Basel Committee on Banking Supervision

BANK FOR INTERNATIONAL SETTLEMENTS

Regulatory equivalence and the global regulatory system

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Introduction

Thank you for the opportunity to share my views on regulatory equivalence and the global regulatory system. One of the (many) outstanding questions regarding the impact of Brexit is what this means for (i) financial institutions' access to the single market, whether through some equivalence arrangement or another form; and (ii) financial regulation in the United Kingdom. I will not comment on the specifics of these live policy issues. Rather, I'd like to take this opportunity to highlight the importance of global standards for financial regulation, which, if anything, may assume even greater importance in the future. I will also provide an overview of the Committee's finalisation of the Basel III post-crisis reforms, and will say a few words about what is next on the Basel Committee's agenda.

Global standards and supervisory cooperation

I have spoken recently about the "implementation imperative" and noted that the starting point for achieving financial stability is a resilient banking system – which can only be based on robust global prudential standards combined with effective bank supervision.[1] Any review of "regulatory equivalence" requires an analysis to ensure regulatory comparability and then a determination of whether jurisdictions (and/or banks) have kept to the Basel standards. This is why in 2012 the Committee launched its comprehensive Regulatory Consistency Assessment Programme (RCAP). Our assessments document the significance of any deviations from the Basel framework and include a scale that gives an overview of a jurisdiction's regulatory compliance with the global standard. In my view, the RCAPs have been highly successful in raising the consistency of implementation of the Basel minimum standards.

Today I would like to focus on the importance of robust global minimum standards. The Basel framework comprises a set of global *minimum* standards. This is particularly relevant for large banks with cross-border operations, since a common global standard provides certainty and clarity from jurisdiction to jurisdiction.

The Basel Committee's Charter states that the Committee "expects full implementation of its standards by BCBS members and their internationally active banks. However, BCBS standards constitute

[1] W Coen, "Global adoption of the Basel framework: enhancing financial stability across countries", speech at the 9th Islamic Financial Services Board Public Lecture on Financial Policy and Stability, Kuala Lumpur, Malaysia, April 2017, www.bis.org/speeches/sp170405.pdf.

minimum requirements and BCBS members may decide to go beyond them." Our Charter further notes that BCBS "members are committed to … implementing and applying BCBS standards in their domestic jurisdictions within the pre-defined time frame established by the Committee" and to "undergo and participate in BCBS reviews to assess the consistency and effectiveness of domestic rules and supervisory practices in relation to BCBS standards."[2] Minimum standards serve to level the international playing field and to promote global stability. If minimum standards are not agreed and implemented, the risk is that (i) jurisdictions will engage in a race-to-the bottom in terms of regulatory standards or (ii) there will be less reliance on global rules, leading to fragmentation. Both outcomes create inefficiencies, complexity, and risks and are therefore undesirable for both banks and regulators. That is why it is so important to agree and implement harmonised global standards for global businesses.

It is an established principle that jurisdictions are free to adopt a standard that exceeds the Basel minimum standards. This is driven by local circumstances and conditions such as a country's or a jurisdiction's:

1. regulatory or supervisory framework;
2. legal framework including its insolvency or resolution regime;
3. banking structure; and
4. experience from a previous crisis or episode of banking system stress.

This practice is often referred to as "gold plating" but, as former Bank of England Governor Mervyn King once observed, large complex financial institutions are global – at least in life if not in death.[3] As such, until a cross-border regulatory or supervisory or resolution regime can cover with certainty all relevant jurisdictions, the country in which a bank is established has the ultimate responsibility for that bank.

A deviation below the minimum standard is a different story. Such a deviation may be unsafe or unsound as it dilutes the global standard to which internationally active banks are held. Competition may be distorted and the playing field unlevelled. Market discipline could suffer if comparability between large, internationally active banks is eroded. Departures from the global minimum standard can also be costly for banks as they are required to tailor their IT systems and risk management for each jurisdiction in which they operate. While a departure may provide short-term financial relief, this "benefit" is only transitory as it does nothing to enhance the bank's long-term resilience. Indeed, over the longer term, a departure from the minimum Basel standards can damage the bank's long-term viability, reduce confidence in the banking system and have adverse effects on economic development and growth.

Update on the main BCBS policy and supervisory issues

This brings me to the other topic that I want to discuss today and that relates to the Basel Committee's unfinished business. Over the course of the past 18 months or so, the Basel Committee has published a broad package of revisions to the global capital framework. This work was carried out via a careful process of public consultation – in some cases, twice over – and extensive studies to assess the quantitative impact of the proposals. These assessments involved a painstaking analysis of large data volumes, and the testing of multiple scenarios.

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[2] Basel Committee Charter. See in particular Article 5, *BCBS members' responsibilities*, and Article 12, *Standards*, www.bis.org/bcbs/charter.htm.

[3] Mervyn King, Governor of the Bank of England, "Banking: from Bagehot to Basel, and back again", October 2010, www.bankofengland.co.uk/archive/Documents/historicpubs/speeches/2010/speech455.pdf.

What has been done and where do we stand? Based on feedback from the consultative process and the results of our impact studies, the Committee has largely completed the technical work needed to revise the framework. There is one piece of unfinished business and that relates to the calibration of the output floor. Before I discuss the floor, let me give you a sense of what has already been done:

1. The Standardised Approach for credit risk has been enhanced to increase its granularity, while still keeping it relatively simple. This is important since the standardised approach is the method used by most banks around the world. Once adopted, it will also serve as a much improved backstop to the modelled approach for credit risk.

2. The Internal Ratings-Based (IRB) approach: based on lessons learned from the crisis, safeguards have been added for banks that use their internal models for estimating regulatory capital. For example, tighter restrictions have been adopted for input estimates, such as probability of default and loss-given-default; and the removal or restricted use of IRB for certain portfolios for which scant loss data are available;

3. Operational risk: here, the option for a bank to use its internal models – the Advanced Measurement Approaches – has been eliminated and replaced with a simpler standardised method;

4. Leverage ratio surcharge for global systemically important banks (ie the G-SIBs): The set of rules for the banks that are deemed systemically important already includes a risk-based capital surcharge. Adopting a non-risk-based leverage surcharge would align the leverage ratio with the risk-based ratios.

5. Output floor design: the Committee has reviewed and consulted on various ways of designing the output floor. This includes a very granular "exposure class/type" floor, based on individual exposures such as mortgages. We also considered a floor based on "risk types" such as credit risk and market risk. In the end, the Committee has chosen the simplest form – an "aggregate" output floor. This is simple and straightforward – a bank's measure of risk-weighted assets (using internal models) can in aggregate be no lower than, say, 70–75% of the risk-weighted assets that would result if the bank had applied the standardised approaches to determine its risk-weighted assets.

And this question – the calibration of the aggregate output floor – is the final piece of the jigsaw. Why a floor? As estimating regulatory capital for unexpected losses is imprecise, a floor serves to guard against excessively optimistic assessments of risk, which may arise due to a lack of stress in historical data or incentives for banks to underestimate their risk-weighted assets when using internal models. A further reason is to even up the playing field by limiting the differences in capital requirements between banks using internal models and those of banks using standardised approaches. This principle is not new. A capital floor exists in the current regulatory framework and the 80% calibration was reaffirmed by the Basel Committee in 2009. Given, however, that the existing floor references the Basel I risk-weighting system, it clearly needed to be updated to accord with the most up-to-date standardised approaches.

The calibration of the output floor is a difficult question because of concerns related to its impact. Even though the use of models for regulatory capital purposes related to credit risk has only been in place since around 2008 and despite the 80% floor that is part of the Basel II capital framework, the floor will likely have an impact on some banks. To acknowledge such differences in the readiness of banks across jurisdictions to meet new rules, the Committee has in the past allowed time for banks and supervisors to meet the implementation timelines, along with transitional arrangements to meet the new standards. Recall that in 2010, the Committee adopted 2019 as the date by which the Basel III requirements needed to be fully phased in. I suspect a similar approach will be taken for this set of revisions. Given the wide range of revisions, some time is needed to allow jurisdictions to conduct their legislative and rule-writing processes, and for banks to implement the changes in their systems and processes.

The Committee is also considering a reasonable phase-in for some elements of the revised standards. When it comes to the start date for the new rules and the adoption of any transitional and phase-in arrangements, it is important to note that these are solely at the discretion of the national supervisor. Early adoption of the rules is always an option. Some say generous transitional arrangements do not offer the intended gradual, steady glidepath for adopting a new standard because the market expects implementation right away.

While there is an element of truth to this statement, we do observe banks and jurisdictions continuing to use the phase-in arrangements provided for in the 2010 Basel III rules. In 2010, there was an immediate and pressing need to recapitalise certain banks, which could have been reflected in the market reaction. Today, the Basel III reforms are more structural in nature, and lend themselves naturally to a transitional arrangement. I might add that there could be a dark side to long transitional arrangements. The more time that is granted to phase in a regulatory standard, the more time there is for dilution or backtracking.

A case in point may be the leverage ratio. The Basel framework's 3% minimum leverage ratio is not yet officially a Pillar 1 requirement and there continues to be much discussion about its impact and ways to mute its impact. A point of particular concern among stakeholders has been the ratio's treatment of initial margin received by a bank for derivatives it clears on behalf of clients. The Committee acknowledged this issue in the consultative document published last year, and we will continue to monitor the impact of the treatment going forward. The Committee will, of course, remain mindful of the impact and consequences of the treatment, but will ultimately be driven by our interest in ensuring that banks maintain levels of capital sufficient to support their key role in providing clearing services.

Everyone wants to know when the Committee will be able to come to an agreement on the Basel III post-crisis reforms including the output floor. Given the very broad support for reaching an agreement from all stakeholders, including the banking industry, I am hopeful that we can finalise the reforms in the near future.

So now that the Committee has moved closer to completing the capital framework, what are its priorities and what is on its work programme? We will continue to monitor and analyse the impact of the reforms as well as the effectiveness of the new standards. In a sense, a significant part of our work programme can be described as "back to basics" as the Committee is focused on (i) helping to ensure better, more effective supervision and (ii) improving supervisory cooperation and communication. For example, the Committee plans to provide insight into developments in fintech and to explore the implications for banks' business models and supervisors.

Our policy-related work, which has dominated the agenda for the last 10 years, will be more narrowly concentrated on a small number of initiatives (eg provisioning); responses to frequently asked questions; and, importantly, gauging the impact of the new standards on bank business models and behaviour. This includes identifying regulatory arbitrage. For example, the Committee on the Global Financial System (CGFS) has observed that repo markets have recently been characterised by volatilities in prices and volumes over quarter- and year-ends. This is likely a reflection of incentives that banks have to "window-dress" their balance sheets at period-ends by downsizing their balance sheets, or improving their composition. These incentives include regulatory constraints such as the leverage ratio.[4] As part of our ongoing monitoring of the Basel framework, we will pay particular attention to regulatory arbitrage and determine the appropriate response, be it regulatory or supervisory.

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4 Committee on the Global Financial System, "Repo market functioning", *CGFS Papers*, no 59, www.bis.org/publ/cgfs59.pdf.

Conclusion

The Basel regulatory framework comprises global *minimum* standards, which are particularly relevant for large banks with cross-border operations. A common, global standard provides certainty and clarity from jurisdiction to jurisdiction. Yet the value of even the most robust standard is seriously impaired if it is not promptly and consistently implemented as agreed.

When it comes to the current set of Basel III post-crisis reforms, the Basel Committee has taken the approach of publicly consulting on its proposals, carefully considering the feedback received and assessing the quantitative impact. The technical work for these revisions has been completed, and they will, I believe, greatly enhance the global regulatory framework. Discussions continue on the final piece of the jigsaw – the calibration of the output floor – and I am optimistic that this measure will also soon be agreed. Thank you.