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FSI High Level Meeting on "The Emerging Framework to Strengthen Banking Regulation and Financial Stability" for Africa

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"The New Framework for Banking Supervision"

I. Introduction

Let me first start by thanking Josef Tošovský and the Financial Stability Institute for organising this meeting and Governor Gill Marcus and Errol Kruger of the South Africa Reserve Bank for hosting this event. Much has happened since last year's FSI High Level Meeting here in Cape Town. At that meeting, I presented the Basel Committee's comprehensive strategy for responding to the financial crisis and detailed its proposals to strengthen capital and liquidity requirements. With the endorsement by the G20 Leaders in November and the December publication of the Basel III framework, our ambitious reform programme has been successfully completed. Now we move to the implementation phase of the new framework. Basel III is a key milestone in strengthening banking supervision and regulation, but also, more broadly, in promoting a safer and sounder financial system.

This morning I will present an overview of the Basel III framework. My focus, however, will be on how its adoption will contribute to stronger banking systems and supervisory regimes across the globe, including, in particular, Africa. I will then discuss how the Basel Committee's future work programme will build on our recent achievements to help ensure sound and stable banks and banking systems globally.

II. Financial crisis and important lessons for Africa

A common misconception is that Basel III is intended only for industrialised economies with large, complex banks. Some view Basel III as a solution to a problem they did not cause and which did not affect them. It is true that the crisis had its roots in the United States, and through the imprudent use of complex securitisations by large, complex banks its devastating effects spread to other industrialised countries. The current debate over the use of contingent capital or the treatment of systemically important financial institutions ("SIFIs") might further reinforce the impression that Basel III only targets specific markets or banks. But this is only part of the story.

If one looks beyond the ruinous fall-out from the crisis, a careful analysis reveals a series of fundamental shortcomings, any of which could affect all jurisdictions and banking systems. When developing Basel III, the Committee's objective was to address these deficiencies, which are not only the domain of big banks but of all banks, regardless of size, complexity, and geographic location. Some of the failures that characterised this crisis and which Basel III addresses include:

- Poor liquidity risk management and insufficient liquidity buffers, despite a global glut of liquidity;
- Too much leverage in the banking system, combined with weak credit underwriting;

- Bank capital that was of inadequate levels and of insufficient quality;
- Serious shortcomings in corporate governance, risk management and market transparency.

The crisis was also deepened by a disorderly deleveraging process and by the interconnectedness among institutions. These two dynamics – procyclicality and systemic risk – illustrate the imperative of taking account of bank-specific weaknesses *as well as* the risks that build up in the banking and financial system. Leading up to the crisis, a commonly held belief was that bank supervision's exclusive focus was the safety and soundness of individual banks. Ultimately, the effects of the crisis were transmitted in ways and to regions that were not previously envisaged. This crisis reminded us that in a global and open financial world, any crisis can be transmitted easily and rapidly through very different and often unexpected channels.

The factors that played a role in the recent crisis could thus occur anywhere. Accordingly, the Basel Committee's response was designed to ensure that all banks and banking systems are better prepared for the next crisis, whatever its source and nature.

Basel III

The central element of the Committee's response is Basel III. Our goal is to enhance bank and banking sector resilience to unexpected shocks and thereby promote financial stability. The combination of firm-specific approaches and macroprudential measures to address procyclicality and systemic risk is a key feature of Basel III. It is important for all countries, both developing and industrial, as it will contribute to promote greater financial stability and less boom-bust growth.

Basel III comprises a comprehensive set of measures. Some measures introduced by Basel III correspond to new concepts and tools. I can point to the introduction of regulatory buffers as an example. In my view, Basel III is not overly complex nor is it an overhaul of Basel II. And this is another misconception: that Basel III somehow replaces Basel II or Basel I. Basel III *complements* the Basel II and Basel I frameworks. It simplifies and strengthens the numerator of the capital ratio – an area left largely unchanged by Basel II – and introduces some macroprudential components to the regulatory framework.

Among the components of the new framework, I would like to mention the following that are fully relevant for African banks and banking systems. These elements should protect against the types of internal and external shocks banks and banking systems often face, regardless of the state of development or complexity.

- First, it substantially raises the quality and quantity of capital, with a greater focus on common equity. Capital needs to be of the highest quality to better absorb losses from shocks that could emanate from anywhere.
- It also introduces a simple leverage ratio, which will act as a backstop to the risk-based measure. Such a measure is critical to underpinning the whole regime and will provide a simple, easy to understand sanity check of the results produced by the risk-based framework.
- A third dimension of Basel III is the use of capital buffers. The conservation buffer provides a strong incentive for banks to build up capital in good times while the countercyclical buffer should help protect banks against the dangers of rapid credit growth, which might be particularly relevant for emerging economies.
- Finally, sound liquidity risk management principles and global liquidity standards will help ensure that banks more effectively manage this risk and maintain adequate liquidity buffers.

Standards where we have less experience, such as the liquidity and leverage ratios, will be phased in gradually and their implementation monitored accordingly. This will enable us to address any unintended consequences by making adjustments where appropriate. However, this process should in no way call into question the commitment to fully implement strong global standards in this area according to the agreed timelines.

While the Committee has accomplished quite a lot in a very short time frame, much work remains. We have quite an ambitious agenda to help address remaining policy issues, as well as to ensure a successful and effective implementation of the new regulatory framework.

II. Further efforts to strengthen global supervision and regulation

Basel III's intense focus on capital and liquidity standards should not overshadow the equally important efforts of the Committee to strengthen risk management and supervisory practices. This has been the longstanding mandate of the Committee and our recent work includes efforts that go beyond minimum standards for capital or liquidity. A good example of this is the Committee's *Principles for Enhancing Corporate Governance*. The principles, which were published last year, address major governance failures observed during the crisis. These included, for example, insufficient board oversight of senior management, inadequate risk management and unduly complex or opaque organisational structures and activities.

Other examples include work on stress testing, operational risk and cross-border bank resolution. There is a common theme that runs through these and other guidance documents: fundamentals are essential – they need to be applied successfully by all banks, in all jurisdictions, and supervisors need to ensure that they are indeed being implemented and enforced.

The *Core Principles for Effective Banking Supervision* are the foundation on which strong supervisory systems are built. It is therefore fitting that the Committee is reflecting on the many supervisory lessons learned during the recent crisis as it sets out to revise the *Core Principles*. This work has recently begun and will consider those lessons, many of which have already been articulated in recently released Committee standards and guidance. In addition, the Financial Stability Board has identified areas of the Core Principles that could be expanded or clarified.

I would also like to highlight two initiatives of a related nature, which are particularly, if not directly, relevant for emerging economies. The first one outlines the general applicability of the Core Principles to the supervision of microfinance activities. This effort illustrates the commitment of the Basel Committee to facilitate financial inclusion and also supports an important G20 effort in this regard.

Another Committee effort of global relevance is the 2009 *Core Principles for Effective Deposit Insurance Systems*, which were developed jointly with the International Association of Deposit Insurers. These deposit insurance core principles should help protect depositors and customers in all jurisdictions. A methodology for assessing compliance with these principles has also recently been published.

The Committee's policy development work will also continue in a number of specific areas. One of these areas is a fundamental review of the trading book. The review addresses basic questions like: Should the distinction between the trading book and banking book be maintained? If we maintain it, how should trading activities be defined? Is VaR the best method for calculating capital requirements? The focus should be on building sound business models underpinned by adequate capital and liquidity. We will consult with the industry as this work progresses.

Another high priority for the Committee is our work on systemically important banks, in collaboration with the FSB. The Committee has developed a provisional methodology to identify systemically important banks at the global level. While Africa as a region may not be home to global SIFIs, the presence of systemically important institutions is still of paramount concern. Each country must determine if it has banks of a size and complexity relative to its domestic economy that are too big to fail and should take appropriate measures. After focusing on global SIFIs, the FSB will then take on the issue of how best to treat domestic SIFIs.

Work to reduce the reliance on external ratings in the regulatory capital framework is another area of focus. This includes addressing cliff effects from ratings downgrades, reviewing the treatment of securitisations and strengthening independent due diligence standards. The Committee will also initiate a review of our existing guidance on large exposures. In addition, the use of sound provisioning methods based on expected rather than incurred losses is also a topic of high interest to us.

Another topic that might be of interest to emerging markets is the treatment – under Basel III – of trade finance. The G20 leaders have ask us to examine this issue with a particular focus on low income countries. In December, the Committee announced publicly that this issue will be on the agenda of its Policy Development Group.

IV. Implementation

This work that I just described dealing with fundamentals and core principles is and will continue to be a top priority for the Committee. But for supervisors a key takeaway from the crisis has been the imperative – the absolute necessity – of implementation. While Basel III is the core *regulatory* response to problems revealed by the financial crisis, it can only contribute to soundness and stability if it is fully and effectively implemented and supported by strong *supervisory* practices.

The Committee's renewed focus on implementation begins with Basel III. The new framework will take effect from the beginning of 2013 and will be progressively phased in by 2019. These transitional arrangements ensure that Basel III can be implemented in all countries without impeding the economic recovery. All countries should therefore take the necessary steps to adapt the Basel III agreements to their national laws and regulations in time for an effective implementation in 2013. Efforts to delay or weaken the agreements will jeopardise financial stability and the robustness of the recovery over the long term.

The Committee has agreed to put in place stronger mechanisms to ensure that our standards are fully and consistently implemented by its members. Countries should take similar actions at the domestic level. The Committee's Standards Implementation Group will play a key role in that respect. In addition to closely monitoring the adoption of Basel III by its members and by the industry, it will also address the implementation issues that could challenge a consistent implementation. The Committee will also conduct follow up and thematic peer reviews of Committee members' implementation in a number of key areas, like stress testing and liquidity risk management. The lessons learned when conducting these assessments and monitoring will benefit to the broader supervisory community.

V. Conclusion

Let me bring my remarks to a close by reiterating a common misconception of Basel III: that it is relevant for only certain regions and only for big banks. While Basel III is indeed one of the key tangible responses to the financial crisis, it was designed to protect against future stresses and not to fight the last battle. Moreover, Basel III is relevant for all countries, regardless of the state of economic development – and for all banks, regardless of their complexity.

Two years ago when I addressed this High Level Meeting, the title of my remarks was "The Future of Supervision" and the theme was "Back to Basics". Those basics back then – as now – were a focus on fundamental standards and core principles. We as supervisors must continue to make sure we and our banks have got the basics right.

Thank you for your attention.