Basel Committee on Banking Supervision
BANK FOR INTERNATIONAL SETTLEMENTS

Finishing the job: next steps for the Basel Committee

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Good morning. It is my great pleasure to be with you again today. I would like to thank the Reserve Bank of South Africa for its superb hospitality in hosting this annual event. And, at the same time, let me extend my warm appreciation to Josef Tošovský and the Financial Stability Institute for all their efforts in bringing us together again for another High-Level Meeting. The Basel Committee views these events as an important forum for sharing thoughts on critical issues and challenges facing regulators and supervisors. I am therefore very pleased to be able to join you here in Cape Town.

The Committee's policy and implementation related output over the past 12 months has been exceptionally high. And, there is still a lot on the Committee's plate – at last count, a total of around 50 projects. Today, I would like to give you an outline of our strategic priorities for the next two years or so. As you will see, there will be no slackening of pace. On the contrary – the success and durability of the agreed reforms will depend very much on the persistence and vigour of our collective efforts over the next few years to get the job well and truly done.

What the Committee achieved in the past year

A little over 12 months ago, the Basel Committee's governing body – the Group of Governors and Heads of Supervision (GHOS) – endorsed the new Liquidity Coverage Ratio (LCR), a key component of Basel III. But there was no time for a pause after completing the LCR. Instead, it marked the start of a record year in which the Committee published 46 papers of some sort or another, over one third more than in the previous 12 months.

This is not the place for an item-by-item account of all that the Committee produced, but I would like to draw your attention to four key themes within this workflow – themes that will continue to shape our programme for the next several years. First was **the drive forward with the post-crisis reform agenda**. The steady stream of consultation papers – on LCR disclosure, the leverage ratio, trading book capital requirements among other subjects – gives you a flavour of what was achieved here. The announcement of an agreed measure for the leverage ratio at the GHOS meeting a couple of weeks ago shows that we continue to make real progress in bringing the reforms to a conclusion, but there is still more to do.

A second point was our **focus on implementation**, a theme that will take on increasing importance over the coming two years. I have made the point many times previously that the

Committee's work to help build a resilient banking system will be in vain if the agreed standards are not implemented in a full and consistent manner at a national level. The Committee cannot itself enforce all standards, of course, but it can ensure there is transparency about what national authorities are actually doing. Here the Committee's implementation monitoring outputs included two special reports to the G20, as well as four assessments of Basel III implementation of capital standards in individual jurisdictions, the so-called RCAP assessment exercises to review regulatory consistency in member countries.

Third, the Committee raised the question of how best to **balance simplicity, comparability and risk sensitivity** within the capital framework – this topic, aired in a discussion paper last July, was discussed by Wayne Byres in his presentation yesterday. As you would appreciate from his comments, simplicity and comparability are highly desirable, but difficult to attain. Comparability was also the key focus of our work on inconsistencies in risk-weighted asset calculations undertaken as part of the RCAP – a topic that I'll return to in a few minutes.

Fourth, in the field of **supervisory effectiveness**, important work was done in issuing principles for data aggregation and guidance on FX settlement exposures. The Committee also issued proposed revisions to the guidance on dealing with external auditors and proposed guidelines for managing risks related to money laundering and the financing of terrorism.

Priorities for 2014–15

Collectively, these four themes reflect the Committee's key strategic priorities, and I would now like to elaborate on how they will continue to shape our efforts over the next few years.

First, and most importantly, the Committee needs to bring the post-crisis reform agenda to a satisfactory conclusion. In Sweden, we have a saying that, if you bring the devil aboard the boat, you have to row him ashore. In other words, the job you start must be finished. For Basel III purposes, this is especially apposite. In 2010 we agreed on the Basel III package, but the devil was, as always, in the details. Much more work was needed to put the Basel agreement into action.

The details are certainly in the boat for most of the major remaining projects. These include the leverage ratio, the Net Stable Funding Ratio, the trading book, and securitisation. We should be able to row most of them to shore over the next 12 months or so, given the current effort and commitment. This will be an important milestone for the international community, when we can say that all the main pieces of reform have been settled.

Of course, even once the Committee has done its part, the reforms will only have concluded the "design stage" – they will still need to be adopted and implemented by individual countries. The second priority is therefore to monitor and evaluate the implementation of reforms – not just by conducting country-by-country assessments, but also by making sure the intended outcomes of reforms and to stay alert to any unintended prudential consequences.

After the GHOS agreed to start this work, two years ago, we've made good progress. For example, by the end of this year, the assessment work under the RCAP will have been completed for all the countries that are home to the world's globally systemically important banks. By the end of 2015, detailed peer reviews of the capital regulations of all 27 Basel Committee member jurisdictions will have been completed, or at the very least they will be well under way. Since Basel Committee member countries account for more than 90% of global banking assets, this will provide a very important assurance that the Basel III capital requirements will be underpinning a much stronger global banking system.

We will also be expanding the coverage of the RCAP work to encompass other aspects of the regulatory framework as they come into force: for example, the LCR, global and domestic SIB regimes, leverage and, in due course, the NSFR.

And this brings me to the third theme, which is dealing with the inconsistencies we have found in risk-weighted asset calculations. In a sense, this task is part of the broader aim of finding the right balance between simplicity, comparability and risk sensitivity in regulation. It is also closely tied to the Basel Committee's implementation agenda. Much is at stake here – in fact, nothing less than the credibility of banks' model-based capital ratios and hence the confidence of external parties that such ratios can be meaningfully compared.

It's worth noting that the work we have done here marks an important first. Never before have *international* teams of supervisors looked at the modelling practices of individual international banks. This is a telling example of the regulatory community's commitment to improving the "truth in advertising" for bank capital ratios.

To investigate this question, the Basel Committee has published three studies on the variability of risk-weighted assets – two for the trading book and another for the banking book. Taken together, the three reports suggest that underlying differences in actual risk drive the lion's share of variations in risk weights and capital requirements, just as they ought to do. However, some variations arise from supervisory and practice-based idiosyncrasies, and these can result in material discrepancies. While it is difficult to be precise on how much scatter is "too much", the observed range of practice-based variations is too wide.

Let me give you a flavour of that variability. If we just take the banking book results alone, two banks with exactly the same assets could report capital ratios that differ by 4 percentage points – the most conservative bank would report a regulatory capital ratio of 8% when the least conservative one would report 12%. Of course, this simply compares the extremes in the sample – most banks are much closer to the average. But if outsiders have no way of identifying who is "average" and who is an "outlier", this variance is clearly too wide to underpin confidence in the measurement of bank capital.

So what is to be done? Building upon these initial studies, the Committee has started extending its analysis to establish a comprehensive picture: for the trading book, the initial analysis was extended to more complex portfolios, with results showing that the initial conclusions remained valid. In parallel, the work on the banking book has been extended to the other remaining core asset classes, especially retail portfolios, SMEs and so-called "partial use" exposures (ie exposures that have not been migrated to the internal models). And, once the Committee has done an initial round of assessment, we will need to repeat the exercise periodically to see whether the policy measures that I will discuss shortly are being properly implemented and are having the desired effect.

Further analysis to establish a comprehensive picture on risk-weighted assets will take us into 2015, but this does not, of course, prevent us from taking action in the meantime. It is clear that a problem exists and needs corrective measures. The Committee is thus considering a range of supervisory and policy responses – without, I should add, settling on anything definitive just yet.

Given the nature of the problem, there is no silver bullet. We will need a series of policy and supervisory changes, along the following lines:

- Most immediately, there will be supervisory action. Our studies have provided supervisors with a clearer picture of how their banks stack up against their international peers, and supervisory action is already being taken against a number of the outlier banks that are on the low side.
- Similarly, the Committee's RCAP work is helping to reduce variability due to undesirable differences in national regulations, thereby improving the consistency of outcomes. The Committee is also looking at the issue of national discretions and Pillar 2, and it is investigating whether more can be done to reduce variability from these sources.

- Since a lack of transparency in bank modelling practices lies at the heart of the problem, the Committee will propose enhancements to Pillar 3 in the first half of this year.
- At the heart of this problem is a question of whether, for regulatory purposes, banks have too much freedom in their modelling choices, so we are looking at whether, and how far, greater constraints on the modelling practices of banks are needed.
- To make a more direct impact, we are also examining the role of floors and benchmarks within the regulatory framework, and considering whether they should have a greater role to play.
- Finally, we now have the leverage ratio as a backstop to the risk-based regime. And the case for a leverage ratio will only grow stronger if risk-weight variability is not adequately dealt with.

In sifting through these potential actions and trying to find the preferred policy mix, it is important that supervisors and the industry engage in a constructive dialogue on the best way forward. Banks have a keen interest in ensuring that their risk measurement methods are seen as robust and credible: not only does this affect confidence in the reliability of their capital ratios, but any doubts also call into question their stress-testing results and their risk management systems more generally, since these are invariably all built on the same foundations.

And then, finally but no less importantly, I come to the ongoing task of promoting effective supervision. This was the Committee's original purpose, although it can sometimes be overlooked in the current focus on regulatory reforms. But those reforms cannot be properly implemented and put to work without effective supervision to support them. This topic, thus, is central to the success of all the objectives that I mentioned earlier. When it comes to building a strong supervisory framework, the Committee's starting point remains the Core Principles for Effective Banking Supervision, which was updated in 2012.

A range of additional supervision-related initiatives are currently under way. You may have seen that, last week, the Committee proposed to update its guidance on the conduct of supervisory colleges, taking into account practical experience over the past couple of years. Colleges are a critical part of the infrastructure necessary to supervise banks operating on a cross-border basis, and the Committee, encouraged by the G20 and FSB, is keen that they be as effective as we can make them. Your feedback on these proposals, particularly from the perspective of host supervisors, would be most welcome.

We also put out a short paper last week highlighting what we see as good practice in the capital planning processes of banks. Capital planning is critical for ensuring that banks have enough capital not just for today but also to cover future anticipated growth and, inevitably, unanticipated shocks.

The Committee is also doing work to update our corporate governance principles, and our guidance in dealing with weak banks. In both of these areas, there were important lessons from the financial crisis that the Committee needs to capture – we need to ensure these lessons are not forgotten by those who will follow us.

And finally, the Committee is starting an interesting project to examine how the impact and accountability of supervision activities can be measured. Since good supervision serves to prevent problems, it is often hard to prove its real worth to the community. If the financial system is stable and banks are healthy, is that because the community was well served by supervisors who helped steer the system away from problems, or would nothing have happened anyway? This is clearly no easy question, but our project will look at how supervisors can measure their impact – with a view, we hope, to helping the broader community understand the value of good supervision, and the contribution it makes to financial stability.

Conclusion

Let me sum up by returning to that Swedish proverb: "The devil is in the boat, and now we have to row it ashore". As with all folk wisdom, one shouldn't take this saying too literally. It's true that much of the detail of the planned reforms is now in place. A salient exception is the NSFR, but we have recently issued some revised proposals for its formulation and I see no reason why this can't be finalised within the coming 12 months.

It's also true that the Committee's workflow will continue to be shaped by the same four priorities that have guided us to date – namely, the reform agenda itself, the focus on implementation, the attention to consistency, and the emphasis on supervisory effectiveness. All these are familiar to you from the work to date.

But this continuity shouldn't delude us into thinking that the next two years will be plain rowing. What matters now is the quality and consistency of implementation. As we go forward, we will inevitably find things that need adjusting. Some measures may need improving to ensure that they can be effectively implemented. So I confidently expect that landing the reforms will take at least as much effort and commitment as launching them in the first place.