Remarks of Nout Wellink
Chairman, Basel Committee on Banking Supervision
President, De Nederlandsche Bank

High Level Meeting on Better Supervision and Better Banking in a Post-crisis Era

FSI and EMEAP Working Group on Banking Supervision (hosted by Bank Negara Malaysia)

Kuala Lumpur, Malaysia, 17 January 2011

"Basel III and beyond"

I. Introduction

I would first like to thank Governor Zeti, Jozef Tošovský and EMEAP for inviting me to Kuala Lumpur to speak to you today. It is now one month after we published the Basel III rules for capital and liquidity, which is a milestone in global regulatory collaboration. With the publication of the Basel III rules, one can say that the Basel Committee has now moved from the standard setting to the implementation phase.

This morning I would like to review what the supervisory community has achieved in reforming the global regulatory system and to remind you why it was necessary. Basel III is a landmark achievement that required enormous resources and focus. As I will discuss in a moment, our shift from the standard-setting phase to the implementation means a much greater focus on intensive supervision. I will talk about implementation of the standards followed by a description of the Basel Committee's future work programme.

Before we look into the details of the work ahead of us, I would like to recall the motivation for the Basel III reforms and the main issues the reforms have addressed.

II. Basel III

While Basel III was designed to address the weaknesses of the past crisis, the Committee's main intent was to prepare banks and the banking sector for the next crisis. Let us remember that crises spill over, no matter where they emanate. The combination of globalisation and ever more rapid financial innovation means that all countries need to hold higher capital and liquidity buffers to protect the banking system and economy from unexpected risks. Unfortunately, memories tend to be short and significant risks to the banking sector persist. Let me recount some of the causes of the crisis:

- The financial crisis was triggered primarily by excess global liquidity, too much leverage, too little capital of insufficient quality, and inadequate liquidity buffers;
- It was made worse by a procyclical deleveraging process and the interconnectedness among systemically important financial institutions that were considered too-big-to-fail;
- A number of other factors also played a major role. These include major shortcomings in risk management, corporate governance, market transparency, compensation practices, and the quality of supervision. Risk management and supervision failed due to an overly narrow, firm-specific focus and an insufficient understanding of how broader system-wide risks could play out under stress.

Basel III was designed to address these shortcomings and, more importantly, to enhance both bank-specific soundness and wider banking sector stability. The framework includes firm-specific approaches but also incorporates macroprudential measures to help address systemic risk and interconnectedness.

- First, Basel III substantially raises the quality and quantity of capital, with a much greater focus on common equity to absorb losses.
- Second, we have achieved a more comprehensive coverage of the risks, especially related to capital markets activities. Trading book exposures, for example, will be subject to a stressed value-at-risk requirement. Banks must hold appropriate capital for less liquid, credit sensitive assets with much longer holding periods. Securitisation exposures will be subject to capital charges more consistent with those for the banking book.
- And third, we have introduced stronger supervision, risk management and disclosure standards.

In addition to these microprudential measures, Basel III introduces fundamentally new elements into the global regulatory framework. These include:

- Capital buffers that can help protect the banking sector against credit bubbles and that can be drawn down during times of stress. This could also help moderate upward pressure on real estate prices, for example, which in parts of Asia is a mounting concern;
- A simple leverage ratio that provides a backstop to the risk-based regime, and
- An internationally harmonised liquidity framework.

I should also note that the Committee has undertaken a thorough review of the potential impact of the Basel III standards through our Macroeconomic Assessment Group (MAG) and the Long term Economic Impact Group (LEI). Based on conservative assumptions, the MAG results show that the new standards are expected to have only a modest impact on economic growth over the transition period, while the LEI results show that the economic benefits associated with the higher capital and liquidity requirements will substantially exceed the costs. The MAG recently published follow-up work that started with an average capital position of 5.7% for large banks, which was based on the results of our quantitative impact study, and assumed a fully phased-in Basel III framework according to the Committees' transitional arrangements. Under these conditions, raising the global common equity capital ratio to 7% would result in a maximum decline in the level of GDP, relative to baseline forecasts, of 0.22%. In terms of growth rates, annual growth would be 3 basis points below its baseline level over this period, with the benefits of increased capital well surpassing the costs.

I will now turn to the challenges ahead and the future work of the Committee. The most immediate and significant imperative is, of course, implementation of the regulatory standards.

III. Implementation is essential

The Committee and its oversight body of Governors and Heads of Supervision have consistently stated that the new standards will be introduced in a manner that does not impede the recovery of the real economy. This is embodied in the staggered timeline we have adopted for implementing the standards. For example, the July 2009 enhancements that strengthen regulatory capital and disclosure requirements for capital markets activities are due to take effect by no later than the end of this year. The Basel III requirements begin to take effect from the beginning of 2013 and will be progressively phased in by 2019.

The rules need to be implemented in a timely and globally consistent manner. All Basel Committee member countries must now begin the process of translating the Basel III rules text into national regulations and legislation to meet the 2013 deadline. Banks, for their part, must also begin to plan and prepare. I would like to stress that the official and the private sector have a shared responsibility in this, as they both will reap the benefits of a more stable financial system.

Basel III is the core *regulatory* response to problems revealed by the financial crisis but new rules and standards are not enough. The next critical task at hand relates to better and more intrusive *supervision* at the global level. The Committee has put in place stronger mechanisms to ensure that regulations and standards developed by the Committee and endorsed by the G20 are implemented in full. For that purpose, the Committee's Standards Implementation Group will conduct follow up and thematic peer reviews. Areas of focus will include common interpretation of standards and potential areas for regulatory arbitrage. We will also follow up to review implementation by banks and supervisors in areas like stress testing and sound liquidity risk management. Nobody benefits from weak banks and supervisory practices, and members should therefore welcome a process of greater and more critical reviews by peers. We need somewhat of a cultural shift here, where greater recognition is given to the opportunities provided by a critical peer review process, rather than seeing such reviews as a threat.

Standards where we have less experience, such as the liquidity and leverage ratios, will be phased in gradually and their implementation monitored accordingly. This will enable us to address any unintended consequences by making adjustments where appropriate.

IV. Future work

I will now turn to future work. In parallel to the Committee's focus on implementation, our future work programme covers the following areas: (i) the observation of certain elements of Basel III; (ii) further development of supervisory standards; and (iii) efforts to improve supervisory practices and cross-border bank resolution practices.

(i) Observation of Basel III

With respect to the liquidity framework, the Committee decided to take a deliberate but cautious approach when it comes to implementing the liquidity standards. This is why the short-term liquidity coverage ratio will become a minimum standard in 2015 while the longer term net stable funding ratio will become a minimum standard in 2018. The recently published rules text provides for an "observation period" that will enable supervisors to obtain more robust reporting over this period. The intent is to assess the impact of the new standards on individual banks, the banking sector and the broader markets.

To the extent that the standards produce any unintended consequences, revisions to the LCR would be made by mid-2013 and by mid-2016 for the NSFR. While it was critical that we put in place global liquidity standards, at the same time we recognise that – compared to capital regulation – data and experience for liquidity regulation is less complete. Given the significance of introducing minimum liquidity standards, we want to make sure we get it right. However, this process should in no way call into question the commitment to fully implement strong global liquidity standards according to the agreed timelines.

The Committee will also carefully monitor the performance of the leverage ratio, as well as its behaviour compared to the risk-based measure. We will track the underlying components and the ratio. Beginning in 2015, banks will be required to disclose their leverage ratio and components. The Committee will carry out any final adjustments to the definition and calibration in the first half of 2017 in preparation for a Pillar 1 treatment on 1 January 2018.

(ii) Standard setting

In the standard setting area, policy development work continues on the market risk rules, systemically important banks, the reliance on external ratings and large exposures.

Taking these in turn, we are conducting a fundamental review of the trading book. The review addresses basic questions like: Should the distinction between the trading book and banking book be maintained? Is VaR the best method for calculating capital requirements? How should trading activities be defined? We will consult with the industry as this work progresses.

More generally, we will be taking a very close look at how banks arrive at their measures of exposure, how they risk-weight their assets, and how they engage in risk mitigation activities. The focus should be on building sound business models underpinned by adequate capital and liquidity.

Another high priority for the Committee is our work on systemically important banks, in collaboration with the FSB. The Committee has developed a provisional methodology that includes both quantitative and qualitative indicators to identify systemically important banks at the global level. We are also examining the magnitude of additional loss absorbency that global SIFIs should have, which could be met through some combination of common equity, contingent capital and bail-in debt. This work will be fleshed out in the next few months. I expect that the Committee will also initiate a review of our existing guidance on large exposures.

Work to reduce the reliance on external ratings in the regulatory capital framework is another area of focus. This includes addressing cliff effects from securitisation ratings downgrades and strengthening independent due diligence standards for securitisations.

(iii) Efforts to improve supervisory practices and cross-border bank resolution.

The third broad area of focus relates to supervisory practices and cross-border bank resolution. While many efforts focus on the prevention of crises, there is still a need to continue working on cross-border bank resolution. The Committee is currently assessing implementation by its member countries of recommendations made by its Cross-border Bank Resolution Group.

Finally, a topic which makes the link between the implementation of our principles which I discussed earlier, and the future work of the Committee, is the revision of the Core Principles for Effective Banking Supervision. Many of the supervisory lessons learned during the crisis and articulated in the Committee's documents need to be incorporated in a revised set of Core Principles. In addition, the FSB has identified areas of the Core Principles that could be expanded or clarified to address topics related to the supervision of systemically important financial institutions. The Committee will therefore revise the Core Principles in 2011. The review will be undertaken by a group consisting of Committee members as well as members of our Basel Consultative Group, which includes for example, Malaysia, Thailand and the Philippines as well as regional groups like EMEAP.

V. Conclusion

Let me conclude by saying that, while I am proud of the Basel Committee’s achievement in finalising Basel III, I quickly acknowledge that more work needs to be done. Implementing the rules in a timely and consistent manner will be as important as what has been achieved so far.

Looking ahead, it will also be essential for regulatory standards to keep pace with new risks. While financial innovation produces many benefits for the financial system, it can as well jeopardise financial stability if it is not properly managed and supervised.

In addition, I underscore the importance of supervision. Basel III and other global standards have provided a strong basis for a more stable banking system and it is now the role of supervisors to ensure the rules are implemented and adhered to.

Finally, cooperation and exchange of views among supervisors is of crucial importance. I therefore appreciate events like this one where we can openly discuss issues of comment interest.

Thank you for your attention.