



## **Current focus of the Basel Committee: Raising the bar**

### **Remarks by Stefan Ingves**

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Remarks at the 7th High-Level Meeting jointly organised by the Association of Supervisors of Banks of the Americas, the Basel Committee on Banking Supervision and the Financial Stability Institute

Panama City, Panama, 15 November 2012

I am very pleased to be here for this year's High-Level Meeting, organised by ASBA, the Basel Committee and the FSI. At its meeting in March of this year, the Basel Committee discussed a number of strategies for enhancing its relationship and communications with non-Basel Committee member countries. One proposal that was readily endorsed by Committee members was to establish even closer collaboration with the FSI with regard to its High-Level Meetings. Many of our members are familiar with these well-established annual conferences, which draw together senior central bankers and supervisory officials from various regions of the world. In addition to last year's ASBA-FSI event, I have participated in several other High-Level Meetings this year. The feedback that I and my Basel Committee colleagues have gained from these events has been both illuminating and insightful.

When we met last year in San Francisco, I called for action on two items: first, guarding against supervisory complacency, and second, putting into practice the regulatory reforms that were developed to raise the resilience of banks and banking systems to future shocks. These two themes – putting policies into practice, and recognising supervision as an essential complement to regulation – continue to pervade the Basel Committee's work. I am going to repeat these themes today, although in doing so I am not suggesting we have failed in our efforts in the past. On the contrary, we have made good progress in both areas. But more needs to be done. I will share with you today some of the Committee's efforts to further these objectives. I will also say a few words about our ongoing policy work since there is also more to be done to fully reflect lessons learnt from the crisis.

### **Supervision matters**

I will start with supervision. I have been quite vocal in warning that the Basel III Framework is not sufficient – by itself – to set banks and banking systems on a clear path to becoming stronger and more resilient. It must be matched in practice by good supervision. Good regulation empowers firm supervision, and firm supervision enforces good regulation. They are mutually reinforcing, and it is unrealistic to think that one can be successful without the other. Basel III provides a better rulebook by which to judge the safety and soundness of banks, but the crisis taught us that we also need better supervision. And better supervision begins with the basic building blocks, which is the Core Principles for Effective Banking Supervision.



## Core Principles for Effective Banking Supervision

Every financial crisis is an opportunity to reflect on what went wrong, what worked well and what improvements can be made. This is true for bankers and risk managers, for policy makers, and, of course, for bank supervisors. For the Basel Committee, the supervisory lessons learnt from the financial crisis prompted our review of the Core Principles. While Basel III has attracted most of the attention, its effectiveness will only be realised if it rests on a solid bedrock of supervision and implementation. The Core Principles provide such a foundation.

The revised Core Principles were published in September, with the endorsement of supervisors and central bankers representing more than 100 countries that were gathered in Istanbul for the 17<sup>th</sup> International Conference of Banking Supervisors. The latest revision was conducted jointly with the Basel Consultative Group, which comprises banking supervisors from both member and non-member countries of the Basel Committee, as well as regional groups of banking supervisors, the IMF, the World Bank and the Islamic Financial Services Board. The review took account of post-crisis lessons and other significant supervisory developments. At the same time, we have remained mindful of the fact that the Core Principles are applied on a global basis and that we need to maintain continuity and comparability. We have not sought to reinvent the wheel: many of the revisions are designed to reinforce the fundamentals of banking supervision by emphasising effective risk-based analysis, a more forward-looking perspective and early intervention. Given the importance of these basic principles as the foundation for any supervisory regime, it is imperative that they be implemented with determination and rigour around the globe.

As many of you would already know, the revised Principles have been reorganised to highlight the difference between what supervisors do and what they expect banks to do. The principles covering supervisory expectations of banks emphasise the importance of good corporate governance and risk management, as well as compliance with supervisory standards. In addition, the review took account of several key trends and developments that emerged during the last few years of market turmoil, in particular the need for greater intensity and resources to deal effectively with systemically important banks.

Our agenda for this High-Level Meeting includes an in-depth review and discussion of the revised Core Principles, so I will not go into any more detail now. Let me simply make one very important point. In discussing the revisions to the Core Principles, the Committee was clear in its objective: we wanted to raise the bar. Just as we needed to lift regulatory requirements that were too low, the *status quo* for supervision was not going to be acceptable either. An enhancement of supervisory capabilities is necessary if we want to keep pace with the increasingly complex, diverse and interconnected financial system. We cannot stand still. More importantly, and as I have stressed previously, we cannot allow ourselves to think that just because the problems in the banking system did not occur in our backyard this time will mean that they will not occur there in the future.

### Systemically important banks

The financial crisis that began in 2007 not only reminded us of the critical role of intensive supervision, it also reminded us of the importance of systemically important banks. During the crisis, the failure or impairment of a number of large, global financial institutions sent shocks through the financial system which, in turn, harmed the real economy. The shocks were exacerbated when it became apparent that supervisors and other relevant authorities had limited options to deal with these banks, and therefore to prevent the problems from spreading through the financial system. As a consequence, public sector intervention to



restore financial stability during the crisis was not only necessary, but had to be conducted on a massive scale.

In response, the Committee adopted a series of reforms that, once implemented, will raise the resilience of banks and banking systems. These reforms will have a particular impact on global systemically important banks (G-SIBs) since their business models have generally placed greater emphasis on trading and capital markets related activities, which are most affected by the enhanced risk coverage of the capital framework. But Basel III is a minimum standard, and is not enough to address the unique risks posed by G-SIBs, the moral hazard associated with the perception that these firms are too big to fail, nor the cross-border repercussions that problems in a G-SIB would create. To alleviate these problems, the Committee sought to raise the bar further for these largest banks. We developed an assessment methodology for determining global systemic importance, and prescribed additional loss absorbency requirements for banks deemed systemically important.

The G20 Leaders endorsed these rules at their summit last year. At that time, they asked the Basel Committee and the Financial Stability Board to work on extending the framework to domestic systemically important banks (D-SIBs). There are many banks that are not significant from an international perspective, but nevertheless could have an important impact on their domestic financial system and economy compared to non-systemic institutions. The Committee has recently published its framework for dealing with D-SIBs, which is a topic of discussion for this High-Level Meeting. Our goal was to develop a D-SIB regime which was complementary to the G-SIB regime, while at the same time recognising that different jurisdictions will wish to deal with domestic priorities in different ways. The D-SIB framework therefore identifies a set of common actions that all jurisdictions are expected to undertake, but leaves the detailed nature of those actions and the specific policy responses to national discretion. My main message for today is that critical to the success of this approach and the interaction with the G-SIB framework is the need for strong and cooperative dialogue between home and host supervisors where a bank from one country is designated a D-SIB in foreign jurisdiction.

## Implementation

Supervision is a top priority for the Basel Committee, and implementation of Basel III is another. We have seen signs of progress on implementation in some countries, but much more is needed. Rules and regulations have to be consistently formulated and effectively applied. The implementation process is, therefore, a continuing one. At its September 2011 meeting, the Basel Committee agreed to initiate a programme to review members' implementation of the Basel regulatory framework (which includes Basel II, Basel 2.5 and Basel III). This is a comprehensive programme which seeks to spur full implementation of the Basel standards within the agreed timelines – this is something that the Committee has not previously done.

The Committee has no doubt that with proper implementation, the regulatory reforms – both those already announced and those still in the pipeline – will help make banking systems more resilient. That is why the G20 Leaders have also asked us to keep focus on implementation issues and finish the job. In Mexico recently, the G20 Finance Ministers and Central Bank Governors said “We remain committed to the full, timely and consistent implementation of the financial regulation agenda ... We agree to take the measures needed to ensure full, timely and effective implementation of Basel II, 2.5 and III and its consistency with the internationally agreed standards.”



Three baseline assessments (the European Union, Japan and the United States) covering 11 Committee member jurisdictions have been completed and the reports have been published. Preparatory work relating to the next round of country assessments is under way and includes Australia, Brazil, Canada, China, Singapore and Switzerland. A system of follow-up for those assessments already completed is being designed and will be part of the regular implementation process going forward.

The Basel Committee's systematic review of implementation is helping to identify the regulatory fault lines early on by providing Committee members a detailed and a point-of-time review of the progress made and the materiality of the shortcomings. As intended, the assessments are developing as a means to an end rather than an end in themselves. The expectation is that our assessments will help create a dependable global regulatory environment that will also help strengthen supervisory efficacy.

The assessments we have thus far conducted demonstrate the strong cooperative nature of the programme. It involves senior-level experts from different jurisdictions, technical counterparts and select industry participants from the assessed jurisdiction, and the Committee's Secretariat. The expert nature of the country assessments is central to its legitimacy. Apart from assessing the regulatory consistency and materiality of the gaps, the Basel III implementation process has drilled down to the level of individual bank portfolios, and I expect the work will help us to identify the key drivers of variations in risk-weighted assets across banks, across jurisdictions and across time. As other Basel standards and policies are completed – such as those relating to liquidity, G-SIBs and large exposures – the focus on implementation is expected to rise.

The implementation work is also helping inform the Committee's ongoing policy initiatives. This is an important feedback loop for the Basel Committee as our premise is that tougher capital and liquidity rules under the Basel III Framework are entirely appropriate for reducing the likelihood of failure for systemically important banks. Assessing implementation and the application of the Basel framework among Committee members also becomes important for many non-member countries where banks from BCBS jurisdictions operate and become systemically relevant. Their failure may not even be seen as a viable option since these banks play a critical economic role in credit intermediation and maturity and risk transformation.

Proper implementation of Basel III will enable internationally active banks in emerging and developing markets to perform their role in a safer, prudent and economically constructive fashion. When globally active banks manage their capital and liquidity prudently, they act as a source of financial stability in the relevant jurisdiction. But an important pre-condition is that such banks must play by the international norms. Collectively, the regulatory requirements and the supervisory standards should push these banks along the path of the intended post-crisis reform agenda so that even during times of stress the banking system operates without material disruption to the financing of economic activities.

## **Further regulatory reforms are needed**

The reforms to the capital adequacy rules have been substantial, and the Basel Committee's efforts to ensure they are put into practice properly and in a timely way have been considerable. But we cannot say that our work to further improve the regulatory framework is complete.



## Liquidity

Basel III's liquidity rules are the most obvious element of the regulatory framework that we are working to finalise. Forging agreement on minimum liquidity rules for international banks has been a longstanding but elusive goal for supervisors and central bankers. Indeed, Sir George Blunden, the Basel Committee's first chairman, opened the Committee's very first meeting in 1975 by noting that its mandate was "to help ensure bank solvency and liquidity". While the Committee's reputation has been founded on the first part of the task, it has taken 35 years – until Basel III was agreed in 2010 – to find success on the second. Liquidity is an extraordinarily difficult and multifaceted topic. There are a wide range of views on how to define liquidity, as well as on how best to supervise, regulate and manage its risk. For example, in 1984 some of the questions relating to liquidity discussed by the Committee included:

- What constitutes liquidity for an international bank, and how can it be measured?
- What should be the role of particular asset classes within an overall approach to liquidity in an international context?
- How does the degree of maturity transformation undertaken affect a bank's liquidity?
- To what extent can lending in the interbank market constitute liquidity? Does the ability of banks to draw funds from the interbank market affect the extent to which they need liquid assets?
- What are the basic supervisory approaches to liquidity used by the different countries represented on the Committee? What relationship do these approaches bear to the monetary policies applied by the central banks?

These questions remain highly relevant, and they are just as difficult as they were then, but I am pleased to say that the Committee has now come to grips with them. What has changed? While the persistently increasing globalisation and interconnectedness of our financial systems were known to be creating potential vulnerabilities, there was no consensus on how (or how urgently) to deal with it. Unfortunately, it took a global financial crisis to provide the necessary impetus for agreeing on the Basel III liquidity rules. So the storm clouds of the crisis at least had a silver lining in that respect.

As you know, the liquidity rules are comprised of a short-term Liquidity Coverage Ratio (LCR) and a longer-term, structural Net Stable Funding Ratio (NSFR). Since these represent the first time we have had global standards, the Committee agreed that we would review and, if necessary, refine them before they came into force. And the question everyone therefore wants to know is where do we currently stand with respect to finalising them, particularly the LCR which is due to come into force in 2015? The Committee is aiming to reach agreement by its December meeting on a few outstanding issues. As any bank supervisor, central banker or risk manager can attest, this is very difficult work given the wide range of issues we must consider. It has far-reaching implications, for example, for banking, financial markets and monetary policy, and for this reason our work has been undertaken with considerable care and caution.

It is important to note that several countries have already adopted the liquidity framework in their jurisdictions, including Sweden, and I am pleased to say the Swedish experience with liquidity regulation has been very positive. For more than a year now Swedish banks have been reporting their liquidity coverage ratios to Sveriges Riksbank and the Swedish FSA, and the large banking groups also disclose their LCR publicly. Furthermore, from January 2013 minimum standards for the LCR will be introduced for the largest banking groups, both on an aggregated basis and separately in euro and US dollars. The results so far are reassuring



and there are no signs that monetary policy operations or the functioning of the interbank market have been affected by the implementation of the LCR.

Given the implications and potential costs – not the least of which are the social costs – of not raising the bar for liquidity requirements and liquidity risk management in banks, we would be failing in our responsibilities if we did not push on to finalise these proposals in the near future.

### **Trading book and securitisation**

Let me now turn to the work we are doing with respect to some of the capital rules. Following on from the changes introduced in Basel 2.5, the Committee is now undertaking a more fundamental review of the trading book and the securitisation rules. With respect to the former, we want to achieve a regulatory framework that promotes more comparable levels of capital across banks with similar trading book portfolios. We also aim to provide more transparency, and limit arbitrage between the banking and trading books. Regarding securitisation, the complexity of the products, lack of transparency and poor underlying incentives led to massive losses. The Committee's objective is to address these weaknesses by making capital requirements for securitisation products simpler, better reflective of risk, less reliant on credit ratings and without significant cliff effects.

### **Standardised approaches**

Also on the agenda in 2013 is to improve the standardised approaches for credit and operational risk. Our aim is to ensure these approaches continue to be suitable for assessing the capital adequacy of internationally-active banks – as well as other banks – that are not using the advanced approaches for risk measurement. While it would be premature to say what the result of our deliberations will be, one issue to be considered will be the extent to which the revised standardised approaches could also serve as a backstop or benchmark to the models-based approaches (eg banks, when publishing their risk-weighted assets, could be required to reference the calculations based on the standardised approaches). Linking the standardised approach with the models-based approach is already being considered in the fundamental review of the trading book. Using the standardised approaches as a backstop or benchmark could help increase the comparability of risk-weighted asset calculations among banks and jurisdictions.

### **Large exposures**

Another important regulatory policy that is under review by the Committee is the large exposures regime. The Committee's original guidance – *Measuring and controlling large credit exposures* – was published in January 1991. It was successful in promoting broad convergence in the supervision of large exposures, while recognising the scope for variation according to local conditions. However, it is fair to say that the regulation of large exposures has become increasingly inconsistent. While there is considerable apparent homogeneity in the general approaches being adopted, there are significant differences in the specifics.

Another lesson from the crisis has been that we did not pay sufficient attention to risk concentrations. This makes a strong case for a more consistent and effective framework for large exposures. Such an internationally consistent framework would ensure a level playing field, reinforce consistency in underlying capital requirements (since the capital framework does not directly capture concentrations) and avoid loopholes or exemptions where risks can build up undetected. The Committee is therefore examining the merits of a more consistent



approach to large exposures, and will publish its proposals for comment during the course of 2013.

## **Other areas for review**

Let me quickly touch upon two other areas on the Committee's agenda: one a broad theme, and the other a specific initiative that is supervisory in nature.

### **Simplicity and comparability**

I am the first to acknowledge that a number of areas of the regulatory framework have become increasingly complex over the years. As a result, the Committee has this year been evaluating ways in which it can be simplified, without materially altering its underlying objective or strength. There is a fine balance that must be achieved. The use of a regulatory measure that is too simple and blunt can provide strong, perverse incentives for banks. On the other hand, there is a limit to how much faith we should put into the complexity and sophistication of models.

A specific example of the Committee's current thinking is our recent announcement on the regulatory treatment of debit valuation adjustments (DVAs). This is a complex issue relating to the impact of a bank's own credit risk on the valuation of derivative transactions. To precisely measure this impact, which we wished to remove from the capital base, would have been extremely complex and difficult. The maths and analysis necessary would be beyond the capabilities of the average bank supervisor – let alone a central bank Governor! The Committee therefore decided on a more simplistic, but conservative, treatment. This was criticised for not being precise enough and therefore potentially overstating the risk. But the Committee decided that there was a trade-off to be made, and that the additional precision involved in refining the approach was not worth the cost involved. The message here is not that the Committee is dismissive of the benefits or desirability of risk sensitivity, but rather that it needs to be traded off against other objectives. At some point it is inevitable that the never-ending pursuit of greater precision in risk measurement is not worth the effort – indeed, it can lead to a dangerous false sense of precision, which is best avoided.

### **Capital planning**

Given that we have raised minimum capital requirements, capital planning will necessarily become more important – both for banks and their supervisors. Recognising this, we have established a task force to examine current industry practices and develop guidance on good capital planning processes. This work is looking at issues such as:

- processes for establishing targets for the level and composition of capital;
- monitoring and decision making with respect to capital;
- linkages to strategic plans and other business planning considerations; and
- coordination with the assessment of firms' risk profile and appetite.

The objective of this work is not a new policy that will impose specific requirements on banks such that every bank does its capital planning in the same way. Rather, it will be sound guidance that banks and supervisors can use to help judge whether an individual bank has a robust capital planning process, given its size, shape and complexity. This will be particularly important in a Basel III world, with a number of capital constraints (CET1, Tier 1 and total



risk-based ratios, and the leverage ratio) and buffers (capital conservation, countercyclical and SIB surcharges) to which banks will need to manage.

## **Conclusion**

I would like to bring my remarks to a close by emphasising as I did at the outset that regulatory reform has two essential complements: supervision and implementation. Even strong international regulations will be ineffective if they are not implemented fully or if the associated supervisory regime is weak. Hence, the Committee is raising the bar in all three areas. First, it is obvious that we have been working to strengthen the regulatory framework. This is not just in the form of Basel III, but also the work we have completed on SIBs, and the work still in train on the trading book, securitisation and large exposures. Second, we have been much more proactive in making sure that the international agreements are implemented in full, on time and in a consistent manner. And, finally, we have used the revisions to the Core Principles to also raise the bar for supervision. Doing one is not enough; neither is doing two. We need to raise the bar in all three areas if we are to achieve a robust and resilient financial system for the future.