I. Introduction

I would like to start by thanking Governor Carlos da Silva Costa and the Bank of Portugal for inviting me to speak today. The theme of this conference is Basel III and the new challenges for supervisors, risk managers and auditors. It cuts to the very core of the lessons learned from the financial crisis and how we respond to them – through the effective implementation of Basel III and regulatory reform.

The crisis has entered a dangerous new phase in which weak public finances have interacted with remaining fragilities in financial institutions to open up fault lines in both the financial system and the economy. This is evident particularly – though not exclusively – in the euro zone. This new phase has also reopened some debates about: how fast the full transition to Basel III should be made; about how far some banks need to be recapitalised; about how sovereigns should be treated in the regulatory framework for capital and liquidity; and about how consistently the new rules should be applied – by this I refer to both the formal adoption of the rules and their actual implementation in national jurisdictions. Some of these debates are not new, yet I am not sure that they have been properly worked through. I will therefore offer my views on some of them.

The conference theme also underscores that responsibility for Basel III does not rest only with the regulatory community. Bank boards, senior management and risk managers all have a clear role in adapting to the new framework. Auditors also play a key part in providing independent and disciplined review and feedback on management’s efforts. Let me start with a few thoughts related to these issues.

The policy development behind Basel III has been successfully completed and was endorsed by the G20 leaders last year. The next step, no less important, is to put the rules into practice. Now is the time when we ensure that measures agreed at the international level are given the chance to deliver the intended benefits. The intended
benefits will come from a more resilient financial system that is better capitalised and therefore better able to provide credit to the economy, while absorbing shocks instead of amplifying them. At the macro level, the ultimate goal is to limit both the severity and the probability of financial crises.

But implementation is taking place during an uneven and uncertain recovery. Growth prospects have weakened and dangerous feedback loops have been created between weak sovereigns and still fragile financial systems. These tensions may be most evident in some euro zone countries, but concern about public finances extends much further than that.

A main driver of the perverse feedback loop between weak sovereigns and fragile financial systems has been the rapid erosion of confidence in sovereigns. Initially, the 2007 financial crisis highlighted the fragilities of private financial institutions. Now these problems have interacted with weak public finances. Markets are questioning the risk-free status of the debt issued by an increasing number of governments worldwide. This morphing of sovereign debt from a risk-free to a “credit risk” instrument has far-reaching implications, not least for the smooth functioning of financial systems. It creates adverse feedback effects on financial institutions and, in particular, it magnifies counterparty credit risk and creates significant funding challenges for banking systems.

It is vital, of course, to bolster the capital of banks and repair their balance sheets. This will increase their financial strength and improve confidence in their funding. Indeed, the authorities are currently redoubling their efforts to shore up private sector balance sheets in the face of market stress. But this is not enough, I believe: we also need to attack the root of the problem. The key priority is to restore confidence in sovereigns by taking steps so as to be able to re-establish their “risk-free” status. Corrective action is needed on the fiscal side to convince markets that adjustments are under way and will endure. Structural reforms are needed to deal with the underlying economic problems that plague a number of euro area countries. In addition, credible financing backstops will be needed during the adjustment phase. Given the sheer scale of the sovereign debt overhang and the speed of market dynamics, time is critical if contagion is to be contained. Thus, the restoration of confidence in sovereign debt is the vital first step in maintaining overall confidence.
The new standards are tough and they were meant to be – but the long phase-in will help

Nobody would deny that the financial system needs to be strengthened to deal with the new challenges it faces. It is all the more surprising, therefore, that we are again hearing proposals to slow the speed of adjustment so as to not jeopardise the recovery.

In my view, quite the opposite conclusion should be drawn from the recent past: namely, that the banks that most vigorously rebuilt their capital and repaired their balance sheets are now the best positioned. The fundamental question is this – how resilient do we want to be when we face the next turbulence?

Basel III was developed expressly to reduce both the frequency and intensity of financial crises. Studies indicate that the accord will lower the very significant economic costs of crises. Such benefits will not materialise, however, unless we fully and consistently implement it. Any weakening of the standards – or delay in implementing them – will only hinder efforts to restore confidence in the financial system.

For many banks, the implementation of Basel III will be a significant hurdle. After all, the capital and liquidity rules are designed to meaningfully strengthen banks’ capital and risk management. In some respects, the agreement represents an overhaul of existing rules. The new, tougher definition of capital is an example. In other respects, the new rules are groundbreaking, especially those on liquidity. These are meant not only to address the painful lessons of the past but also to better position banks for the next set of pressures.

When the Basel Committee’s oversight body of Governors and Heads of Supervision agreed to phase in Basel III over an extended period, they recognised the challenges many banks would face, particularly under present market conditions. The carefully planned transitional arrangements were intended to provide sufficient time for banks to make the necessary adjustments along the prescribed timeline without jeopardising economic recovery. Banks need to attract new capital, preserve existing capital by limiting the payout of dividends and bonuses, and realise efficiency gains. And it is not just the regulators that are asking for these changes: the market itself is leaning on banks to do more, and do it faster, on all these fronts.
The Basel III response to the crisis is substantially complete. A few policy-related areas, such as the liquidity standards, are under review by the Basel Committee. This should not be surprising since – in contrast to capital regulations – there are relatively little experience and data when it comes to global liquidity standards. The aim is to ensure that the rules work as intended and that any *unintended* consequences will be addressed. I should emphasise here, however, that the basic design and structure are unlikely to change.

In the best of worlds, implementing a global set of rules on a consistent and timely basis would be challenging. The scope and rigour of the Basel III rules heighten this challenge. Therefore, I would now like to discuss what implementation means for banks, including their senior management, risk managers and auditors. Then I will talk about the role of supervisors, including the Basel Committee, which recently announced its comprehensive programme for monitoring implementation.

II. Basel III and the responsibility of banks

Proper governance is the necessary first step

The Basel Committee has reached agreement on principles and rules that must now be implemented. Otherwise, our journey – towards a more resilient banking system – will end even before we have properly set out. The publication of the Basel III framework was the first step in this journey. But the next steps can only be taken by banks, and this by adopting the “risk governance” that best suits their business model and risk profile.

The crisis showed that existing risk management systems could not cope with unforeseen stresses. But systems alone were not to blame; sound governance was often lacking. The Basel Committee recommendations in this regard are very clear. To illustrate my point, let me quote two principles set out in the Basel Committee’s recently revised corporate governance guidance for banks:

- First, “Board members should be and remain qualified, including through training, for their positions. They should have a clear understanding of their role in corporate governance and be able to exercise sound and objective judgment about the affairs of the bank”.

• Second, “Under the direction of the board, senior management should ensure that the bank’s activities are consistent with the business strategy, risk tolerance/appetite and policies approved by the board”.

These principles may sound very abstract. Yet they are, in fact, the cornerstone on which any effective risk management framework, sound incentive structure and robust governance arrangements must be built. To forge the link between corporate governance and risk management, some banks have drawn up a “triple line of defence”. I believe that this approach is particularly valid, as it correctly distinguishes between the roles of business units, support functions and internal audit.

• The first line of defence is the business unit, which is accountable for identifying, measuring, taking and mitigating the risks of its business.

• The second line of defence, which includes risk management, compliance, legal, finance, operations and information technology, works with the business units to ensure that the first line has properly identified, measured and reported their business risks. Collectively, all elements of this line of defence are responsible for developing a bank-wide view of risk.

• The third line of defence, namely internal audit, independently and systematically reviews the efficiency and effectiveness of the first two lines of defence and contributes to improving their effectiveness.

The role of audit

The ever increasing complexity of products and operations and the parallel development of regulations such as the Basel Accords place intense demands on the technical resources and authority of internal auditors. Internal auditors need a deep understanding of the bank’s business. They must critically analyse the operations they audit and recommend improvements to the internal control framework. For its part, management must ensure that the organisation pays due regard to auditors’ recommendations, and that these are properly understood and meticulously implemented without delay. Senior-level follow-up within the organisation to ensure this occurs is key.
Rightly so, expectations concerning the effectiveness of audit are high – most immediately from management and the board, but also from supervisors. The Basel Committee recognises audit’s important role and promotes collaboration between supervisors and both the internal and external audit function. In many respects the concerns of banking supervisors and auditors are complementary.

III. Monitoring and review process

I would like to turn now to the actions that the official sector, including banking supervisors in particular, has taken or is considering to ensure the successful implementation of Basel III and other reforms as part of the G20 agenda. Our experience with the crisis and with the implementation of former significant reforms has taught us that we need to be more active and more involved on the implementation front if we want to succeed. A sound policy initiative signifies nothing if it is not properly implemented. It is therefore imperative that policy responses be implemented fully, consistently and globally.

To ensure greater global consistency, the Basel Committee’s Standards Implementation Group (SIG) has stepped up information-sharing among supervisors. To strengthen the global implementation process, the Committee will carry out peer reviews as well as “thematic reviews” that assess progress across jurisdictions in implementing specific reforms, such as stress-testing guidance. The Committee’s follow-through on implementation represents a significant practical and cultural shift in the way international agreements are implemented.

The Committee is also putting in place a comprehensive and robust monitoring and review process covering all aspects of Basel III implementation. I should clarify that Basel III actually encompasses the entire regulatory capital framework of Basel II and its subsequent amendments – often called “Basel 2.5” – which are related to securitisation exposures and market risk as agreed by the Committee in 2009. Basel III builds upon and enhances the regulatory framework introduced by Basel II and Basel 2.5. If we want to have a meaningful and comprehensive view of how global bank rules are being implemented, we need to look at all components of the regulatory capital framework – not only at the latest developments even if these are the ones that attract the most attention.
As a first step, the Committee has started to review the domestic rule-making processes to ensure that the Basel capital standards are enacted into law or embodied in regulation by its members according to the agreed international timelines. A first progress report on Basel III implementation, detailing the status of members’ adoption of the capital framework, will be published by the Committee in the coming days.

As a second step, after having made sure that domestic laws and regulations are adopted, the Committee will review their consistency with the internationally agreed standards. The main objective here is to identify any slippage from the minimum international standards that could flag a race to the bottom. This work will require detailed and comprehensive peer reviews of domestic regulations and will be a key element to help ensure a level playing field.

The Committee aims to start this work in early 2012, using the regulations of its members in draft form so as to provide feedback before the domestic rules are final and therefore difficult to modify. Now we have a unique opportunity to influence domestic rule-making process by exerting strong peer pressure, before it is too late.

As a third and complementary step, the Committee will review the outcome of the rules to ensure that the capital framework operates as intended and that the actual implementation is consistent in practice. In particular, this effort will entail a review and validation of how banks calculate their risk-weighted assets for both the banking book and the trading book. The aim is to ensure that risk-weighted assets accurately reflect the underlying risks as well as to assess and to explain observed differences across banks and countries. This implementation work on the denominator of the capital ratio will supplement the policy work done on its numerator, with the strengthening of the definition and level of capital in Basel III. The aim is to ensure market participants’ and public confidence in regulatory ratios; it will also ensure a level playing field at the global level.

These reviews provide clear evidence that the Basel Committee is fully committed to a successful implementation of Basel III. The review process will be supported by appropriate public disclosure to reinforce incentives for member jurisdictions to implement Basel III in a full, consistent and timely manner.
This process, which will require members to be challenged on their implementation plans and country-specific information to be disclosed, represents a significant step forward for the Basel Committee. Its implementation work has previously been limited to information exchanges and cooperative work. This time, the follow-through will require strong support from all members together with adequate resources.

Basel III was an impressive response to the crisis in terms of both substance and timeliness. But even with full, consistent and global implementation, it represents just one element that, by itself, cannot ensure long-term financial stability. Further progress on other reforms is needed, including, for example, on accounting standards. Should international accounting standards fail to keep pace with other responses to the crisis, this would certainly weaken overall efforts to make banks more resilient. For example, a well capitalised bank can still be threatened by poor valuations and underprovisioning. In my view, such outcomes cannot be ruled out in the absence of a true expected-loss approach for impaired assets.

In addition to reviewing the implementation of Basel III by its members, the Committee is also committed to helping other authorities to implement Basel III. In particular, the Committee intends to promote a common understanding and interpretation of the new rules. Accordingly, frequently asked questions are being identified and answered; a first set of answers on the definition of capital and on liquidity was published in July and another set will be published shortly. The Committee also intends to reinforce supervisory cooperation to solve the practical implementation issues that may arise, notably by pursuing its ongoing work on supervisory colleges.

At the cross-sectoral level, the Financial Stability Board (FSB) will play an important role in monitoring the implementation of agreed G20 and FSB financial reforms. The FSB has adopted a monitoring framework that relies on close cooperation and coordination with standards setters, including the Basel Committee. This should help ensure that international financial reforms are effectively implemented.

Conclusion

In conclusion, I would like to reiterate that there are high expectations from all parties involved in the process, including the G20 and the general public. To achieve the
stated objectives of the reform, sufficient resources will be needed on the part of banks, supervisors and auditors.

This effort is necessary as another crisis could turn out worse; there is no alternative to strengthening the system. And that will only be possible if we implement Basel III and other reforms globally, fully and consistently.

But Basel III is only part of the new regulation we aim for. We must complete the regulatory agenda, and in particular the further FSB-led work on SIFIs (eg non-bank G-SIFIs and domestic SIFIs), resolution regimes, OTC derivatives and CCPs, and shadow banking.

And, of course, regulation is only part of the broader public policy agenda. This is something we at the BIS like to repeat every time we talk about regulation. Regulation was only part of the problem and is therefore only part of the solution. It is an important part and we need to continue with the finalisation and implementation of regulatory reform. Safeguarding financial stability, however, requires action in all areas of public policy – including fiscal, monetary and macroprudential measures. These policies need to take a long-term view and to better internalise systemic risk.

And, lastly, various institutional reforms and private sector reforms are essential if confidence in the financial system is to be restored. The private sector also has a vital part to play in building a more resilient financial system.