Building a resilient financial system

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Principles

- Resilience ↔ buffers, solid infrastructure, strengthened resolution
- Regulation is one part of a wider macrofinancial stability framework
- Global system ↔ global rules
- Stay focused on the objectives:
  - Less leverage (= more high-quality capital)
  - Better liquidity management
  - Less moral hazard ↔ market discipline
  - Stronger oversight
  - More transparency
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
- Macropurudential
  - 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
Challenges for 2012

- Implementation
- Managing the transition
- Completing the agenda – especially:
  - Liquidity
  - Resolution
  - OTC derivatives
  - Shadow banking
- Stronger oversight
  - Microprudential
  - Macroprudential
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
Implementation

- Basel III: more and better capital/liquidity + macroprudential overlay
- Consistency in terms of timing, adoption, enforcement, results
  - Review of risk-weighted assets
- The countercyclical buffer
- The SIFI framework
- Monitoring implementation

→ Basel III is a minimum standard!
### Implementation: from Basel II to Basel III

<table>
<thead>
<tr>
<th>As a percentage of risk-weighted assets</th>
<th>Capital requirements</th>
<th>Additional macroprudential overlay</th>
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</thead>
<tbody>
<tr>
<td></td>
<td>Common equity</td>
<td>Tier 1 capital</td>
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<tr>
<td></td>
<td>Minimum</td>
<td>Conservation buffer</td>
</tr>
<tr>
<td>Basel II</td>
<td>2</td>
<td></td>
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<tr>
<td><strong>Memo:</strong></td>
<td></td>
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<tr>
<td>Basel III New definition and calibration</td>
<td>4.5</td>
<td>2.5</td>
</tr>
</tbody>
</table>

|                      | 10.5%   | 15.5%                |

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.
**Implementation: a lengthy phase-in timetable**

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<tbody>
<tr>
<td></td>
<td>Supervisory monitoring</td>
<td>Parallel run 1 Jan 2013 – 1 Jan 2017 Disclosure starts 1 Jan 2015</td>
<td>Migration to Pillar 1</td>
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<tr>
<td>Minimum common equity capital ratio</td>
<td>3.5%</td>
<td>4.0%</td>
<td>4.5%</td>
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<tr>
<td>Capital conservation buffer</td>
<td>0.625%</td>
<td>1.25%</td>
<td>1.875%</td>
<td>2.50%</td>
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<tr>
<td>Minimum common equity plus capital conservation buffer</td>
<td>3.5%</td>
<td>4.0%</td>
<td>4.5%</td>
<td>5.125%</td>
<td>5.75%</td>
<td>6.375%</td>
<td>7.0%</td>
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<tr>
<td>Phase-in of deductions from CET1</td>
<td>20%</td>
<td>40%</td>
<td>60%</td>
<td>80%</td>
<td>100%</td>
<td>100%</td>
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<tr>
<td>Minimum tier 1 capital</td>
<td>4.5%</td>
<td>5.5%</td>
<td>6.0%</td>
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<tr>
<td>Minimum total capital</td>
<td>8.0%</td>
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<tr>
<td>Minimum total capital plus conservation buffer</td>
<td>8.0%</td>
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<tr>
<td>Capital instruments that no longer qualify as non-core tier 1 capital or tier 2 capital</td>
<td>Phased out over 10-year horizon beginning 2013</td>
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<tr>
<td>Liquidity coverage ratio</td>
<td>Observation period begins</td>
<td>Introduce minimum standard</td>
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<tr>
<td>Net stable funding ratio</td>
<td>Observation period begins</td>
<td>Introduce minimum standard</td>
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Implementation: the Basel III framework

New capital ratios
- Common equity
- Tier 1
- Total capital
- Capital conservation buffer

Raising the quality of capital
- Focus on common equity
- Stricter criteria for Tier 1
- Harmonised deductions from capital

Capital ratio = \( \frac{\text{Capital}}{\text{Risk-weighted assets}} \)

Enhancing risk coverage
- Securitisation products
- Trading book
- Counterparty credit risk

Macroprudential overlay

Leverage ratio

Mitigating procyclicality
- Countercyclical buffer
- Capital conservation rules

Mitigating systemic risk
- Systemic capital surcharge for SIFIs
- Supervisory intensity and effectiveness
- Infrastructures
Monitoring implementation

- **BCBS**
  - Progress reports
  - Peer reviews
  - Thematic reviews
    - Risk-weighted assets
- **FSB**
  - Coordination framework
  - Peer reviews
  - Thematic reviews
Managing the transition

- Do we really want to be doing this when global growth is still weak?
- The Macroeconomic Assessment Group (MAG)
  - Growth impact should be modest
  - Longer transition ↔ lower growth impact
- The Long-term Economic Impact (LEI) study
  - Benefits significantly outweigh costs
Completing the agenda

- Liquidity
- Resolution
- OTC derivatives
- Shadow banking
Completing the agenda: liquidity

- Objectives
  - Increase resilience to liquidity shocks
  - Increase banks’ internal recognition of the liquidity risks and encourage appropriate pricing
  - Stability of funding, consistent with assets and business model
  - Reduce dependence on public sector support in times of stress
- What is expected of banks?
  - Lengthen term of their funding
  - Improve their risk profiles
- The aim is not simply to hold more liquid assets
Completing the agenda: liquidity ratios

- **Liquidity coverage ratio (LCR)**
  \[
  \frac{\text{Stock of high-quality liquid assets}}{\text{Net cash outflows over a 30-day period}} > 100\%
  \]

- **Net stable funding ratio (NSFR)**
  \[
  \frac{\text{Available amount of stable funding}}{\text{Required amount of stable funding}} > 100\%
  \]
Completing the agenda: resolution

- Authorities should have broad intervention powers
- Cooperation across agencies and borders
- The key attributes
- Implementation
  - Resolvability assessments
  - Recovery and resolution plans
  - Crisis management groups
  - Cross-border cooperation agreements
- A tight timetable
  - Peer review of implementation by mid-2013
  - Resolvability assessments and RRPs for the largest G-SIBs by end-2012
Completing the agenda: OTC derivatives

- Standardised derivatives should be traded on an exchange and cleared through a CCP
- Derivatives trades to be reported to trade repositories
- Lower capital requirements for centrally cleared instruments
- Safeguards to ensure the robustness of the global clearing architecture
  - Supervisory cooperation
  - Liquidity arrangements for CCPs
  - Fair and open access
  - Resolution
Completing the agenda: shadow banking

- Regular monitoring
  - Three-step approach
    1. Map the overall shadow banking system
    2. Narrow down the focus to potentially risky sectors/activities/instruments
    3. Assess the systemic risk
  - Yearly exercises

- Regulatory responses
  - Interaction with banks
  - Money market funds
  - Securitisation
  - Repo markets
  - Other shadow banking entities
Proactive oversight

- Macroprudential oversight
- Enhanced microprudential supervision