Progress and challenges in financial reform

Speech by Jaime Caruana

General Manager, Bank for International Settlements

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Chairman Ignatiev, ladies and gentlemen, good morning. The Central Bank of the Russian Federation has taken a leading role in supporting and contributing to the work of the BIS, as well as the Financial Stability Board (FSB) and other international committees. Russia will occupy centre stage when it chairs the G20 in 2013. So it is a special honour for me to have the opportunity to talk with you today about building a resilient financial system.

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.

The uncertain and uneven recovery has led to calls in some quarters for weakening financial reform. I would argue, on the contrary, that this uncertainty makes it all the more important that we press on and fulfil our promises. We want a financial system characterised by less leverage, better risk management, better incentives, less moral hazard, stronger oversight and more transparency. While the short-term challenges are real, it would be wrong to let them weaken our commitment to financial reform. This morning I would like to outline the key elements of the global financial reform agenda, both what we have done and what we still need to do.

Underlying principles

Before going into details, however, I'd like to outline some of the broad principles that guide our work.

First, we need to have reliable buffers in the system – capital, liquidity, sound infrastructure, strengthened resolution – that will prevent macroeconomic surprises, problems in a specific institution or particular market strains from disrupting the broader financial system.

Second, preserving financial stability involves a wide range of policies. 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 sharpen market discipline by making firms and markets more transparent, among other things, through stronger accounting standards.

Third, a globalised financial system requires consistent global rules. The alternative is a race to the bottom as market players arbitrage across divergent national regimes – and no financial centre would want to win such a race.

And fourth, building a stronger system is not just a job for the public sector. It is in the interest of the private sector to contribute to financial stability and to end the cycle of destabilising crises. Managers and directors of banks can and should put in place better risk management, better governance, better incentives and sustainable business models. Safer banking will mean lower returns on bank equity, but returns will be more stable and more sustainable – and long-term investors will welcome this.

Progress in devising this framework has been impressive. It has involved top policymakers and technical experts from advanced and emerging market economies alike in an intensive, collaborative effort.

The remaining challenges for financial reform fall into three broad groups:

– First, consistently implementing what has already been agreed;

– Second, completing the regulatory reform agenda, including resolution regimes, over-the-counter (OTC) derivatives and the shadow banking system;

– And third, ensuring adequate oversight, including macroprudential oversight and more proactive prudential supervision.

Consistent implementation of what has been agreed

Basel III enhances the regulatory framework introduced by Basel II at the level of individual institutions, and sets up a macroprudential overlay to limit systemic risk. But agreeing on Basel III is only a first step; the next phase, implementation, is just as critical.

1. Better and more capital and liquidity

As you all know, Basel III raises the level and quality of capital in the system.

- When the whole Basel III package is implemented, banks' common equity will need to be at least 7% of risk-weighted assets, and higher for the most systemically important banks. This compares to a Basel II level of 2% – and that's before taking account of the changes in definitions and risk weights, which require even more high-quality capital.
- A non-risk-weighted leverage ratio will backstop these risk-based capital requirements.
- The wider capital buffers will be phased in gradually, starting in 2013 and reaching their target width by the start of 2019. This lengthy transition period is intended to mitigate any potential negative macroeconomic impact.

Basel III also addresses systemic risk in both of its dimensions, mitigating procyclicality over time, and reducing interconnection and contagion risk across firms and markets.

- With respect to the *time dimension*, Basel III allows supervisors to impose a countercyclical buffer on their banking system – including both foreign and domestic banks – when credit growth seems to be getting out of hand.
- With respect to the *cross-section of risks*, the key initiatives involve reducing the probability and impact of stress or failure at systemically important financial institutions (SIFIs). This implies higher loss absorbency for the largest, most interconnected institutions.

The second central element of Basel III, complementing capital, is liquidity. The new liquidity standard includes a liquidity coverage ratio (LCR) and a net stable funding ratio (NSFR).

- The LCR is intended to address short-term loss of market access. A bank is expected to have a stock of high-quality liquid assets that would enable it to weather a stress scenario, for example, a credit downgrade or loss of wholesale funding.
- The NSFR addresses longer-term challenges. It requires banks to maintain stable funding that matches the maturity profiles of their assets and their contingent liquidity needs.

2. Monitoring implementation

Full, consistent and timely implementation by national jurisdictions is now at the top of the Basel Committee's agenda. It has started to conduct peer and thematic reviews to help ensure timely and consistent implementation of all elements of the Basel framework.

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 on Banking Supervision and other standard-setting bodies, to intensify monitoring and public reporting of implementation on a country-by-country basis.

Completing the regulatory reform agenda

My second point is that, while this progress is impressive, the work is not yet finished. I will highlight three priority areas right now for the international regulatory community: resolution, derivatives and shadow banking.

1. Strengthening resolution

The goal of strengthening resolution frameworks is to significantly reduce the possibility that authorities will find themselves forced to bail out institutions in order to prevent costly market disruption. By reducing the impact of failure, we also lessen the expectation of an official bailout, and thereby reduce moral hazard.

Last November the FSB developed *Key attributes of effective resolution regimes for financial institutions*. These set out the responsibilities, instruments and powers of the national resolution regimes that should apply to a systemically significant financial institution.

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

2. OTC derivatives markets

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

First, the G20 has agreed that standardised OTC derivatives need to be traded on an exchange and cleared through a central counterparty, or CCP, not bilaterally. This will strengthen the system by making financial institutions less interconnected. However, since risks become concentrated in the CCP, it needs to be highly robust itself. In April, the Committee on Payment and Settlement Systems and the International Organization of Securities Commissions set out principles for addressing risks related to systemically important financial infrastructures, including CCPs. A central clearing house should be well capitalised and well supervised and should provide a level playing field for dealers and end users.

Second, OTC derivatives trades will need to be reported to a trade repository, which registers electronically all relevant details of an OTC derivatives transaction over its lifetime.

And third, banking and market supervisors are developing rules to make sure that the risks of derivatives that are not centrally cleared are covered by appropriate capital and margining. Market participants will thereby face incentives to trade through CCPs and organised platforms when feasible.

For any global system of derivatives platforms to be robust and resilient, safeguards are needed. These include multilateral, cross-border oversight; cross-border liquidity provision; resolution regimes for CCPs; and fair and open access for all market participants. Work is under way in all of these areas.

3. Shadow banking

A third critical element of the reform agenda is to monitor and, where appropriate, to address the risks posed by the shadow banking system. Shadow banking can perform valuable functions, such as supplying alternative funding for the real economy, and providing banks and investors with the means to manage credit, liquidity and maturity risks. However, as the financial crisis has shown, systemic risk and regulatory arbitrage can build up in the shadow banking system. Therefore, it is important to monitor the evolution of shadow banking and to address the risks it poses.

At the international level, the FSB takes a two-pronged approach:

– First, in its *monitoring exercise,* authorities regularly exchange data and information on shadow banking in their jurisdictions. A process to examine available data on these markets, and to identify areas of concern, is being overseen by the FSB’s Standing Committee on Assessment of Vulnerabilities, which I chair.

– Second, and complementing this, the FSB can frame *regulatory responses* to specific risks in shadow banking. Work is ongoing in five priority areas, including money market funds, securitisation and repo markets, with specific recommendations expected within months.

Proactive oversight of the financial system

My third point is that writing rules is not enough. Institutions and processes are needed to ensure that the goals of the new regulatory framework are achieved consistently and effectively.

On the one hand, countries are putting in place macroprudential oversight frameworks that will support and complement reforms at the microprudential level. The relevant authorities – including market regulators, prudential regulators and central banks – need to cooperate with each other to develop effective, consistent policies on when and how to address cyclical and cross-sectional threats to the system.

On the other hand, efforts to implement the new rules need to be supported by enhanced supervision of individual banks, including of their asset composition and risk management practices. Supervisors must also be alert to the ongoing evolution of the financial system, in order to address the consequences of financial innovation and regulatory arbitrage.

Conclusion

In the current uncertain global environment, businesses and households will not regain the confidence to plan, to invest and to innovate over the long term until they are reassured that the financial system is not at risk of another crisis. Completing the regulatory agenda and monitoring implementation are essential to this reassurance. This is a task to which both the public and private sectors can and must contribute.

Carrying through the regulatory reform agenda and seeing to its global implementation are part of the broader framework for global recovery and macroeconomic stability. All three elements of policy – fiscal, monetary and prudential – will need to work together to deliver strong, sustainable global growth.