Research and the Basel Committee on Banking Supervision

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Introduction

Good afternoon, and thank you for inviting me to speak at this year's EBA Policy Research Workshop.

As many of you know, research is critical to the work of the Basel Committee. Since its inception in 1974, the Committee's work has been grounded on two key analytical principles:

- First, policy and supervisory initiatives should be based on rigorous conceptual and empirical analyses; and
- Second, there is a need to engage extensively and transparently with a wide range of external stakeholders, including academics. Unlike with global pandemics, self-isolation is not an option for effective policymaking and supervision. Whether it is through our research conferences, working papers or ad hoc outreach events, the Committee places great weight on the input of researchers.

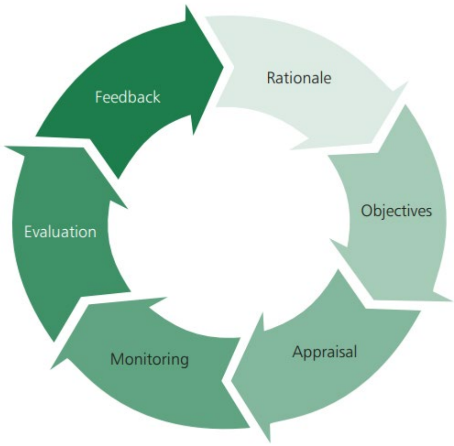
I will focus my remarks today on the relationship between the Committee and research. I will first review some examples of how research has contributed positively – and, at times, somewhat less positively – to the work of the Committee in the past. I will then discuss some of the topical initiatives on the Committee's work programme that would benefit greatly from academic input.

Research: a powerful tool for policymakers…

Research has always influenced the design and evolution of the Basel framework.[1] Since the hoary days of Basel I, the Committee has relied extensively on analytical inputs from its members – including in-house researchers at central banks and supervisory authorities – and external academics. In many instances, such research has triggered a virtuous cycle of an enhanced regulatory framework that, in turn, is subject to further research to monitor its impact, assess its effectiveness and consider further enhancements if needed. Indeed, effective policymaking should draw on research at each stage of the so-called policy lifecycle (Figure 1).

[1] Goodhart (2011).

Figure 1: Stylised policy lifecycle



Source: Adapted from HM Treasury (2018).

Let me highlight two notable and recent examples of the important role of research for the Committee.

First, in finalising the calibration of Basel III, the Committee conducted a wide range of studies on the short- and long-term economic impact of stronger capital and liquidity requirements.[2] It also conducted a series of "top-down" assessments of the overall optimal level of capital in the banking system.[3] These analyses drew on state-of-the-art research by our own members and academics.

Importantly, we did not conduct this work as a rubber-stamping exercise or as an ex post rationalisation of the final Basel III calibration. These studies provided the foundation for subsequent research on optimal capital and liquidity requirements. Indeed, a recent literature review by the Committee of research over the past decade finds that the range of estimates for the optimal level of capital requirements is likely to be either similar to or higher than the Committee's original estimate.[4] The Covid-19 pandemic has further demonstrated the net benefits of having a resilient banking system underpinned by a prudent regulatory framework.[5]

Second, research played a paramount role in the design of the Basel III macroprudential framework. The extensive literature on credit cycles and the interconnectedness of the financial system provided the much-needed intellectual stimuli for the Committee to incorporate a macroprudential overlay in the Basel framework.[6] This fed directly into the design and calibration of the countercyclical capital buffer and framework for systemically important banks.[7] These buffers are an important tool for banks during the Covid-19 crisis as they seek to absorb shocks and maintain lending to the real economy.[8]

2 BCBS (2010a, 2010d).

3 BCBS (2010b).

4 BCBS (2019).

5 Hernández de Cos (2020).

6 For example, Acharya and Richardson (2009) Adrian and Shin (2008), Aikman et al (2013), Borio and Lowe (2002, 2004), Brunnermeier (2009), Gorton and He (2008).

7 BCBS (2010c, 2013).

8 BCBS (2020).

….if handled with care

But there have also been instances where insights from research may have been taken on board overzealously in the regulatory framework, with less satisfactory outcomes.

Perhaps the most glaring example was the wholesale adoption of internally modelled approaches, starting with the market risk framework in 1996. Buoyed by modern portfolio theory and advances in modelling, the Basel II framework provided much greater discretion for banks in calculating their capital requirements.[9] This shift was motivated by the well-intentioned aim of increasing risk sensitivity, and with the belief that the use of internal models for regulatory purposes would create incentives for banks to improve their own risk management systems.[10]

In practice, and with the benefit of hindsight, the excessive reliance on internal models opened a Pandora's box. The Great Financial Crisis exposed the fault lines within the underlying assumptions about portfolio correlations and volatility-based risk measures.[11] Granting too much discretion to banks provided incentives to underestimate risk.[12] More generally, capital requirements for risk categories and asset classes with insufficient data and fat tails cannot be modelled robustly for prudential purposes. The excessive variability in banks' modelled capital requirements – as highlighted in the many hypothetical portfolio exercises conducted by the Committee – ultimately undermined the credibility of the risk-weighted capital framework.[13]

What lessons can we draw from this experience? First, the regulatory framework should rely on multiple metrics, which is more robust to arbitrage and erosion over time, as each measure offsets the shortcomings and adverse incentives of the others. The recently finalised Basel III standards are designed around this principle.[14] Second, in the light of the uncertainty that policymakers face when designing standards, it is always optimal to err on the side of prudence.[15] This is why Basel III constrains the use of internally modelled approaches. Third, and perhaps most importantly, strong supervision is an integral complement to the regulatory framework.

Evaluations, emerging risks and the role of research

Looking ahead, how can research continue to assist the Committee in its current work programme? I see two key areas that are particularly ripe for academic input.

First, the Committee has a comprehensive work programme to evaluate its post-crisis reforms.[16] The Committee is conducting a range of empirical analyses, based on 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 empirical analyses of the Basel III reforms that have already been implemented. This is where academic research is crucial to provide

9 Markowitz (1952), Sharpe (1994).
10 BCBS (2013b).
11 Taleb (2012).
12 BCBS (2013b).
13 BCBS (2013c).
14 BCBS (2017).
15 Brainard (1967), Bahaj and Foulis (2017).
16 Hernández de Cos (2019).

a rigorous basis and to help counter the noise and *idées fixes* emanating from vested interests. If left unchecked, some of these popular narratives can go viral and ultimately undermine the resilience of the banking system – recall the experience of Basel II.[17] To this end, the Committee is seeking to appoint academic advisors to assist our evaluation work. I encourage all interested researchers to submit their nominations for these roles.[18]

Second, as the financial system continues to evolve and the risk environment changes, the Committee will need to draw on a wide range of research to help inform its supervisory and policy initiatives on topical issues. This includes work related to the ongoing digitalisation of finance, the role of banking in the future, and climate-related financial risks.[19]

Importantly, we will need to cast a wide net to draw on insights from fields beyond finance and economics. Policymakers and supervisors can and should learn from anthropology, organisational behaviour and natural sciences, to name just a few areas.[20] Tackling some of the emerging risks and trends in the banking system will require a fusion of insights from multiple disciplines.

While I have focused thus far on how researchers can help the Basel Committee, I would be remiss if I did not ask how the Committee can help researchers.[21] One notable area relates to data. As some of you know, the Committee collects granular data on banks' balance sheet and various regulatory items as part of its Basel III monitoring exercise. While we regularly publish studies that draw on this data, the Committee is keen to make some of it available to external researchers as well. Recently, the Committee set up a formal process for interested researchers to request the use of this data in response to calls for research proposals.[22] The greater use of this data will be of mutual benefit to researchers and the Committee, and will ultimately help deepen our regulatory and supervisory insights.

Conclusion

Let me conclude. Research has always been a critical input to the work of the Basel Committee. Looking forward, we will be drawing on research insights to help inform our evaluation of the Basel III reforms and to assist our supervisory and policy initiatives on topical issues and emerging risks. Today's workshop includes a number of interesting papers that touch on some of these issues, and I look forward to the upcoming sessions.

Thank you.

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[17] Shiller (2017).

[18] Further information is available at www.bis.org/bcbs/events/call_201030.htm.

[19] Stiroh (2020).

[20] Haldane and Turrell (2017).

[21] To borrow and adapt Kennedy's (1961) famous chiasmus.

[22] Further information is available at www.bis.org/bcbs/publ/d489.pdf.

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