BANK FOR INTERNATIONAL SETTLEMENTS

Challenges for regulators and supervisors after the post-crisis reforms

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Introduction

Good afternoon, everyone. Let me join Fernando Restoy in welcoming you to the BIS and to this Financial Stability Institute conference. Thank you for your participation.

The main theme of this conference is implementation. I would like to offer a few reflections on this topic.

Let me start with the obvious. The Great Financial Crisis triggered a substantial regulatory reform effort worldwide to better internalise systemic risk and strengthen the international financial system. The two main objectives are crystal clear: to reduce as much as possible the probability of financial crises going forward; and to minimise the real costs of such crises should they nevertheless occur at some point.

The emphasis on enhancing resilience for the whole system – not just individual institutions – is critical. It also implies a very broad-based endeavour. During the past nine years, major financial reforms have taken place in multiple areas.

In the crisis prevention domain, a number of new standards were developed to increase the resilience of financial institutions and market infrastructures, to make financial transactions safer and to reduce the scope for key entities to generate systemic risks. In the crisis management domain, authorities have developed ways to make the resolution of unviable institutions more orderly in future, ideally without involving government finances – in contrast to what happened in many countries during the crisis.

On this occasion, I will refrain from listing the whole catalogue of reforms and their implementation status. Should there be any need to assess the breadth and depth of these reforms, I believe you are familiar with the multiple and detailed progress reports produced by the individual standard setters and the Financial Stability Board (FSB).[1] For an overview, I recommend the latest FSB annual report on implementation and effects of the G20 financial regulatory reforms.[2]

Although there are still a few important pending issues, it is fair to recognise that a huge amount of work has taken place over the past nine years. These efforts have contributed to making the financial system more resilient and better equipped to facilitate sustainable economic growth. Also worth highlighting is that this progress is largely the consequence of an impressive, possibly unprecedented, international cooperation effort, involving authorities from jurisdictions around the world.

Designing the reforms is only the first step. After developing a comprehensive reform package that affects almost all aspects of the financial system, there is still the need to complete what is pending and concentrate efforts on proper implementation and monitoring effects.

Completing the elements that are pending is, of course, essential. Basel III comes to mind – and I expect that it will soon be finalised. Stabilising the regulatory framework will help the financial sector adjust and adapt to these changes.

At this point in the regulatory cycle, one of the best contributions that the international regulatory community could make in support of financial stability is to promote the comprehensive, consistent and timely implementation of the reforms.

Before turning to implementation, my main topic today, let me add a couple of thoughts that we at the BIS believe to be important to bear in mind.

First, it would be a mistake to declare victory too soon. The world economy is still subject to risks and vulnerabilities, most notably those relating to the generalised increase in indebtedness and the rich valuations of assets. As we know from experience, debt is an extremely powerful mechanism that can amplify the destabilising impact of adverse shocks.

Second, financial stability is a very elusive, multifaceted objective. Its pursuit requires the contribution of other policies. Monetary, fiscal and structural reform policies also need to contribute to limiting financial stability risks both at the national level and globally. I don't think that prudential policies, not even together with macroprudential ones, can do the job alone.

Against this background, let me turn to my main topic.

We all agree that proper implementation is essential to reaping the full benefits of the global regulatory reforms. It is crucial to ensure consistency among the different segments of the regulated financial sector. It is also vital to promote a level playing field both within and across jurisdictions.

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1 For example, Basel Committee on Banking Supervision (BCBS), "Implementation of Basel standards – A report to G20 Leaders on implementation of the Basel III regulatory reforms", July 2017, www.bis.org/bcbs/publ/d412.pdf; the Committee on Payments and Market Infrastructures (CPMI) webpage "Monitoring the implementation of standards", www.bis.org/cpmi/info_mios.htm; BCBS, CPMI, IOSCO and FSB, "Chairs' report on the implementation of the joint workplan for strengthening the resilience, recovery and resolvability of central counterparties", July 2017, www.fsb.org/wp-content/uploads/P050717-3.pdf; and FSB, "Review of OTC derivatives market reforms: Effectiveness and broader effects of the reforms", June 2017, www.fsb.org/wp-content/uploads/P290617-1.pdf.

2 FSB, "Implementation and effects of the G20 Financial Regulatory reforms: 3rd Annual Report", 3 July 2017, www.fsb.org/wp-content/uploads/P030717-2.pdf.

Policy implementation: three dimensions

In talking about implementation, I would like to adopt a relatively wide definition, under which good policy implementation covers three different but related dimensions.

The first relates to adopting the new standards into national regulation in a proper, consistent and timely way. The second is about assessing whether these standards, once implemented, are achieving their objectives. The third is about putting in place supervisory frameworks that help maximise the benefits of the new standards.

Let me address each of these in turn.

Adopting new standards in a proper, consistent and timely way

First and foremost, implementation requires the proper adoption of the new regulatory standards. As documented in the progress reports of the various standard setters and the FSB, significant progress has been made in implementing the new standards in all domains. This general progress, however, is uneven.

The various standard setters have identified some areas where more expeditious implementation is desirable in some jurisdictions. This is the case, for example, for the standards relating to counterparty credit risk in the banking sphere. This is also the case for the standards relating to margin requirements for non-centrally cleared derivatives, even though implementation has taken place in the major financial centres.

The FSB, for its part, has identified in its latest review of post-crisis reforms that substantial work remains to be done before an adequate implementation of resolution regimes can take place in a number of jurisdictions. This is particularly the case regarding resolution powers. The key missing powers are those that enable bail-in and those that allow for a temporary stay on the exercise of early termination rights.[3]

In other words, the adoption of new rules is still very much a work in progress.

In talking about implementation, we often emphasise the need for consistency. However, consistency does not necessarily require uniform application of standards to all entities and in all jurisdictions. For instance, as you know, the Basel Committee standards are minimum standards. There is scope for supervisors to ask for more than the minimum if necessary. And these standards are in principle meant to apply to large international banks. We need to be sensitive to the compliance costs.

Following the principle of proportionality, it may be appropriate to apply simpler standards to banks with simpler business models – as long as this does not result in less stringent requirements for these institutions. Indeed, ever since its Market Risk Amendment in 1996, the Basel Committee has envisaged the use of both standardised and advanced methods for determining capital charges, with the former applying to less complex businesses. In fact, this simpler, standardised approach is associated with higher capital requirements. And a number of jurisdictions currently apply specific rules to purely domestic banks.

Yet, when applying the principle of proportionality, we should give due consideration to the potential consequences that may result from heterogeneous regulatory requirements. For example, we should consider what impact such heterogeneity might have on the resilience of individual institutions, or on the domestic competitive environment.

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[3] See FSB, "Implementation and effects of the G20 Financial Regulatory reforms: 3rd Annual Report", 3 July 2017, www.fsb.org/wp-content/uploads/P030717-2.pdf (in particular, pp 10–15) and "Ten years on – taking stock of post-crisis resolution reforms", 6 July 2017, www.fsb.org/wp-content/uploads/P060717-3.pdf.

Assessing whether standards, once implemented, achieve their objectives

The second dimension of implementation relates to assessing the reforms' impact once we gain some experience with operating under the new rules. Given the wide scope of the reforms, spanning virtually all segments of financial activity, it is necessary to assess their combined impact on the financial system and on the real economy.

Since the early stages of designing the current reforms, there have been significant efforts to assess their potential impacts. As these reforms are being implemented, more valuable information is becoming available to assess whether the new rules are working as intended and whether they generate adverse unintended effects. These can include the excessive shift of risks towards less regulated areas,[4] the reduced liquidity in some securities markets or the retrenched provision of correspondent banking services to some countries. Such assessments no doubt require a comprehensive and inter-sectoral approach to grasp the whole range of effects that the new standards could generate.

This comprehensive analysis should build on the extensive impact assessments conducted by each standard setter. For instance, the Basel Committee began conducting impact assessments more than a decade ago, when finalising Basel II. Ever since, it has developed and refined its methodologies, conducting increasingly elaborate assessments of its standards.[5]

The next logical step is to systematically conduct and generalise these types of assessments. Indeed, the FSB, in cooperation with the relevant standard setters, has recently launched a methodological framework[6] for the evaluation of the post-crisis reforms so as to analyse their overall effects and to compare these with their objectives.

In this context, two elements seem to be critical to me:

The first is about the need for fact-driven analysis as well as data availability and quality. To assess the impact of reforms, we will need sufficient practical experience with the reforms and long enough series of robust data. The usefulness of these assessments for policy recommendations will depend on the extent to which they can identify and measure the effects of regulation. Gaining experience and gathering good data will take time. Good collaboration with the private sector will thus be crucial. It may also require an additional effort by private sector stakeholders to ensure the quality of their IT systems and the information they can provide.

The second critical point about assessment methodology – and perhaps the biggest challenge in this regard – is the need to establish some kind of reference point, some kind of measurable benchmark that helps to capture the social benefits and costs of the reforms. This will help determine whether the actual outcomes are satisfactory and sufficient to meet the reforms' intended objectives.

In any case, this collaborative effort at the FSB, when combined with all of the ongoing impact assessments conducted by the individual standard setters, will no doubt help address concerns about potential imperfections in the different standards.

At the same time, we should be careful to avoid the impression that there will be frequent adjustments to the regulatory standards. Otherwise, we would be contradicting our objective to achieve

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[4] See FSB, "Assessment of shadow banking activities, risks and the adequacy of post-crisis policy tools to address financial stability concerns", July 2017, www.fsb.org/wp-content/uploads/P300617-1.pdf.

[5] See the Basel Committee's Regulatory Consistency Assessment Programme (RCAP) and other implementation efforts at www.bis.org/bcbs/implementation.htm.

[6] See FSB, "Framework for post-implementation evaluation of the effects of the G20 financial regulatory reforms", 3 July 2017, www.fsb.org/wp-content/uploads/P030717-4.pdf.

soon a sufficiently stable and predictable regulatory environment. This stability is also critical for an evidence-based assessment of the impact of the reforms over time.

Putting in place supervisory frameworks that maximise the benefits of new standards

The third dimension of policy implementation is to have supervisory frameworks that help support and maximise the positive effects of the regulatory reforms on the proper functioning of the financial system. This is a broad topic that includes resources, powers, methodologies, cooperation, etc. Let me focus on a few specific observations.

First, the crisis has confirmed the need for supervisors to take a more comprehensive approach to address the build-up of vulnerabilities at financial institutions. Accordingly, they are now increasing their efforts to directly assess asset quality, proper classifications, valuations and provisions. At the same time, supervisors are combining this traditional focus with greater attention to corporate culture and governance, including the framework for risk appetite and the compensation system. All these elements must be part of their comprehensive efforts to identify vulnerabilities. Importantly, authorities are now complementing the traditional microprudential focus of their supervisory programmes with a macro perspective. This allows them to better assess system-wide risk concentrations, the build-up of financial imbalances and procyclical effects.

Supervisory priorities and practices are also becoming more forward-looking. Over the last few years, national supervisors have increasingly combined the analysis of financial statements, supervisory reporting and on-site inspections with stress testing exercises to assess banks' resilience under different risk scenarios. Supervisors are also assessing and challenging the sustainability of banks' business models in order to anticipate difficulties.

More cooperation across authorities when conducting stress tests could enhance the analysis. This would help, for instance, to improve the assessment of cross-border spillover effects. It would also help to take these effects into consideration in a more consistent manner across jurisdictions.

Another key lesson reconfirmed by the crisis is the need for supervisory intervention to be more proactive. This generally means earlier and perhaps more forceful interventions that address problems well before the situation deteriorates to the point of non-viability. Proactive supervisory interventions have long been a known challenge because they involve delicate trade-offs. In particular, they rely not only on early identification of problems, but also on the exercise of just enough supervisory discretion and supervisory powers to solve the problems at stake. Doing too much would risk arbitrary intervention. Doing too little would risk complacency.

Last but not least, technological innovations are facilitating the emergence of new players in the market for financial services. That in turn is forcing supervised institutions to change and to adapt their business models. These changes can increase the efficiency of the industry. In some jurisdictions, they may also encourage financial inclusion. But at the same time, innovations and new players also mean that the nature of the risks affecting the financial system is evolving. All these developments require specific policy attention by both conduct of business supervisors and prudential supervisors. The Basel Committee's current public consultation on the implications of fintech for the financial sector is one recent case in point.[7]

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7 See BCBS, *Sound Practices: Implications of fintech developments for banks and bank supervisors*, August 2017, www.bis.org/bcbs/publ/d415.pdf.

Concluding remarks

Let me conclude. I started my intervention by highlighting the magnitude of the post-crisis regulatory reforms and their progress. These reforms will help the orderly functioning of the financial sector. They will promote systemic stability and, therefore, sustainable growth. That being said, there is no room for complacency. We certainly need to work more, especially – but not exclusively – on policy implementation. Avoiding watering down what we have achieved so far, completing Basel III and implementing the reforms in a consistent and timely manner are top priorities.

I want to reiterate, however, that the task of maintaining financial stability goes beyond ensuring effective regulation and supervision. The vulnerabilities in the financial system often have multiple causes. It is therefore important to recognise the interactions across policy domains in order to deliver an adequate combination of policy actions – a combination that helps to meet all objectives effectively.

This can only be achieved through the work of the international regulatory community. Without the dedicated spirit of cooperation across national authorities, the substantial strengthening of regulations governing the functioning of the financial system would not have been possible. We should certainly maintain this attitude and level of commitment in order to deal effectively with the challenges that lie ahead of us.

One key aspect of this cooperation is the exchanges of practices and experiences among regulators and supervisors to help ensure that sound policy approaches are adopted worldwide. I believe that the Financial Stability Institute can support the standard setters in this regard and should continue to play a key role in promoting the adoption of good policy practices across jurisdictions. This work goes well beyond the dissemination of standards. It also includes, as the FSI is now doing, facilitating information-sharing and providing analysis that helps financial sector authorities identify the appropriate policy approaches. I believe that this conference organised by the FSI fits very well with the objective to promote reflection and cooperation, across countries and sectors, in the field of policy implementation.