henceforth would have to be measured using only the standardised approach.

The Committee has also published for consultation a proposal on the setting of further restrictions on the use of internal models to measure credit risk. These restrictions would consist in limiting modelling of the so-called "low-default portfolios" for which there is an insufficient history of default to be able to use advanced models. This would be the case, for example, of portfolios of banks, specialised lending or large corporations.

In addition, in portfolios deemed suitable for modelling, minimum levels would be established for parameters (for example, probability of default and loss given default) so as to rule out abnormally low estimated values.

Lastly, the Basel Committee has also published for consultation the possibility of setting a floor or minimum values for RWAs resulting from internal models. Not only the advisability of this is being discussed, but also, if approved, the design and calibration of these minimum values. Essentially, it would be a question of limiting to a certain percentage the maximum capital saving that institutions may obtain by modelling risk on their own account, rather than measuring it using the standardised approach.

Conceptually, and provided it is correctly designed and calibrated, a floor of this kind can be a useful tool in the aim to reduce unwarranted and unwanted variation in RWAs: it would set for all institutions the same maximum level of saving obtainable using models, and it would help to ensure a minimum desired level of capital for a specific level of risk, and all without relinquishing risk sensitivity.

In the process of finalisation of Basel III, the Committee has also stated its intention to improve the standardised approaches for credit and operational risk. Broadly speaking, the aim is also to make them more risk-sensitive.

The standardised approaches are important per se, since they are used by a great number of banks worldwide; but as restrictions on the use of internal models are introduced they will become even more important.

Thus, discontinuing the use of internal models to measure operational risk would mean that all institutions, irrespective of size, business model or type of business, would have to use the same standardised approach to measure operational risk. Measuring such a heterogeneous risk using a standardised approach clearly presents considerable difficulties.

The proposal published for public consultation by the Basel Committee has a series of limitations that must be remedied before it is approved.

Regarding the use of the standardised approach to measure credit risk, the Committee is striving to make it more risk-sensitive and, at the same time, to reduce its excessively automatic reliance on external credit ratings. This is no easy task either, and the final outcome may possibly be less ambitious than was initially intended. It is important, however, that the approach be robust and correctly calibrated. The impact assessments being performed by the Basel Committee will provide more information in this respect.

In accordance with the guidelines we all subscribe to, as I mentioned earlier, this package of reforms should not produce a significant widespread increase in capital requirements.

Nevertheless, with the aim of reducing unwanted variation in risk-weighted assets, it is likely that capital requirements will indeed increase for banks that are using internal models in a more aggressive or inappropriate manner.

In other words, given the aim of the reform, any resultant increase in capital requirements would be confined to the review of internal credit risk models, or to the possible limits on savings arising from their use. In general, the review of the standardised approaches should not result in increases in capital, as applied either to credit or operational risk.

Conclusion

To conclude, following our meeting in Basel, the challenge ahead for the Central Banks and Supervisors is to reach an agreement on a new capital framework that maintains a balance between risk sensitivity, simplicity and comparability.

Reaching this agreement before the end of the year will be no mean task, and will require each of us to cede some ground. But a non-agreement scenario is not an option. Basel is a most valuable edifice that we must preserve so as to maintain a global banking system.

A delay in the agreement is not desirable either. It is not a matter of merely patching up Basel III. I believe banks and supervisors would benefit from finalising the new framework, and allowing ourselves a regulatory breather.

Thank you for your attention.