Basel Committee on Banking Supervision

BANK FOR INTERNATIONAL SETTLEMENTS

Basel III: Are we done now?

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Introduction

Good morning, and thank you for inviting me to deliver the keynote speech.

The title of this conference is "Basel III: Are we done now?". Let me answer this question at the outset: yes, we are done, but that doesn't mean the work has ended. In some respects, it's only just beginning. While finalising Basel III was an important milestone, work remains to (i) implement Basel III nationally in a full, timely and consistent manner; (ii) evaluate its effectiveness in reducing the excessive variability of risk-weighted assets (RWAs); and (iii) continue to monitor and assess emerging risks. My remarks this morning will focus on these three topics.

Basel III: from 2010 to 2017

But let me start with a brief review of the Basel III framework, which has been ten years in the making.

As you know, the Basel III framework is a central element of the Basel Committee's response to the global financial crisis. The initial phase of Basel III reforms, published in 2010 (BCBS 2010(a)), focused on addressing some of the main shortcomings of the pre-crisis regulatory framework, including:

- improving the quality of bank regulatory capital by placing a greater focus on going-concern loss-absorbing capital in the form of Common Equity Tier 1 (CET1) capital;
- increasing capital requirements to ensure that banks can withstand losses in times of stress;
- enhancing risk capture by revising areas of the risk-weighted capital framework that proved to be acutely miscalibrated, including the global standards for market risk, counterparty credit risk and securitisation;
- adding macroprudential elements to the regulatory framework, by: (i) introducing capital buffers that are built up in good times and can be drawn down in times of stress to limit procyclicality; (ii) establishing a large exposures regime that mitigates systemic risks arising from interlinkages across financial institutions and concentrated exposures; and (iii) putting in place a capital buffer to address the externalities created by systemically important banks;
- specifying a minimum leverage ratio requirement to constrain excess leverage in the banking system and complement the risk-weighted capital requirements; and

- introducing an international framework for mitigating excessive liquidity risk and maturity transformation, through the Liquidity Coverage Ratio and Net Stable Funding Ratio.

These reforms have demonstrably helped to strengthen the global banking system. Since 2011, the Tier 1 leverage ratio of major internationally active banks has increased by over 65% (from 3.5% to 5.8%), while their CET1 risk-weighted ratio has increased by over 70% (from 7.2% to 12.3%). The bulk of this change was achieved by an increase in banks' CET1 capital resources (from €2.1 trillion to €3.7 trillion). There has also been a corresponding reinforcement of banks' liquidity: holdings of liquid assets have increased by 30% (from €9.2 trillion to €11.6 trillion).

There are also clear social benefits from these reforms. During the global financial crisis, the weaknesses in the banking sector were transmitted to the rest of the financial system and the real economy, resulting in substantial costs. Ten years after the start of the crisis, the global economy is still recovering from its effects. These costs include much higher public debt, increased unemployment and substantial output losses. To give just one example, a recent study estimates that the cumulative output loss resulting from financial crises is in the order of 100% of GDP in net present value terms.[1] This output loss would probably have been much larger without the massive public sector interventions. The increase in banks' capital and liquidity resources will help mitigate both the probability and impact of future banking crises.

But a major faultline remained in the regulatory framework, namely, the way in which RWAs were calculated. At the peak of the global financial crisis, a wide range of stakeholders lost faith in banks' internally modelled risk-weighted capital ratios. The complexity and opacity of internal models, the degree of discretion provided to banks in modelling risk parameters, and the use of national discretions all contributed to an excessive degree of RWA variation. A growing number of studies by authorities, academics and the private sector pointed to a worryingly large variation in banks' estimated RWAs (BCBS (2013a,b)). For example, one study found that banks' reported capital ratios could vary by 50% for the same hypothetical portfolio.[2] The loss in the public's confidence in banks' reported capital ratios clearly highlighted the need for tighter limits to the way in which RWAs are calculated and greater transparency.

The recently finalised Basel III reforms seek to restore the credibility of RWA calculations, and as a result the public's confidence in the banking system, by:

- enhancing the robustness and risk sensitivity of the standardised approaches for credit risk and operational risk, which will make banks' capital ratios more comparable;
- constraining the use of internally modelled approaches, including by removing the use of the most advanced modelled approaches for certain credit risk asset classes and for calculating operational risk; and
- complementing the risk-weighted capital ratio with a finalised leverage ratio and a revised and robust output floor.

Collectively, the set of Basel III reforms addresses a number of shortcomings in the pre-crisis regulatory framework and provides a foundation for a resilient banking system that will help mitigate the impact of future banking crises and the build-up of systemic vulnerabilities. The post-crisis framework will also help the banking system support the real economy and contribute to economic growth.

[1] Fender and Lewrick (2016).

[2] BCBS (2013a).

Full, timely and consistent implementation: more than just words

But are these reforms enough, or does more need to be done? The answer depends in part on the extent to which the reforms are implemented in a full, timely and consistent manner across jurisdictions. To borrow the words of Goethe (1829): "willing is not enough, we must do".

The Basel Committee's standards are global *minimum* standards. The Committee has no supranational authority, its decisions carry no legal force, and it cannot impose fines or sanctions. Rather, once the Committee agrees on a standard, its member jurisdictions are responsible for converting this standard into law or regulation. So internationally agreed standards that are not properly implemented will ultimately have no impact in practice. It is therefore imperative that the Basel standards are effectively implemented by all the Committee's jurisdictions.

To this end, the Committee's flagship Regulatory Consistency Assessment Programme (RCAP) monitors the timely adoption of Basel standards across jurisdictions and reviews whether standards are completely and consistently adopted by member jurisdictions. They also highlight any deviations from the Basel framework. As a result of the RCAPs, over 1,200 deviations were identified as part of the peer reviews focusing on the initial Basel III capital reforms. Two thirds of Basel Committee members have risk-weighted capital standards that are considered compliant or largely compliant with the Basel standards.

Looking forward, the RCAP will continue to play a key role in ensuring that the recently finalised Basel III reforms are implemented as agreed by the Committee. But let me stress three points.

First, in developing its standards, the Committee actively seeks the views of all stakeholders, public and private. For example, in finalising Basel III, the Committee consulted extensively with academics, analysts, banks, finance ministries, parliamentarians, market participants and trade associations as well as the general public. These views were duly considered by the Committee in finalising its standards. So there are plenty of opportunities for all stakeholders to express their views before the standards are finalised. The focus then should be on full, timely and consistent implementation.

Second, in endorsing the finalised Basel III reforms, the Group of Governors and Heads of Supervision (GHOS) has unanimously reaffirmed that they expect full, timely and consistent implementation "of all elements" of the Basel III package (BCBS (2017a)). So I take comfort that all of the Committee's members keep this aim in the forefront of their minds during the implementation phase.

Third, the move to national implementation should not be read as an invitation to reopen policy issues and debates at a domestic level. While the varying legislative and procedural arrangements used to implement Basel standards across the Committee's membership must be fully respected, It is concerning to see ongoing lobbying efforts by some banks and other stakeholders to undo or dilute aspects of the agreed Basel standards in some jurisdictions. The unsound expedient of adopting standards that fall below the Basel Committee's minimums can only lead to regulatory fragmentation, and in a bad scenario a potential race to the bottom.

Just getting up close, as we like to say in Sweden, isn't enough to shoot the hare.

Reducing excessive RWA variability: mission accomplished?

Assuming that the Basel reforms are properly implemented, will they reduce excessive RWA variability and restore the credibility of the risk-weighted capital framework? While I am confident that the Basel III reforms are an important step in that direction, the honest answer is that only time will tell.

To that end, the Committee has initiated a rigorous evaluation of its post-crisis reforms, including those that relate to reducing excessive RWA variability. As the reforms will only start to be implemented from 2022 onwards, this exercise will take several years. But I believe that the Committee should remain open to the possibility of considering whether additional measures, or revisions to existing measures, are warranted to reduce excessive RWA variability.

In a similar vein, the Committee is also further evaluating the interactions and coherence of its post-crisis reforms. The findings will provide an important input for future deliberations by the Committee about the robustness and effectiveness of its post-crisis framework.

I will not prejudge the outcomes of these evaluations, but let me make three observations. First, the purpose of these evaluations is not to reopen already agreed standards. Second, the Basel Committee is a member-led and consensus-based body. Accordingly, the Basel III reforms are a compromise that reflects the different views of its members. Third, as the Basel reforms are minimum standards, jurisdictions are welcome to apply more conservative requirements should they wish to do so. This could include faster transitional arrangements and/or more conservative steady-state requirements.

Enhancing financial stability: an ongoing journey

If the Basel reforms do reduce excessive RWA variability, is the job then done? Probably far from it. Banking crises are inevitable. So, while the Basel standards cannot prevent all future crises, they can seek to mitigate their likelihood and impact. This, in turn, requires the Basel Committee to remain vigilant for emerging conjunctural and structural risks. It also needs to monitor how banks are responding to its post-crisis reforms. All this highlights the importance of supervision as a complementary tool to regulation. Let me say a few remarks about both these issues.

Emerging risks

An example of a topical risk of direct relevance for the Basel Committee is cyber-risk. The banking system is increasingly reliant on information technology, which exposes it to a growing and evolving set of operational risks. Banks with operationally resilient systems, staff, processes and technology can better adapt to evolving shocks and maintain the provision of critical financial services. The Committee is reviewing its existing cyber-risk measures and will consider whether additional measures are needed to enhance banks' operational resilience.

Behavioural responses to post-crisis reforms

With the Committee's post-crisis reforms now finalised, and with only minor technical issues remaining, the Basel Committee will carefully monitor banks' responses to its reforms. It will continuously assess banks' behavioural responses, and the potential emergence of any optimisation or arbitrage techniques that may not meet the letter or spirit of the Basel standards. In this case, it will consider whether any measures are needed to address such issues.

Supervision

The Committee's response to the global financial crisis included much more than just regulation. It also encompassed a range of measures to support strong supervision. These include principles and guidance on corporate governance, risk data aggregation, the prudential treatment of assets, the treatment of weak banks and an updated set of core principles for effective banking supervision. The Committee will step up its efforts to promote improvements in banking supervision practices and principles.

Conclusion

In summary, the finalisation of Basel III in December 2017 represents an important milestone for the Basel Committee's response to the global financial crisis. The full set of Basel III reforms will help enhance the resilience of the banking system. But we cannot rest on our laurels. Whether it relates to the proper implementation of these reforms, their evaluation, or the assessment of emerging risks, the Basel Committee will continue to exercise its mandate to strengthen the regulation, supervision and practices of banks worldwide. The agenda changes, but the purpose is constant – to safeguard and enhance financial stability.

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