Building a resilient financial system

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President Kuroda, Governor Tetangco, Governor Kim, friends from the ADB, ladies and gentlemen, good morning. It is a special pleasure for me to come here today to talk about building a resilient financial system. First of all, I know that under the leadership of President Kuroda, the ADB has identified financial sector development as one of its core areas. Indeed the ADB has pursued this strategy by taking a leading role in finding ways to make financial systems in Asia stronger and more resilient.

Second, this forum is an opportunity to join Governor Tetangco and Governor Kim and to learn from them. Not only are they very good friends of the BIS, they have also done so much for financial stability. With Governor Tetangco at the helm of the Bangko Sentral, the Philippine financial system has escaped the recent global crisis virtually unscathed. And Korea's successful chairmanship of the G20 in 2010 owes a lot to Governor Kim's contribution to the process.

The global financial system is facing an especially complex set of challenges. Some countries and regions are slowly recovering from the financial crisis of 2007–09, while others, especially in Europe, are confronting renewed turbulence.

Financial systems in Asia face a number of challenges from both short-term and structural factors. The sovereign debt crisis in the euro area has raised questions about the stability of portfolio flows and bank funding. Pressures are being felt in specialised financial sectors such as trade finance. European banks face pressure to sell assets and scale back their operations, especially outside their home markets. From a somewhat longer-term perspective, several countries in the region have experienced rapid credit growth and possible asset price bubbles over the past few years, in part because of portfolio inflows related to weak global growth and accommodative monetary policy in the major economies. Managing these rapid asset price developments has posed challenges to domestic micro- and macroprudential policies.

The uncertain and uneven recovery has led to calls in some quarters to weaken financial reform. I would argue, to the contrary, that it makes it all the more important that we carry through on what we have promised to do. While the short-term challenges that threaten the system are real, and should be dealt with promptly using a variety of policies, it would be wrong to let them weaken our commitment to financial reform. Considerable thought has been given on how to manage the transition, but the endpoint needs to be beyond question.

This morning I would like to outline the key elements of the global financial reform agenda, reviewing both what has been done and what we still need to do. In many cases, the policies have been developed, and the key task now is to implement what has been agreed. In other areas, we still have important work to do in terms of identifying the key risks and crafting appropriate responses.

Before I go into details, however, however, I'd like to outline some of the broad principles that are guiding the work.

First, financial stability is about resilience and should be prepared in advance. We need to have reliable buffers in the system – capital, liquidity, sound infrastructure, strengthened resolution – that will prevent macroeconomic surprises, or problems at a specific institution or market, from disrupting the broader financial system.

Second, preserving financial stability involves a wide range of policy areas (Chart 1). Today I will focus mainly on micro- and macroprudential policies. But it is also important to pursue sound monetary and fiscal policies; to protect consumers; to safeguard financial infrastructure; and to improve market discipline by enhancing the transparency of firms and markets, including through stronger accounting standards. All of these are necessary components of financial stability; none of them, by itself, is sufficient.

Third, a globalised financial system requires global rules. This does not mean that identical rules must be applied for every country or region. But it does mean that, to be effective, financial regulation and supervision should be guided by broadly consistent approaches. The alternative is a race to the bottom as market players seek to arbitrage across divergent national regimes – and no financial centre would want to win such a race. In this respect, policymakers worldwide have a lot to learn from the reforms that were put in place in many emerging economies, especially in Asia, in the aftermath of the crises of the late 1990s. A key lesson is that, done right, financial reform can provide a foundation for strong, sustainable growth.

And fourth, we should stay focused on the end result we want to achieve, namely a financial system characterised by less leverage, better risk management especially for liquidity, better incentives, less moral hazard, stronger oversight and more transparency. As we learned during the crisis, these goals are vital for protecting the system from shocks. In implementing them, policymakers should work to reinforce and enhance the discipline provided by markets. Banks and other institutions that incorporate these objectives into their business models are already being rewarded by the market with higher valuations and lower borrowing costs.

With these broad goals in mind, we have worked out appropriate timetables. We should monitor implementation for unintended consequences. But at the same time we should set out the endpoints as clearly as possible. This will aid the decision-making of banks, firms and households, by providing them with an unambiguous vision of the framework of financial regulation that we are aiming for.

Progress in defining this framework has been impressive. It has emerged from an intensive, collaborative effort involving top policymakers and technical experts from the largest advanced and emerging economies. While we should not lose sight of the achievements, which have been substantial, today I will focus on the remaining challenges for financial reform.

In my view the challenges fall into four broad groups.

First, consistently implementing what has already been agreed, especially with respect to stronger bank capital.

Second, building a resilient financial system given a still weak recovery. This has been the question of designing the right transition, to which a lot of thought is being given by the international regulatory community – what is the right speed, and the right sequencing, at which we should move to a more robust system? How do we monitor material unintended consequences, and respond to them effectively?

Third, completing the regulatory reform agenda. I will focus on four main issues: liquidity standards, resolution regimes, OTC derivatives, and the shadow banking system.

And fourth, ensuring adequate oversight. This has two main parts: macroprudential oversight, and more proactive prudential supervision.

Consistent implementation of what has been agreed

Basel III is a crucial regulatory response to the crisis and a major step towards creating a stronger and safer financial system. To simplify, what Basel III brings is twofold (Chart 2): an enhancement of the regulatory framework introduced by Basel II at the level of individual institutions; and the set up of a macroprudential overlay so as to address systemic risk in its two dimensions, namely its time dimension (by mitigating procyclicality) and its cross-sectional dimension (by mitigating interconnection and contagion risk).

But agreeing on Basel III is only a first step: the next phase is just as critical, and that is implementation. One of the most important lessons we learned from the crisis is the need for full, timely and consistent implementation and enforcement of rules. Today I will not go through the details of Basel III, but let me summarise a few elements that are relevant for consistent implementation and outline what remains to be done.

1. Better and more capital – ensuring effective loss absorption capacity

As you all know, Basel III raises the level and quality of capital in the system (Chart 3). When the whole Basel III package is implemented, banks' common equity will need to be at least 7% of risk-weighted assets. This compares to a Basel II level of 2% – and that's before taking account of the changes to definitions and risk weights, which make the effective increase in capital all the greater. The 7% figure includes a 2.5% capital conservation buffer, which is designed to be drawn on in difficult times. Among the improvements in capturing risk on the assets side, I would especially point to the stronger treatment of risks related to securitisation and contingent credit lines. Moreover, these risk-based capital requirement measures will be supplemented by a non-risk-based leverage ratio, which will serve as a backstop and address model risk. As from January 2013, a minimum Tier 1 leverage ratio of 3% – that is, the ratio of Tier 1 capital to the bank's total non-weighted assets plus off-balance sheet exposures – will be tested and is expected to become a requirement in 2018. Banks will be required to disclose the ratio and its components from 2015.

The basics of the framework have been settled, and the members of the Basel Committee are committed to implementing them. The challenge now is to ensure consistency, in terms of timing, enforcement and results.

In terms of *timing,* supervisors have agreed to implement the wider capital buffers gradually, starting in 2013 and reaching their target levels by the start of 2019 (Chart 4). As I will discuss further in a moment, this lengthy transition period is intended to mitigate the negative macroeconomic impacts that might occur if banks try to adjust their balance sheets too quickly. *Enforcement* will be tracked through rigorous monitoring and review of members' progress in implementation, which will include peer reviews of members' progress in adopting the Basel regulatory framework as well as thematic reviews on specific issues. And *results* will be tracked through regular monitoring of capital levels, as well as any unintended consequences that need to be addressed.

Higher capital ratios are accompanied by improvements in the quality of capital. The focus will shift from Tier 1 and similar kinds of intermediate instruments, to common equity, which was shown during the crisis to be the most important capital concept in terms of its capacity to absorb losses. In addition, the risk weights in Basel III are intended to better capture the underlying risks.

Alongside work to reduce the riskiness of individual banks, I would also highlight the elements of Basel III that are intended to address systemic risk, in both of its dimensions: the time dimension, mitigating procyclicality, and the cross-sectional dimension, mitigating interconnection and contagion risk.

With respect to the *time dimension*, Basel III allows supervisors to impose a countercyclical buffer on their banking system when credit growth seems to be getting out of hand. They will be able to apply this equally to foreign and domestic banks. Additionally, the leverage ratio will help contain the build-up of excessive leverage in the system in good times, even if it is used to purchase supposedly safe assets.

The rules for the countercyclical buffer also represent an important step forward in terms of home-host cooperation. They require an internationally active bank to take account of the prevailing buffers in each jurisdiction in which it has a credit exposure in calculating its overall capital requirement. In other words, a host supervisor can increase the capital buffer required of a foreign-headquartered bank if this is called for by domestic conditions. Since credit booms and busts are not always correlated across countries and regions around the world, this is an important and useful step forward.

With respect to the *cross-section of risks*, the key initiatives relate to reducing the impact of stress or failure at systemically important financial institutions, or SIFIs. The rationale for adopting additional measures, including higher loss absorption capacity for so-called global, or G-SIFIs, is based on the negative cross-border externalities they create and which current regulatory policies do not fully address.

The framework for SIFIs that has been developed by the Financial Stability Board (FSB) – and by the Basel Committee for global systemically important banks, or G-SIBs – comprises four main components: greater loss absorbency, more intense supervision, stronger resolution and stronger infrastructure. These complement each other, and aim at a common set of objectives.

We know that the distress or failure of certain institutions has a greater impact on the system than the distress of others. So we want to do more to reduce the *probability* of such a failure, by insisting that these institutions have more capital to absorb losses and by strengthening the ability of supervisors to spot potential problems early. Complementing this, we want to reduce the *impact* of a SIFI's distress or failure, by making it possible to close or restructure such an institution without causing excessive disruption to the rest of the financial system, even if its activities span national borders. Strengthening market infrastructure – including platforms for trading, clearing, and settlement – can reduce the impact of the failure of a large market participant on the stability of the system, by ensuring that trading markets keep functioning in such an event. And we want to develop a framework that reduces the probability and impact of a SIFI's failure without increasing moral hazard or providing an implicit too-big-to-fail subsidy to the banks that are subject to the framework. Improved resolution regimes, including cross-border cooperation in bank resolution, perform this task by strengthening the credibility of the commitment by authorities that insolvent institutions, no matter how large or complex, should and will be resolved without disrupting the broader system.

On 4 November 2011, the Basel Committee issued final rules for G-SIBs. As endorsed by the G20 Leaders at their summit in Cannes, these represent an important step forward on the SIFI agenda. The G-SIB framework includes a methodology for assessing the systemic importance of G-SIBs, based on an objective set of indicators that will be updated annually. A preliminary list of 29 banks that would potentially qualify for this framework under the agreed methodology was released in November. This list will be modified as the methodology is refined and the data brought up to date. The rules also specify additional loss absorbency requirements, which are to be met with a Common Equity Tier 1 (CET1) capital requirement ranging from 1% to 2.5%, depending on a bank's systemic importance. They also provide for a surcharge of up to 3.5% as a disincentive for G-SIBs to become even more systemically important. In a nutshell, a bank would be required to have a capital ratio of between 10.5% and 15.5%, depending on how systemic it is and on the position in the credit cycle (Chart 3).

I should emphasise that this is just the global framework, which is to be applied to the world's largest banks. A number of countries are likely to supplement these rules with additional loss absorbency requirements and other rules applicable to banks that are systemic within their national financial systems – the so-called domestic SIFIs, or D-SIFIs. The Basel Committee is working to develop broad principles to guide these supplemental rules, which will understandably differ across countries.

Finally, I should note that, while most of the recent discussions have related to systemically important *banks*, there are other financial institutions that, although different in nature, are potentially systemic. Rules are being developed for insurance companies, asset managers and providers of market infrastructure. Discussions on how to strengthen the regulation and supervision of these entities are proceeding, under the leadership of the relevant global bodies. But the underlying principle is the same: that the risks potentially posed by these institutions to the broader financial system call for more intensive supervision, for greater loss absorbency, and for measures to reduce both the probability and impact of distress or failure.

2. Monitoring implementation

Full, consistent and timely implementation by national jurisdictions is now at the top of the Basel Committee's agenda. Through the work of its Standards Implementation Group, the Committee has started to conduct peer reviews and thematic reviews to help ensure timely and consistent implementation of Basel II, Basel II.5 (that is, the enhanced framework for trading risk exposures), and Basel III. These reviews look closely at adoption of the framework into legislation and regulations on the national level and, more broadly, assess whether the standards are producing the desired results. Last October the Committee published its first progress report on members' implementation of what they have agreed; these reports will now be produced on a regular basis. Each member will also undergo a more detailed peer review, starting with the EU, Japan and the United States.

The Basel Committee has decided to follow a three-level approach to analyse how the Basel Framework will be implemented. The aim is to ensure that Basel III is adopted in a timely fashion (level 1), that domestic regulations are framed in accord with Basel rules (level 2), and that the outcome of capital calculations is globally consistent (level 3).

The Committee has already begun its level 3 assessment by reviewing the measurement of risk-weighted assets in the banking and trading book. The goal is to ensure consistency in practice across banks and jurisdictions. At present, risk-weighted assets calculations of similar exposures vary significantly across borders. Such differences have led some to argue that the risk-based capital regime is fundamentally broken or that it is biased against certain jurisdictions. This is an exaggeration: many of these concerns are based on aggregated data that mask the actual differences in the underlying portfolios of banks. Moreover, the Basel Framework lets banks use their own internal data and models as inputs for the calculation of capital requirements, so that some variation in risk-weighted assets is inevitable.

That said, these calculations do vary enough to warrant further investigation. The bottom line is that minimum capital requirements must accurately reflect the risk that banks actually face. Regulators are therefore doing studies based on benchmark or hypothetical portfolios. The Basel Committee will publish the results of this very promising work in the near future. Transparency should be an important component of any eventual solution.

For its part, the FSB is working to promote implementation of global standards through its own peer review process. It has set up a coordination framework, in collaboration with the Basel Committee and other standard-setting bodies, to intensify monitoring and public reporting of implementation on a country-by-country basis. Priority areas include the Basel capital and liquidity framework, OTC derivatives market reform, compensation practices, G-SIFI policies, resolution frameworks, and shadow banking.

We should not forget that the Basel III standards collectively represent a set of *minimum* requirements. They were agreed based on this understanding and were not developed as a menu of options. If jurisdictions were to choose only certain elements of Basel III, it would dilute the effectiveness of the framework. On the contrary, one of the lessons of the crisis is that jurisdictions that adopted higher capital requirements and more active or, if you want, more intrusive, supervision performed better than those which favoured "light-touch" supervision. Some jurisdictions are already above the capital standard and others may decide to impose higher standards. So let me emphasise once again that Basel III is a minimum, and that its calendar is also a minimum.

Building strength in a still fragile recovery

Let me now turn to the second set of challenges. A lot has been done to ensure the building of a more resilient financial system. But what should be the right transition?

Both during the debate before the publication of Basel III and since, some have expressed concerns that strengthening bank capital, together with other measures, would be harmful to growth and could delay recovery. This discussion has emerged again in the context of the current stresses in Europe. These risks need to be analysed to avoid the possibility that critical elements of financial reform could be delayed, weakened or not fully carried through.

From the beginning, this question has been taken very seriously by policymakers, and has been analysed carefully. A series of studies conducted in 2010 and 2011 under the auspices of the BIS concluded that the growth costs, both in the transition and in the steady state, are likely to be modest, and far outweighed by the benefits**.**

The Macroeconomic Assessment Group, or MAG, a group of modelling experts convened by the FSB and the Basel Committee, concluded that, while banks may attempt to raise credit spreads and to reduce lending growth in the transition to higher capital levels, this is likely to have only a modest impact on the real economy. The longer the transition period, the lower the costs – this is because banks will have more time to accumulate capital through retained earnings, and will have less need to cut back on their lending or to raise costly new capital on the public market. A follow-up analysis by the MAG found that the G-SIB framework would have no more than a modest additional cost in terms of temporarily slower growth.

While the MAG was tasked with examining transitional issues, a separate group studied the costs and benefits of the requirements over the long run. This long-term economic impact (LEI) group found that additional *permanent* GDP costs should be small, while the benefits from reducing crisis risks will be substantial. The costs will be low because, as economic theory teaches, investors will eventually recognise that well capitalised banks are less risky, and will accept a lower return on equity. This sets limits on any long-term rise in credit spreads. At the same time, potential benefits will be gained from reducing the risk of financial crises and the resulting permanent losses to GDP. The LEI group found that the range of capital ratios at which the benefits exceed the costs is quite wide.

The MAG and LEI analyses informed the calibration of the capital buffers and the transition paths under Basel III. Supervisors chose to set the regulatory minima at levels substantially above where they are now, but they allowed a lengthy transition period to avoid the adjustment costs from banks trying to achieve higher capital ratios too quickly.

Completing the regulatory reform agenda

My third point is that we have not yet finished doing everything we can at the global level to reduce both the probability and the severity of financial crises. As I said at the outset, tremendous progress has been already made, and the financial reform agenda has moved forward rapidly with the agreement reached on Basel III. Banks have already increased their capital base significantly. These are no mean achievements, and not one of them was assured just a year ago.

But more needs to be done to complete the regulatory reform agenda. The Basel Process, in particular the FSB and the various associated standard setters, is moving full speed with the support of the BIS to enhance financial regulation in many areas, especially concerning liquidity risk, resolution regimes, OTC derivatives markets and shadow banking.

1. Liquidity standards

A central element of Basel III, complementing capital, is liquidity. Before the crisis, many banks saw liquidity as a free good. They did not imagine that entire markets could freeze up, nor did they anticipate an extended period of funding illiquidity. Some banks became excessively reliant on short-term wholesale funding, which they used to fund long-term, illiquid assets. When the crisis erupted, central banks were forced to step in and provide money markets and banks with unprecedented amounts of liquidity to help stabilise the system. The crisis thus exposed a number of deficiencies in banks' liquidity risk management and risk profiles. Basel III tries to address these deficiencies.

Central bank governors and heads of supervision approved a new global liquidity standard in September 2010. The standard comprises two main elements: a liquidity coverage ratio, or LCR, and a net stable funding ratio, or NSFR.

- The LCR is intended to address short-term shocks to liquidity. The central principle is that a bank is expected to have a stable funding structure and a stock of high-quality liquid assets which should be available to meet the liquidity needs that it might encounter under a stress scenario, such as a credit downgrade or loss of wholesale funding.
- The NSFR targets stresses under a somewhat longer time frame. It requires banks to maintain stable funding sources that match the liquidity profiles of its assets and its potential contingent liquidity needs.

Since this is the first time that detailed global liquidity rules have been formulated, we do not have the same experience and high-quality data as we do for capital. There are a number of areas that require careful potential impact assessment as we implement these rules. The Basel Committee has therefore agreed to take a gradual approach in adopting the standards between 2015 and 2018, and will meanwhile assess the impact during an observation period. This may result in modifications to some of the liquidity standards, if the Committee's assessments yield compelling evidence and analysis to support them. The observation period runs until mid-2013, but the Committee recently decided to accelerate its review, with a goal of completing the review by the end of this year, so that the Committee can make any adjustments well in advance of implementation. This should give banks more time to adapt their balance sheets and business models to the new standards.

The liquidity standards are meant to ensure that banks have a stable funding structure and a stock of high-quality liquid assets that is available to meet their liquidity needs in times of stress. At their meeting on 8 January, the group of governors and heads of supervision that oversees the Basel Committee confirmed that this liquidity buffer is there to be used. Specifically, banks will be required to meet the 100% LCR threshold in normal times. During a period of stress, however, banks would be allowed under specific guidance to draw down their pools of liquid assets and temporarily fall below the minimum requirement. The Committee will clarify its rules to state this explicitly, and will provide additional guidance on the circumstances that would justify use of the pool.

At the same meeting, the governors and heads of supervision reaffirmed their commitment to introducing the LCR as a minimum standard in 2015. They supported the Basel Committee's proposed focus, course of action and timeline for finalising key aspects of the LCR. The modifications currently being investigated are fairly minor, and address specific concerns about the pool of liquid assets and the calibration of net cash outflow. They do not materially change the framework's underlying approach, which is mainly to induce banks to lengthen the term of their funding and to improve their risk profiles, instead of simply holding more liquid assets.

2. Strengthening resolution

As I've noted, another critical element of the global effort to address SIFIs is the strengthening of resolution frameworks. The goal is to significantly reduce the possibility that authorities will find themselves forced to bail out institutions in order to prevent a disorderly wind-down of a failed firm. By reducing the impact of failure, we also reduce the expectation of an official bailout, and thereby reduce moral hazard.

In general terms, a sound resolution regime needs to have a number of key elements. There needs to be clear authority for the designated authorities to initiate the wind-down of a troubled institution. There need to be mechanisms for coordination and information-sharing across agencies within a jurisdiction, as well as across borders. There needs to be advanced planning, both for the immediate management of a crisis situation and for the longer process of winding down a closed entity. There needs to be financing available to support the operations of an institution that is operating in legal bankruptcy, and to ease the transfer of viable operations to other firms. And there need to be mechanisms for safeguarding the assets of depositors and other clients.

More specifically, last November the FSB set out Key Attributes of Effective Resolution Regimes for Financial Institutions. These set out the responsibilities, instruments and powers for national resolution regimes that should apply to any financial institution that could be systemically significant or critical if it fails. Among other things, jurisdictions should:

- Make sure that there is a designated authority with a broad range of powers to intervene and to resolve a financial institution that is no longer viable.
- Remove impediments to cross-border cooperation, including information-sharing. The solution should take account of financial stability impacts in all jurisdictions affected by a financial institution's failure.
- Put recovery and resolution plans, so-called "living wills", in place for all G-SIFIs, and review and update these regularly.
- Maintain crisis management groups for all G-SIFIs, including both home and host authorities.

Working out all elements of this framework in key jurisdictions will take time. Higher loss absorbency for SIFIs can in the meantime reduce our reliance on untested resolution regimes.

The FSB will initiate an iterative process of peer reviews of its member jurisdictions to assess implementation of the Key Attributes, which it plans to complete by the middle of 2013. This assessment methodology would then be used on an ongoing basis by the IMF and World Bank in their Financial Sector Assessment Program work.

For the initial group of 29 G-SIFIs, FSB members have committed to meet the resolution planning requirements by end-2012 – including resolvability assessments, resolution plans and cross-border cooperation agreements. This is a very tight schedule, but it is critical to make rapid progress on this work in order to convince the market that authorities are ready, willing and able to take the steps necessary to resolve a troubled financial institution, no matter how large.

3. OTC derivatives markets

A third critical item on the regulatory agenda is strengthening the infrastructure for derivative instruments, in particular those that are currently traded over the counter (OTC).

The way market infrastructures are designed and how they function have important implications for financial stability because they can either dampen or amplify disruptions. Hence, proper design of these infrastructures can mitigate the risks arising from the interconnectedness of market participants and can reduce the risk of contagion. Even before the financial crisis, striking weaknesses were revealed in the way that widely traded OTC derivatives, in particular credit default swaps, were valued, collateralised, and managed in the post-trade phase. Many of these transactions were inadequately reported, and many of the bilateral exposures between counterparties were insufficiently collateralised.

Against this background, authorities from around the world are pushing for a number of significant changes in the infrastructure for OTC derivatives.

First, most standardised OTC derivatives will need to be traded on an exchange and cleared through a central counterparty, or CCP, instead of bilaterally. A CCP interposes itself between the two original counterparties of a financial transaction. Thus, it makes financial institutions less interconnected. However, since risks become concentrated in the CCP, the CCP itself needs to be highly robust: it must protect itself against the default of one or more of its members. International standard setters have been hard at work in developing safeguards for these important institutions, to ensure that they are well capitalised, that they are well supervised, and that they provide a level playing field for dealers and end users. The Committee on Payment and Settlement Systems and the International Organization of Securities Commissions have developed standards for addressing risks related to systemically important financial infrastructures, including CCPs, and will release finalised standards in the coming months.

Second, OTC derivatives will need to be reported to a trade repository (TR), which is an electronic registry that keeps a record of all relevant details of an OTC derivative transaction over its lifetime. If TRs had existed before the crisis, the build-up of huge derivative positions, such as those at AIG, would have been observed much earlier. In January, international regulators published recommended standards for minimum requirements and formats for the data reported to the TRs. They also put forth recommendations for aggregating these data, so that they can be used in spotting and responding to potential risks to financial stability.

And third, banking supervisors have developed rules to make sure that the risks of derivatives that are not centrally cleared are covered by an appropriate amount of capital. This will help provide the right incentives to route trades through CCPs and organised trading platforms wherever feasible.

We need to ensure that progress is made towards the implementation of OTC derivatives market reforms. In particular, the FSB will review the consistent and non-discriminatory implementation of various G20 commitments concerning standardisation, central clearing, exchange or electronic platform trading, and reporting of OTC derivative transactions to TRs.

We don’t know yet whether we are moving towards a system characterised by a small number of clearing houses based in major financial centres that will clear a wide range of instruments, or a system where there is a larger number of interlinked national and regional platforms. This is something that will evolve in line with the needs of dealers and end users, provided the minimum standards set by global regulators are satisfied. But in any event, for any global system of derivatives platforms to be robust and resilient, a number of safeguards need to be in place.

- There need to be multilateral arrangements for different national supervisors to cooperate, to exchange information, and to coordinate their oversight.
- Arrangements for providing cross-border liquidity to CCPs need to be in place.
- Resolution regimes need to cover CCPs so that, if needed, the failure of a CCP can be managed with limited impact on the broader financial system.
- And, finally, market participants should be able to benefit from both direct and indirect access to CCPs on a fair and open basis.

Global regulators are looking carefully at these issues and aim to address them as the improvements to derivatives infrastructure are put in place.

4. Shadow banking

A fourth critical element of the reform agenda is to monitor and, where appropriate, address the risks that may come from the shadow banking system. Last October, the FSB published a report on “Shadow Banking: Strengthening Oversight and Regulation”, which defines shadow banking as “credit intermediation involving entities and activities outside the regular banking system”. The report offers a number of initial recommendations for strengthening regulation, and sets out a workplan on specific aspects of the shadow banking system that will involve parallel workstreams over the course of this year.

Shadow banking can perform valuable functions, including facilitating alternative sources of funding and liquidity and providing banks and investors with a range of vehicles for managing credit, liquidity and maturity risks. However, as the financial crisis has shown, the shadow banking system can also contribute to systemic risk, both directly and through its interconnectedness with the regular banking system. It can also create opportunities for arbitrage that might undermine stricter bank regulation and lead to a build-up of additional leverage and risks in the system.

Therefore, it is important to monitor the evolution of shadow banking. Where called for, we should enhance the oversight and consider regulation of the shadow banking system in areas where systemic risk and regulatory arbitrage evidently pose risk.

At the international level, the FSB has set forth a two-pronged approach to addressing risks related to the shadow banking system.

The first element is a *monitoring exercise.* Authorities have agreed to regularly exchange data and information on shadow banking activities in their jurisdictions.

The process starts at a broad level, using economy-wide data such as flow of funds statistics to identify elements of the financial system that lie outside traditional regulated sectors and seem to be large, or growing, in systemic importance. Those aspects that raise specific concerns, such as regulatory arbitrage, leverage, maturity transformation or credit risk transfer, merit further attention and further analysis. This more focused analysis would then be used to identify emerging aspects of the system that will benefit from prompt regulatory intervention. The process is being overseen by the FSB’s Standing Committee on Assessment of Vulnerabilities, which I chair.

Second, and complementing this, the FSB will conduct yearly supervisory exercises. In addition the aim is to look at *regulatory responses* to specific aspects of the shadow banking system. Workstreams have been set up in five areas: how banks interact with shadow banking entities; regulatory reform of money market funds; regulation of securitisation; the regulation of repo markets; and regulation of other shadow banking entities. These groups are meeting regularly and are expected to report in the course of 2012. The FSB and other international bodies will then respond appropriately.

Proactive oversight of the financial system

So, in my remarks so far today I have emphasised that, first, a lot has already been achieved, and now it's time to implement; second, we have put a transition period in place; and third, we need to complete the reform agenda and to finish the job.

But my fourth point is that regulation is not enough, and progress will need to be made in developing the institutions and processes that will ensure that the goals of the new regulatory framework are achieved consistently and effectively. I'll make two points.

First, countries are putting in place macroprudential oversight bodies and frameworks that will support and complement these essentially microprudential measures. Basel III includes important macroprudential elements, for example the countercyclical capital buffer. But discretionary measures may be needed at some point in time, and more work is needed in a number of areas to support these decisions, such as developing techniques to anticipate systemic risk and gathering the consistent global data needed to make proper assessments. For example, we need accurate, up-to-the-minute assessments of market conditions to guide our decisions with regard to the strengthening of haircutting and margining practices in securities markets. This means that the relevant authorities – including market regulators, prudential regulators, and central banks – need to be in constant communication with one another and need to work together to develop effective, consistent policies. Indeed, the new macroprudential features of Basel III are already being complemented in many regions by the establishment of key institutions to monitor systemic risk. In the EU, for instance, the European Systemic Risk Board has been set up as an independent body responsible for the macroprudential oversight of the financial system within the Union. In the United States, the Financial Stability Oversight Council is in charge of comprehensive monitoring to ensure the stability of the US financial system.

Second, efforts to implement the new rules need to be supported by strong and enhanced supervision of individual banks. Strong supervision is needed to ensure that banks operate with capital levels, liquidity buffers and risk management practices that are commensurate with the risks taken. Supervision must also address the consequences of financial innovation or risks of regulatory arbitrage that regulation cannot fully capture and, more generally, it must address the firm-level consequences of emerging risks and economic developments. National authorities must supervise in a more intensive and more intrusive fashion, especially for the largest and most complex banks. It will also be important to reinforce both the firm-specific and macroprudential dimensions of supervision and the way they interact.

Conclusion

Some observers have suggested that, in the current global environment, regulatory reform should take a back seat to addressing more immediate concerns, such as sovereign risks, weak global growth and inflation risks. In this view, banks are being asked to do too much, too soon. On the contrary, I would suggest that the persistence of vulnerabilities and the uncertainty about further setbacks argue in favour of building strength now, so as to be prepared for further unexpected strains. In other words, it's rather the case that too little has been done, and too late, to strengthen financial institutions at the global level since the start of this crisis.

Hence, instead of taking the maximum agreed time to achieve the minimum capital strength, where possible, authorities and banks ought to go faster and further. A sound recovery requires a secure financial system. Businesses and households will not regain the confidence to plan, to invest and to innovate until they have been reassured that the financial system is not at risk of another crisis. We need to be better able to provide support for longer-term financing.

Building a strong, resilient financial system is not just a task for the official sector. I've outlined the large volume of work that has been accomplished, or is underway, in the international regulatory agenda. But the private sector also has to contribute to reaching a new equilibrium in which the financial system is more resilient, can absorb shocks and avoids amplifying them. This requires better risk management and governance and re-aligned incentive structures. It also calls for a new approach to risk-taking which recognises existing uncertainties, limitations in our knowledge and the complexity of systemic risk. It may, for example, require investors to accept a lower, although more stable, return on equity. A more prudent approach towards risk is the best insurance policy against tail risks: returns may be more modest and stable in good times, but in turmoil losses would be much smaller.

Measures to strengthen the regulatory framework, complemented by a more prudent risk approach on the part of the private sector, are also important to Asia, Looking past the current set of risks and vulnerabilities to the longer term, strong economic growth and rapid urbanisation are placing increased demands on the financial system throughout the region. Financing is needed for building infrastructure, for investment and innovation by private businesses, and to support rapidly growing household consumption. These needs call for the development of transparent, smoothly functioning capital markets, including securitisation structures, to complement the evolving role of banks. Sound regulation, as part of a broader framework of macrofinancial policies, is essential in building a stable financial system that plays an effective role in supporting growth.

Completing the regulatory reform agenda and seeing to its implementation at the global level are critical tasks for authorities as we continue to recover from the crisis. They are part of the broader challenge of providing a framework for macroeconomic stability, along with bringing debt back to sustainable levels and normalising monetary policy. All three elements of policy – fiscal, monetary and prudential – will need to work together to deliver strong, sustainable global growth.

Chart 1: The macrofinancial stability framework

Macroeconomic policies

Monetary policy

- More symmetrical response
- Consider financial stability in setting monetary policy

Fiscal policy

- Sustainable fiscal positions
- Fiscal policy and credit cycles

Other policy areas

Consumer protection

Financial infrastructure

Prudential policies

Macroprudential

- Reduce common exposures and interconnectedness
- Mitigate procyclicality

Microprudential

- Improve risk capture
- Strengthen capital and liquidity buffers
- Enhance transparency

Financial system stability

- Risk-taking of institutions
- Riskiness of instruments
- Resilience of institutions, markets and infrastructure

Enforcement and monitoring

Proactive supervision

- Pillar II
- Supervisory intensity and effectiveness

Market discipline

- Prevent moral hazard
- Transparency
- Accounting rules
- Market integrity

Monitoring systemic risks

- Macroprudential authorities
- Financial stability reports

Bank resolution

- Bankruptcy regimes
- "Living wills"
- Key attributes of effective resolution regimes

International cooperation

- G20
- Other standard setters

- BCBS capital surcharges
- FSB work on procyclicality

- BCBS capital and liquidity standards

- FSB/IMF Early Warnings Exercise
- FSB peer reviews
- Cross-border resolution

Return to text

Chart 2: The Basel III reform programme – implementation

Enhanced Basel II + Macroprudential overlay = Basel III

Microprudential framework (Enhanced Basel II):

- Increase quantity and quality of capital
- Adequate risk coverage (for trading book, counterparty credit risk, securitisation)
- Enhanced risk management and disclosure
- Global liquidity standards

Macroprudential framework:

- Address stability over time (procyclicality)
  - Countercyclical capital charges
  - Capital conservation rules for stronger capital buffers
  - Dynamic provisioning
- Address stability at each point in time (system-wide approach)
  - Specific treatment for systemically important banks: systemic capital charge
- Leverage ratio

Return to text

Chart 3: Implementation: from Basel II to Basel III

As a percentage of risk-weighted assets	Capital requirements							Additional macroprudential overlay	
	Common equity			Tier 1 capital		Total capital		Counter-cyclical buffer	Additional loss-absorbing capacity for SIFIs
	Minimum	Conservation buffer	Required	Minimum	Required	Minimum	Required	Range	
Basel II	**2**			4		**8**			
Memo:	*Equivalent to around 1% for an average international bank under the new definition*			*Equivalent to around 2% for an average international bank under the new definition*					
Basel III New definition and calibration	**4.5**	2.5	**7.0**	6	8.5	**8**	**10.5**	0–2.5	1–2.5%
								10.5%	**— 15.5%**

Return to text

Chart 4: Implementation: a lengthy phase-in timetable

	2011	2012	2013	2014	2015	2016	2017	2018	As of 1 January 2019
Leverage ratio	Supervisory monitoring		Parallel run 1 Jan 2013 – 1 Jan 2017 Disclosure starts 1 Jan 2015				Migration to Pillar 1		
Minimum common equity capital ratio			3.5%	4.0%	4.5%	4.5%	4.5%	4.5%	4.5%
Capital conservation buffer						0.625%	1.25%	1.875%	2.50%
Minimum common equity plus capital conservation buffer			3.5%	4.0%	4.5%	5.125%	5.75%	6.375%	7.0%
Phase-in of deductions from CET1				20%	40%	60%	80%	100%	100%
Minimum tier 1 capital			4.5%	5.5%	6.0%	6.0%	6.0%	6.0%	6.0%
Minimum total capital			8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%
Minimum total capital plus conservation buffer			8.0%	8.0%	8.0%	8.625%	9.25%	9.875%	10.5%
Capital instruments that no longer qualify as non-core tier 1 capital or tier 2 capital	Phased out over 10-year horizon beginning 2013								
Liquidity coverage ratio	Observation period begins				Introduce minimum standard				
Net stable funding ratio		Observation period begins						Introduce minimum standard	

Return to text