BANK FOR INTERNATIONAL SETTLEMENTS

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Consistent regulatory implementation to keep markets integrated

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Consistent regulatory implementation

International regulators swiftly drew lessons from the crisis and produced an improved regulatory framework. We have now a much better set of standards that address important weaknesses and gaps. Basel III contains a host of improvements: more and better quality capital, more comprehensive coverage of risks, substantially tougher regulatory ratios, including provisions that deal with system-wide risks such as a surcharge for systemically important banks and a countercyclical buffer.

This major overhaul is part of a broader agenda, where a few items are still to be completed, but progress is being made. Among those are standards for the resolution of troubled financial firms and the framework for strengthening trading infrastructure by channelling transactions that currently take place over-the-counter through markets organised around central counterparties. Finally, there are several strands of work that aim to monitor developments and to analyse potential regulatory responses in the so-called shadow banking system.

But rules are only as good as their implementation on the ground. So the Basel Committee, along with other standard setters and the FSB, are working in a number of areas to improve the consistency of implementation:

(i) They have introduced a much more structured and solid framework for cooperation, which includes peer reviews, so that national supervisors are scored by their international colleagues on their progress and consistency in applying the international agreements. These reviews are published in order to provide transparency and to increase convergence incentives.

(ii) The Basel Committee is studying ways to simplify and to increase the comparability of the overall Basel III regulatory framework. The purpose is to ensure that it is easy to understand and, most importantly, easy to implement consistently because it is more transparent.

(iii) The Basel Committee is analysing the consistency of risk-weighted asset calculations across banks in order to understand why there is so much variation across jurisdictions and institutions. This is an important exercise for strengthening the credibility both of the overall framework and of the reported financial conditions of the individual banks.

Allow me to say a few more words on this last point. Industry observers have voiced concerns about the consistency of risk-weighting practices. The Committee's own study found that there are very large differences across banks in the way they risk-weight their trading book exposures. A similar study is underway for the banking book and should be completed soon.

What is the reason for these differences in risk-weighted asset calculations? There are many potential drivers, and not all of them are bad.

A significant part of the variation is due to supervisory choices in the implementation of the regulations. Examples would be: policy decisions to restrict modelling options (eg to disallow any diversification benefit between types of risk) or to apply stricter supervisory multipliers.

Other drivers include the modelling choices of individual banks. Some of these are unavoidable. Models are statistical tools that inevitably rely on samples of data. The estimation noise can be significant and cannot be reduced beyond a certain point (for instance, by enlarging the sample over which the model is estimated). In the absence of an objective measure of risk, some difference in opinion between banks is not only legitimate but also welcome: diversity is necessary for two-way markets.

But certain other modelling choices by the banks are more problematic because they reflect strategic behaviour that seeks to minimise regulatory capital requirements. These choices potentially overstate bank solvency, undermine transparency, weaken market discipline and make the playing field uneven. They are unwelcome. The issue is how best to address the bias embedded in banks' incentives to "over-optimize" regulatory capital. Some solutions may be as simple as standardising the timespan of the data used for modelling.

The Basel Committee is studying these different drivers to get a better understanding of their relative importance and to design an appropriate response. Help from the industry is critical, because it is in everybody's interest to make sure that the framework is implemented consistently.

The solution will necessarily be multifaceted. Some of the options the Basel Committee will be considering include the following:

- Improving public disclosure and regulatory data collection to help understand what risk-weighted assets are and how they are derived. This can build on the work of the Enhanced Disclosure Task Force, which has come up with many useful ideas.

- Narrowing acceptable modelling choices for banks and developing supplementary measures, such as improved supervisory safeguards and backstops.

- Providing additional supervisory guidance for model approvals.

All these options have costs, and some participants will inevitably be reluctant to move from the status quo. But an uneven playing field, and mistrust in reported bank capital, impose high costs that are best avoided. So we should see these costs as a necessary investment in a regulatory system that is better for all.

Financial markets fragmentation.

I have been also asked to say a few words about fragmentation. My starting point here is the premise that consistent, globally applied regulatory standards are not only imperative for global financial stability but they will also help to reduce the pressures that drive the fragmentation of financial markets. Signs of fragmentation have already appeared, particularly in the euro area.

Containing fragmentary pressures is important for a number of reasons. First, we should be very careful not to lose the benefits of globalisation and financial integration. Ultimately, these ensure that capital is allocated efficiently at the global level, supporting growth and development. Second, fragmentation can prevent the proper transmission of monetary policy, constrain the supply of credit and in general amplify divergent economic and financial conditions, delaying the necessary normalisation of economic conditions. This is especially the case in a currency union such as the euro area. The question is what can be done? I will mention three broad points:

1. The first point is that containing fragmentation and making sure that markets are not impaired goes well beyond financial regulation. Let me mention two different examples:

(i) Weak public finances can jeopardise financial stability and induce fragmentation. We have seen how negative feedback loops between sovereign risk and weak financial systems can fragment markets and cause them to malfunction. Implementing the regulatory agenda and strengthening the financial system is important but budgetary consolidation is also required to put public debt on a sustainable trajectory and to restore market integration.

(ii) In extreme circumstances, fragmentation may also put a burden on monetary policy, as it can disrupt funding conditions and hence the transmission and effectiveness of policy. The euro area provides a clear illustration. Over the past couple of years, the ECB, acting within its mandate, has had to take a number of unconventional policy measures to address sovereign and financial system risks, while maintaining its commitment to medium-term price stability. Think, in particular, of the large-scale liquidity injections, notably the three-year refinancing operations, and the programme for outright monetary transactions (OMT).

Today in his opening remarks, the president of the ECB reminded us of the importance of these operations in removing unwarranted redenomination risk and in alleviating fears of a potential euro breakup. I do agree: without these actions, it is difficult to see how we could have avoided the continuation of downward market spirals, a major credit crunch and renewed solvency problems in the banking system. Moreover, by requiring conditionality for the OMT programmes, this facility is consistent with the long-held BIS view that this kind of central bank action can buy time but cannot substitute for consolidating public finances, repairing private balance sheets and implementing necessary reforms. Conditionality lessens the incentive to delay necessary repairs or to conduct unsustainable policies. As examples in different countries demonstrate, central banks, in full autonomy, need to consider this kind of action when financial systems are impaired. The case has been acute in the euro area, where an impaired financial system has led to sharp cross-border fragmentation that, if left unaddressed, could have posed a threat to the single currency.

2. My second point relates to enhanced supervisory cooperation and full and consistent implementation of the regulatory agenda.

I have already mentioned that cooperation is now based on a more structured and solid framework, which includes peer reviews, colleges of supervisors etc. A lot is being done to enhance cooperation but more is needed. A good example is cooperation to implement consistent and cooperative resolution frameworks, in particular allowing domestic authorities to cooperate for resolution purposes with foreign authorities.

I use the word consistency, not harmonisation: we should not forget that the Basel international standards are minimum standards. Domestic conditions and circumstances often compel regulators to exceed internationally agreed minimums out of financial stability considerations. However, when regulators require higher standards two principles are essential: transparency of the rules and non-discrimination. Rules should not be differentiated on the basis of bank nationality.

3. My third and final point is that the private sector too has a very important role to play in addressing fragmentation. It can play its part in two ways:

(i) First, financial fragmentation could occur when local adaptation falls short of the global standard. In this case, while others are playing by the globally agreed rules, some are held to a lower standard. This presents a risk to financial stability and makes the playing field uneven. Industry does not usually argue for higher standards, but in this case you cannot have your cake and eat it too. Unless we want a race to the bottom – which is in no one's long term interests – then industry must argue much more strongly for the benefits of international consistency when dealing with domestic rule-making.

(ii) Second, the banking industry in some parts of the world is struggling to regain the confidence of investors, depositors and other stakeholders. Restoring confidence will help to reduce the pressure to protect and to ring-fence the financial system. Implementing the regulatory agenda, repairing balance sheets and, where necessary, reducing excess capacity, enhancing transparency, and carrying out stress tests with proper backstops could all contribute significantly to restoring confidence. The private sector has a role to play in supporting all of these elements and helping them to achieve their objectives. Because of time constraints, I will not mention other important actions such as the decisive move in Europe towards a banking union. Thank you.