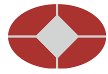
Basel Committee on Banking Supervision

BANK FOR INTERNATIONAL SETTLEMENTS

Covid-19 and banking supervision: where do we go from here?

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Introduction

Good morning, good afternoon and good evening. Welcome to the 21st International Conference of Banking Supervisors (ICBS).

This is my first ICBS, following my appointment as Chairman of the Committee in March of last year. But I had long heard about its reputation as the premier global banking conference for central banks and supervisory authorities. For over 40 years since its inception, the ICBS has been a key forum for senior central bankers and bank supervisors from more than 100 countries to discuss topical supervisory issues. Its enduring success is a testament to the ongoing importance that we all attach to cross-border cooperation, a theme which I will return to. While this year's ICBS is being held in a somewhat different format, I have no doubt that it will continue to build on its historical achievements.

I would like to start by thanking Governor Macklem, Superintendent Rudin and their teams at the Bank of Canada and the Office of the Superintendent of Financial Institutions for hosting this year's ICBS virtually. I am sure that I speak on behalf of all participants in saying that we would have loved to be in Vancouver, the vibrant heart of beautiful British Columbia. But we can still recognise the fitting choice of this virtual venue. Vancouver has long been the financial centre of British Columbia's resource economy. A recent history of this role vividly depicts how "stock brokers, financial agents and bankers played essential roles as intermediaries in the fluid commercial life of early twentieth-century Vancouver".[1] What's more, the Vancouver Stock Exchange was incorporated in 1907 – almost 30 years before the Bank of Canada was founded!

Tiff and Jeremy, while we may be physically distanced around the world at this year's ICBS, you and your organisations have done an excellent job at ensuring that we remain socially together this week. Thank you.

The overarching theme for this year's ICBS - the future of supervision in a changing world – is perhaps more relevant than ever before. The world has changed profoundly since the outbreak of Covid-19 seven months ago. The uniqueness of the sudden stop to the global economy in response to the tragic health crisis is only matched by the sheer uncertainty about the outlook. To borrow a sports metaphor, we still do not know if we are in the first inning, quarter or half of this crisis. Uncertainty is the only certainty there is.[2]

[1] Poitras (2019).

[2] Paulos, J (2003).

So what is the future of supervision in this changing world, and what can we learn from the current crisis? When the former Chinese premier Zhou Enlai was asked in 1972 about the impact of the French Revolution of 1789 – or, as is now generally accepted, the civil unrest of May 1968 – he famously replied that it was "too early to say".[3] Given that we've yet to reach the four year mark since the start of the pandemic – let alone the 184th anniversary! – it would be premature to provide a definitive discourse at this stage.

Yet we have already seen fundamental changes to the way we live and work. For example, we witnessed a tremendously rapid shift to remote working arrangements across many sectors. Professor Prithwiraj Choudhury will discuss the implications of the 'working from anywhere' geographic flexibility in more detail on Wednesday, and we will have the opportunity to discuss what this means for supervision. These changes, whether temporary or permanent, offer some clues about the future landscape.

So there is merit in starting a discussion about what we have learned to date and, more importantly, the future and changes that we want to see in banking supervision. Allow me to outline some personal thoughts on these issues, which may not necessarily represent the view of the Basel Committee.

The supervisory response to a global pandemic: a lesson in global cooperation

Let me start by briefly reviewing the Committee's response to Covid-19. At its last physical meeting in February of this year, the Committee discussed the financial stability implications of the coronavirus outbreak for the banking system and underlined the importance of effective cross-border cooperation in dealing with the ensuing crisis.[4] Since then, it has demonstrated its unwavering commitment to such cooperation, with no fewer than 16 virtual meetings.

In March, the Committee quickly developed a comprehensive strategy to respond to the pandemic underpinned by three objectives. First, safeguarding the financial and operational resilience of the global banking system. Second, ensuring that banks continue to lend to creditworthy households and businesses. And third, ensuring that authorities and banks have sufficient operational capacity to address short-term financial stability priorities.

To that end, we agreed on a range of measures to help meet these objectives.[5] To amplify the effect of the range of government support measures and payment moratoria programmes, the Committee issued technical guidance to ensure that these risk-reducing measures are reflected in banks' capital requirements. To avoid the potential for excessively procyclical dynamics, the Committee set out expectations that banks use the flexibility inherent in expected credit loss (ECL) accounting frameworks to take account of the mitigating effect of Covid-19 support measures. It also provided jurisdictions with greater flexibility in deciding whether and how to phase in the impact of ECL on banks' regulatory capital..[6] And the Group of Central Bank Governors and Heads of Supervision (GHOS) endorsed the Committee's decision to defer the implementation of the outstanding Basel III standards by one year.[7] Importantly, all

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[3] Cowen, T (2011).

[4] BCBS (2020a).

[5] BCBS (2020c).

[6] BCBS (2020e).

[7] BCBS (2020b).

GHOS members unanimously reaffirmed their expectation of full, timely and consistent implementation of all Basel III standards based on the revised timeline.

The degree of collaboration demonstrated by the Committee in its response to Covid-19 is truly remarkable. It is a testament to the strong willingness of our members to cooperate on global financial stability, building on the long and strong track record of dispassionate dialogue and collaboration by the Committee.

History has shown that collective measures to tackle global problems reinforce individual countries' efforts. This time is not different: ongoing global cooperation is key to ensuring a safe banking system that supports the economic recovery. Combatting infectious diseases and safeguarding financial stability are both global public goods which know no borders and require collaboration among countries. We must avoid fragmented and disjointed measures. The path of splintered measures will neither stop this virus nor provide the bedrock of safe and sound banking system.

Initial observations from the pandemic

So what are some of my initial observations about what Covid-19 has taught us about bank supervision and regulation to date? I will sum them up in the form of a resilience anaphora.

First, resilience matters before a crisis emerges. The banking system has thus far been the dog that has not barked (loudly) in this crisis. This is largely thanks to the enhanced resilience of banks emanating from Basel III and related post-Great Financial Crisis (GFC) reforms, and the unprecedented degree of fiscal and monetary support provided by authorities in response to the pandemic. Covid-19 serves as a reminder to all on the importance of having a resilient banking system, underpinned by global and prudent standards. Let us not forget this lesson.

Second, resilience matters during a crisis. Looking ahead, there is no shortage of risks facing the banking system. While the theme of our conference is rightly focused on the future, we are still very much in the depth of the current crisis. The umbilical cord tying banks to the real economy means that banks cannot remain immune from deteriorating macroeconomic conditions. Many 'adverse' stress test scenarios conducted before the pandemic could become the baseline today. It is a question of when, not if, banks' asset quality will deteriorate in this crisis. A resurgence in Covid-19 cases coupled with the unwinding of support measures could further magnify the crystallisation of bank losses. The mutation of this crisis into a banking one would be devastating. A decade after the global financial crisis, output levels remained below pre-crisis trends for 60% of economies.[8]

Importantly, banks now have tools in their hands to navigate the choppy waters and ensure that they do not become part of the problem. Most notably, the Basel III capital and liquidity buffers could be a powerful lever for banks to absorb shocks and maintain lending. Since the start of this crisis, the Committee has publicly reiterated its position that a measured drawdown of buffers to meet these objectives is appropriate, and that supervisors will provide sufficient time for banks to restore these buffers.[9] Using these resources to absorb shocks and support households and businesses should take priority at present over discretionary distributions.

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[8] IMF (2018).

[9] BCBS (2020d).

In addition to mitigating financial risks to the global banking system, another ongoing area of focus for the Committee is to safeguard banks' ability to deliver critical operations through disruption. To that end, the Committee is consulting on a set of principles to improve operational resilience.[10]

More generally, Committee members are closely cooperating in monitoring the risks and vulnerabilities to global banking system as the crisis continues to unfold. The Committee will pursue additional measures if needed.

Third, resilience matters after a crisis. Safeguarding global financial stability requires us to ensure that the regulatory framework remains robust to arbitrage and erosion over time. This is why the Committee has a comprehensive work programme to evaluate its post-crisis reforms.[11] The Committee is conducting a range of empirical analyses based on the experience over the past decade and the current crisis to evaluate the extent to which our reforms have achieved their objectives, the interactions among the reforms, and whether there are any gaps or significant unintended effects.

This evaluation work is agnostic to the final outcome and driven only by rigorous empirical analyses on the Basel III reforms that have already been implemented. Far too often, terms such as "unintended outcomes" are regrettably misinterpreted as an invitation to re-open previously-agreed reforms or as pointing to a unidirectional path towards a weakening of standards. This is far from the case with our evaluation work. In principle, any identified gaps in our framework could require additional, not fewer, regulatory measures.

In the spirit of stimulating some of our discussions over the next four days, let me set out a few questions in three areas about our current framework which may warrant further reflection. These should in no way be construed as prejudging the Committee's own evaluation or hinting towards future initiatives.

First, is there a need to have a greater layer of usable buffers in 'steady state' that can be promptly drawn down in times of stress? There has been an active debate in monetary policy recently on the 'neutral' rate of interest, which is neither accommodative nor restrictive.[12] A clear analogy in bank supervision would be about the role and calibration of the countercyclical capital buffer or a similar buffer at different points of the cycle. Is there a need for a positive 'cycle-neutral' buffer rate, and, if so, how should such a rate be determined?

Second, should more be done to simplify the regulatory framework? The Committee has made great progress over the past years in seeking to rebalance the degree of simplicity, comparability and risk sensitivity in the Basel framework. But are there aspects of the framework that are still unduly complex and therefore hindering the resilience of the banking system? Are there merits in further exploring the role of proportionality in the Basel framework? Examples could include promoting further exchanges of information on the use of proportionality across jurisdictions, the development of high-level principles or a set of simplified approaches that could serve as a starting point for designing a proportionate approach.

Third, have we struck the right balance between regulation and supervision? Most of the Committee's reforms over the past decade have focused on the former. Yet supervision is an integral aspect of the Committee's work. Indeed, many of the responses taken by members at the domestic level to Covid-19 are examples of supervision in action. The impact of the low-interest rate environment during the past decade on banks' business models and risk appetite has been exacerbated by the current crisis. In addition to overseeing and mitigating risks to banks, supervision will also need to ensure that banks'

[10] BCBS (2020e).

[11] Hernández de Cos (2019b).

[12] See, for example, Powell (2018).

business models remain viable. To that end, should more be done to further promote effective supervisory practices and coordination across jurisdictions?

Covid-19: A catalyst for change....

Throughout history, many have rallied behind the Churchillian call to "never let a good crisis go to waste". We have the opportunity during this year's ICBS to rethink the world of banking supervision and shape it in a way to be fit for purpose in the new normal environment after the pandemic. Let me outline some examples of possible areas that could warrant further discussions.

First, as the financial system continues to evolve, what role will banks play in the future? Hardly a day goes by without a mention about the rise and rise of non-bank financial intermediation, the disruptive nature of financial technology, the promises of big data, ever-greater automation and even 'cyborg supervision'.[13] The current pace of innovation and digitalisation is faster than in previous decades, with the rate of adoption increasing commensurately.[14] Fintech promises a lot, whether with regards to more tailored, efficient and faster banking services, lower transaction costs or financial inclusion.

The ongoing digitalisation of finance also presents risks and challenges to the banking system, which Covid-19 has further magnified. This includes the evolving nature of cyber-attacks to banks and the growing reliance on third-party service providers. The technology-enabled disruption could result in a fundamental change in the 'value-chain' of banking services, with an increasing role played by new technology-driven banks, financial technology companies and big tech.

In addition, existential debates are underway about the role of money, whether in the form of private crypto-assets or central bank digital currencies, which could also impact the banking system.[15] Will we see a paradigmatic change in the world of banking as we know it? Or are the rumours about the imminent death of banking greatly exaggerated?

One thing is certain: banking has always evolved throughout history and will continue to do so. I've previously discussed the 150-year symbiotic relationship between finance and technology.[16] And money has continuously taken different forms throughout history. To give just one example related to our virtual venue this week, the Indigenous Kwakwaka'wakw peoples of the Pacific Northwest Coast made use of wool blankets as a form of currency – a far cry from today's discussions about smart contracts and distributed ledger technology![17]

The implications of these developments for supervisors are threefold. First, proactive supervision must be the primary response to these changes, as the traditional regulatory framework may not be sufficient. Second, greater consideration should be given to the regulatory perimeter to ensure that the oft-cited mantra of 'same activities, same risks, same rules" is actually operationalised. And third, cooperation among different authorities – spanning both monetary and regulatory authorities – will be even more important, given the cross-sectoral and cross-cutting nature of the policy issues raised by these technological innovations.

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[13] Proudman (2018).

[14] Hernández de Cos (2019c).

[15] See, for example, BIS (2018).

[16] Hernández de Cos (2019c).

[17] Hawthorn (1988).

So while there has rightly been a greater focus on the non-bank corridors of the financial system, it is imperative that we continue to vigilantly oversee the resilience of the banking system. True, banks' business models may evolve over time and the provision of financial services may be offered by a broader array of entities and channels in the future. But banks will remain interconnected with other parts of the evolving financial system through far-reaching tentacles. Supervisors will need to proactively identify and map these interconnections. More than ever, they will need to apply a holistic approach to assessing and mitigating the risks to the banking system from these channels, including through the development and use of additional macroprudential tools, if needed.

Second, should there be a greater prudential focus on bank conduct, ethics and incentives? Is there scope for greater collaboration among different types of authorities on cross-cutting issues? The GFC exposed serious deficiencies in these areas. In some instances, misconduct by a few 'rotten apples' in the system threatened to undermine the robustness of the barrel. In response, international bodies and authorities in charge of conduct and market integrity have rightly led the efforts to address these fault lines.[18]

Yet episodes of malpractice and related behaviours have clear prudential implications too. They may point towards broader deficiencies in banks' governance and risk management standards. Conduct-related fines to banks over the past decade totalled hundreds of billions of euros, and proved to be a significant driver of provisions and at times a source of risk to banks' capital strength.[19] And, even more importantly, ongoing misconduct practices erodes trust between the banking system and the public. A moral 'run on the bank' would have significant prudential implications.

Third, what more can supervisors do to anticipate longer-term systemic risks stemming from outside the financial system? Traditionally, our focus on safeguarding the safety and soundness of banks has centred primarily around the dynamics of the financial cycle. But Covid-19 is a reminder that exogenous low-probability, high-impact shocks can inevitably find their way to the banking system as well. And slow-moving but longer-term structural trends in our societies can also have financial stability implications. How often can we continue to write-off such incidents as a 'once in a lifetime' or 'one-off' events that could not be foreseen?

Examples of such shocks abound. Perhaps most notably, climate change has clear financial stability implications.[20] This is why the Committee set up a high-level Task Force on Climate-related Financial Risks, which is developing a set of analytical reports on the transmission channels and measurement methodologies of such risks, and will subsequently develop effective supervisory practices. Other examples of longer-term structural dynamics and shocks that could impact the banking system include changing demographics, income inequality, and space weather.[21] To what extent should, and can, central banks and supervisors anticipate and mitigate the impact of these different shocks and longer-term trends on the banking system? How can we delineate the relative roles of different possible responses, be they fiscal, monetary, structural or regulatory in nature?

I won't attempt to provide the answers to these questions, but I hope that they provide some stimulus in thinking through the potential catalysts for change in bank supervision.

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[18] See, for example, FSB (2015).

[19] See, for example, Köster and Pelster (2018).

[20] See, for example, Bolton et al (2020).

[21] See, for example, Goodhart and Pradhan (2017), Mian et al (2020), and Krausmann et al (2014).

…or more of the same?

A critical pre-condition to catalysing any changes we want to see in banking supervision is ensuring that we collectively lock-in the benefits from Basel III through a full, timely and consistent implementation. This is essential to ensuring that we do not revert to 'business-as-normal' once the crisis abates.

Even though the crisis significantly disrupted global economic activity, with a soaring in unemployment and distress, the gravity of the situation quickly paved way to the bathos of lobbying pressures to dilute global standards and weaken the resilience of the banking crisis.

You would be forgiven for wondering whether I am referring to the current crisis or the GFC. The answer is both. As was the case during the past decade, when it comes to Basel III implementation, we are once again seeing the regrettable re-emergence of the regulatory cycle, characterised by signs of amnesia and the fallacy of "this time is different".[22] Symptoms include market fragmentations due to deviations and non-implementation of global standards. Its effects were detected in multiple regions around the world before Covid-19, and are starting to re-emerge again.

The Basel III framework is a central element of the international community's response to the GFC. It was developed address the glaring fault-lines in the banking system. These fault-lines include unsustainable growth in leverage and credit, inadequate loss-absorbing capital, and excessive exposure to liquidity risk. The importance of safeguarding against these shortcomings is as important today as it was a decade ago. There is vast empirical evidence on the benefits of prudent regulation for lending and growth.[23] It falls to all of us to help ensuring that we secure the real economic benefits from implementing the Basel III framework in a full, timely and consistent manner

Conclusion

In conclusion, the Committee's timely and comprehensive response to Covid-19 is another chapter of its long and successful history of global cooperation. As supervision adapts to the challenges of the future, global cooperation should be inclusive in nature and involve a wide range of stakeholders. We must avoid the silo effect of listening only to a subset of our stakeholders, which is a recipe for tunnel vision and regulatory capture. The work of the Committee benefits from an extensive outreach with other global standard setters and international fora, including the G20 and Financial Stability Board, academics, market participants, and the general public. This outreach is integral to the way in which we meet our mandate.[24]

Over the coming days, we will have the opportunity to discuss and help shape the future of banking supervision. A critical catalyst to see through these changes is the implementation of all aspects of the Basel framework by our members.

I wish you all an enjoyable ICBS and look forward to the interesting discussions ahead.

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[22] Hernández de Cos (2019c).

[23] See, for example, Gambacorta and Shin (2018).

[24] Hernández de Cos (2019a).

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