SPEECH

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Necessary reforms for a more stable financial sector

Crises are expensive and should be avoided

When financial crises afflict us it becomes obvious to all how much damage they cause. Unfortunately, this insight is often temporary, as it is easy – even a human survival instinct – to forget problems and leave them behind us. As a representative of the Basel Committee I therefore see it as an important task to remind you of how costly financial crises are to the national economy and how important it is that we have robust regulatory frameworks that reduce both the cost of crises and the probability that they will occur.

Although we often see a return in the growth rate of the economy, crises usually lead to a permanent fall in GDP, which takes a very long time to recover from. Even today, almost 10 years after the financial crisis broke out, many countries are struggling with low growth, high unemployment and low inflation. In several cases they also have high sovereign debt. And in the case of Sweden, there is no other event since the Second World War that has affected Swedish GDP as negatively as financial crises. There are two clear dents in Swedish GDP post-war development: during the financial crisis in the 1990s and during the global financial crisis 2008-2013.

The most acute problems are remedied but some work remains

A crucial cause of the most recent financial crisis was that banks around the world had taken on too much risk. This was possible for two reasons. Firstly, the regulatory framework applying at the time did not sufficiently influence the banks' risk taking. Secondly, the banks themselves evidently did not have the will or ability to manage their risks on their own. The answer was the Basel III Agreement - a comprehensive package of reforms with the main purpose of strengthening the banks' capital base to ensure that they can manage losses in a better way and improve the banks' liquidity management.

But even if Basel III dealt with the most acute shortcomings, work remains to be done to ensure that banks around the world are well capitalised. I intend to spend a little time here talking about the reform work the Basel Committee is currently involved in and why it is important that the new reforms are put into place.

The global capital regulations will become more reliable and easier to compare between banks

A basic idea behind the design of Basel II -the global capital regulations that were completed a few years before the financial crisis - was to create a stronger link between capital requirements and the banks' risks. This is largely attained by the banks having the opportunity to calculate their risk-weighted assets, and thus capital requirements, using internal models. When the financial crisis broke out, however, it became clear that these models often underestimated the risks in the banks' exposures. This meant that the capital requirement was lower than was appropriate. Many actors, both regulators and market participants, have therefore expressed doubts as to how well these models actually reflect the risks.

In 2013, the Basel Committee therefore published a number of reports analysing what capital requirements the banks' internal models generated. The reports show that there are major differences in the banks' capital requirements. They also show that these differences cannot be explained by the differences in the underlying risk in their assets, but are instead due to the way the banks measure risk. The fact that this is so not only makes it difficult to compare capital requirements between the banks, it also reduces the credibility of the international capital regulations. The Committee's current work therefore concerns to a large extent ensuring that the models used by the banks are reliable and reflect the risks in their operations in a correct manner.

This work includes revising and to some extent limiting the banks' scope to use internal models to calculate their risk-weighted assets and thereby their capital requirements. For instance, the Basel Committee is planning to introduce floors for a number of the parameters the banks estimate themselves. The result of this is that we will see less difference in the banks' capital requirements for assets with similar risk profiles. Let me make myself clear: The idea is not that we shall return to Basel I. The banks will be able to continue using internal models in their risk management. What the Committee's current work concerns is instead bringing order to the risk-based system to increase the credibility of the capital requirements the banks have and to make it easier to compare them. Without this work, there is a risk of further erosion of confidence in the regulations.

Another important part of the Committee's work involves modernising and developing standard methods so that they become more risk sensitive and thereby better adapted to banks with international operations. For many types of exposure, such as lending with property as collateral, the current standard measures often give the same risk weight regardless of the loan-to-value ratio. This will probably be changed so that the capital requirement varies according to the loan-to-value ratio. This work also covers trying to reduce the mechanical dependence on external credit ratings, which is in line with the objectives stated by G20.

Supplementary requirements will increase the banks' resilience

On the basis of the revised standard methods, the Basel Committee is also working on new floors to limit how low the banks' risk weights can fall. In this way, one also limits how low their capital requirements can be. It means in practice that the banks' future capital requirements must amount at least to a certain percentage of the capital requirements the banks would have if they instead used standard methods to calculate their capital requirements. Similar regulations already exist in the form of the old Basel I floor. The Basel Committee introduced the Basel I floor for the specific purpose of avoiding a situation where the banks' capital requirements decline too much and too quickly when the Committee decided to introduce Basel II. The new regulations are not at all revolutionary in themselves, but focus on bringing the existing framework up-to-date. It is also reasonable to link together the standard methods and the internal models in this way, from both risk and competition perspectives. The fact that there is some relationship between standard methods and the banks' own models ensures that the capital requirements do not differ too much.

In addition to the floor regulations, the Basel committee will decide on the final form and calibration of the leverage ratio requirement. The Basel Committee is planning, as announced earlier, to introduce an international minimum requirement in the year 2018 of three per cent, and possibly somewhat higher for systemically-important institutions.

Having a leverage ratio requirement is an important step forwards, as this gives us a commonly agreed highest level as to how much the banks can debt finance their operations , regardless of the level of risk in their operations. Excessive debt is namely a common denominator in most financial crises. Even before the crisis, a number of banks expanded their operations substantially with the aid of debt financing. When the markets became shaky it turned out that many banks lacked sufficient capital to cover their losses. The idea of the leverage ratio requirement is that it should be a relatively simple and transparent supplementary capital requirement that sets an upper limit as to how much leverage the banks can take on. Basel II created too much freedom for the banks, with well-known results. We need to put this right. We will therefore now have a system with many different types of constraints.

Government exposures are also risky

Another question discussed by the Basel Committee is if and how the banks should maintain capital to cover their exposures to governments and other public bodies. Today it is in practice possible for the financial supervisory authorities to completely exempt such exposures from the capital adequacy requirement. We know from experience, however, that the banks' exposure to governments is not risk free. The Basel Committee has therefore decided to review whether and how the regulations need to be changed.

Almost 10 years on from the crisis – time to complete reforms

The international regulatory work has been in progress since the global financial crisis broke out in 2007. It is important to many parties, not least banks, investors and policy-makers, to clarify how the global regulatory framework for banks will function. The Basel Committee is therefore working intensively on completing the current reform work by the end of the year[1].

[1] However, it is still not clear when the review of the exposures to governments and public bodies will be complete.

Critics have expressed fears that the reforms I am talking about now will lead to minimum capital for certain banks increasing radically, which in turn risks resulting in a real economic decline. Here I would like to point out that the Basel Committee's ongoing reform work does not aim to significantly increase the total global capital requirements. Instead, it concerns ensuring that all banks around the world have adequate resilience to manage financial crises and that risks are covered by capital in a uniform way in all banks and all countries. One result of this exercise is that banks that currently have very low risk weights will probably face higher capital requirements, while banks with very high risk weights may face lower capital requirements. Designing a uniform global regulatory framework is not an easy task, particularly as banking systems differ from country to country, but also because we are living in a changing world. The Basel Committee's work is therefore largely a question of finding compromises that all member countries can support and which will stand the test of time.

Naturally, the Basel committee is also evaluating very carefully the effects of the proposals now under negotiation. This applies to the effects on the banks as well as on society. Following the financial crisis, a number of studies have been made regarding which capital levels are most appropriate from a socioeconomic perspective[2]. Many of them have shown that the macroeconomic advantages of increasing the resilience of the financial system clearly outweigh the costs of the reforms, both in the short term and the long term.[3] It is not in any way so that the necessary reforms now being discussed threaten general economic developments. On the contrary, economic research has shown that well-capitalised banks tend to lend more than banks with little capital do.[4] This is because banks that are well-capitalised also face lower funding costs. We have experience of this in Sweden, where the relatively higher capital requirements have contributed to the financial markets having considerable confidence in Swedish banks. This in turn has increased the banks' access to cheap funding.

With regard to the effect for banks, I would like to point out that the forms the Basel Committee is working with concern how the minimum capital requirement, also known as the Pillar 1 requirement, should be calculated. Banks with crossborder operations benefit from Basel III now containing this type of joint minimum standard. But Pillar 1 is only a part of the total capital requirement. The amount of capital a bank needs to hold in total is also determined by Pillar 2 and by national buffers, that is, requirements set by national authorities. Now that the Basel Committee is completing Basel III and the minimum requirement will thus have better cover, it is also reasonable that national authorities where necessary review their national capital requirements.

That being said, I would like to stress that the Basel Committee's work involves establishing a global minimum standard that ensures that banks around the world are better equipped to manage losses. Having a regulatory framework that is robust and that is implemented will play a decisive role in reducing the risk that we will have to experience further financial crises that result in large production losses, high unemployment and permanently lower growth.

[2] See, for instance, BIS (August 2010), The long-term economic impact of stronger capital and liquidity requirements
[3] See, for instance, BIS (December 2010), Assessing the macroeconomic impact of the transition to stronger capital and liquidity requirements
[4] Gambacorta and Shin (2016)

References

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