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"Fundamentally strengthening the regulatory framework for banks"

Introduction and background

Let me start by thanking our Korean hosts and the Financial Stability Board for organising this conference. The timing could not have been better as the Basel Committee has entered the final phase of completing its reform programme. It is especially fitting that this meeting is hosted by the Republic of Korea, given the importance and continuing growth of the South Korean economy, its membership on the Basel Committee, and of course its key role as current chair of the G20. As you know, the Basel Committee's reform programme will be presented to the G20 leaders for their endorsement when they meet here in November.

A number of commentators have questioned whether the Basel Committee's reforms of global banking standards are really necessary for countries that neither "caused" the crisis nor were directly affected by it. However, I should point out that all were affected indirectly through the global economic downturn. This includes emerging market economies.

To me, at least, it is clear that we all have a lot to learn from both the recent and past financial crises. History has shown that crises have emanated from all regions of the world and have a range of causes. None of us knows what will be the source of the next crisis. What we do know, however, is that in a dynamic, ever changing global economy, there will be future crises and that it will be hard to predict them in advance. Moreover, as banks are at the centre of the credit intermediation process, it comes as no surprise that the deepest and most prolonged downturns occur when the banking sector ceases to perform its central role in the economy. We therefore must increase the resilience of the banking system to financial and economic shocks, in particular through higher capital and liquidity buffers, but also through a more resilient infrastructure. We also must change incentives in areas such as governance practices, compensation and the moral hazard associated with too-big-to-fail institutions. This is the best form of preparation and will contribute to increasing our long term growth and welfare.

The reforms of the Basel Committee are intended to address these identified shortcomings by promoting a more resilient banking sector that can support more sustainable growth over the long run. Let me elaborate on our reform programme, which is nearing its final stage of completion. My focus will be on strengthening the global capital framework and introducing a global standard for liquidity.

II. Capital reform

Quality of capital base

I will start with capital since raising the level, quality, consistency and transparency of the capital base is one of the Committee's primary objectives. It is only through higher levels of loss absorbing capital that the banking sector will be in a stronger position to shield the

economy from future shocks. The thrust of our work is to improve the level and proportion of the core elements of Tier 1 capital, namely common equity and retained earnings. Under the existing standard, banks could hold as little as 2% of risk-weighted assets as common equity. It is even less if you consider the need for additional regulatory adjustments. This situation is unacceptable and must change. At its meeting on July 26th, the Basel Committee's governing body – the Group of Central Bank Governors and Heads of Supervision – reached broad agreement on a fundamental strengthening of the *definition of capital*, with a focus is on the core elements of capital instead of debt-like substitutes that are of questionable quality. Moreover, virtually all deduction from capital will now occur at the level common equity, instead of Tier 1 capital, as has been the case under the current standard. This will ensure that banks cannot show strong capital ratios and, at the same time, recognise assets that diminish the quality of capital.

Let me be clear: The change to the definition of capital represents – by itself – a substantial strengthening of the global capital regime. This is the case before we even begin to discuss an increase in the level of minimum capital requirements or the introduction of buffers.

Capturing all the risks

In addition to raising the quality of the capital base, we need to ensure that all risks are captured. During the crisis, we learned that many risks were not covered in the risk-based regime. In particular, these include the complex, illiquid credit products which found their way into banks' trading books without a commensurate increase in capital. The Committee has since strengthened substantially the rules that govern capital requirements for trading book exposures as well as for complex securitisations and exposures to off-balance-sheet vehicles. The revised trading book framework, on average, requires banks to hold around three to four times the old capital requirements.

Controlling leverage

An additional and – as recent history has demonstrated – critical element to the regulatory capital framework is a backstop to the risk-based capital requirement. I am talking, of course, about the newly introduced leverage ratio.

In the lead up to the last crisis, banks managed to comply with the risk-based regime: they reported brilliant Tier 1 risk-based ratios, while building up massive levels of on- and off-balance-sheet leverage. In good times, the market did not seem to care about this, but when the crisis hit, market participants required banks to meet basic measures of leverage. The subsequent process of deleveraging resulted in a downward spiral between the financial sector and real economy.

To contain these cycles of boom and bust leverage and the gaming of the risk-based regime, the Basel Committee's governing body agreed recently on the design of the leverage ratio and an indicative calibration of 3%. It is important to understand that the new leverage ratio not only includes on-balance-sheet positions but also off-balance-sheet items and derivatives, like credit derivatives. For global banks with significant capital market activities, this 3% calibration is likely to be more conservative than the traditional measures of leverage that have been in place in some countries. The proposed minimum of 3% will serve as the basis for testing during a parallel run period that will begin in January 2013 with full disclosure starting January 2015. The reason for the parallel run period is not to prolong the implementation. Rather, we want to make sure that the risk-based requirement and the leverage ratio floor interact in a manner that makes sense. And this can only be done when observed over different points of the economic cycle, taking into consideration the impact on different types of business models.

Buffers

The next essential element of the new regulatory capital framework is the build up of buffers in good times that can be drawn down in periods of stress. To achieve this, the Committee has proposed a capital conservation buffer. During the crisis, some banks that were under stress – in an attempt to signal their financial strength – continued to pay out dividends instead of retaining their profits, which would have replenished their capital. This behaviour was partly driven by a collective action problem: a reduction in dividends, it was feared, would be viewed as a sign of financial weakness. As a bank's capital levels move closer to minimum requirements, the conservation buffer would impose a constraint on a bank's discretionary distributions. These include dividend payments, share buy-backs and bonuses. Retaining a greater proportion of earnings during a downturn will help ensure that capital remains available to support the bank's ongoing business operations during the period of stress.

In addition, the Committee recently issued a proposal for a countercyclical buffer. This would be imposed when, in the view of national authorities, excess aggregate credit growth is judged to be associated with a build-up of system-wide risk. The countercyclical buffer would extend the conservation buffer range during such periods of excess credit growth. Conversely, the buffer would be released when, in the judgement of the authorities, the released capital would help absorb losses in the banking system that pose a risk to financial stability. This would help reduce the risk that available credit is constrained by regulatory capital requirements.

Taken together, this framework of buffers will increase banking sector resilience and mitigate procyclicality.

II. A new liquidity framework

The reform measures I just described will radically transform the regulatory capital framework. In a similar way, the Committee has introduced a liquidity framework which is even more far-reaching since a global standard does not currently exist. For the first time, banking supervisors around the world will have a common international standard which they can apply to their banks.

The liquidity phase of the crisis was characterised by the speed with which funding dried up and the extended period of time during which banks suffered from that shortage of liquidity. In response the Committee proposed global minimum liquidity standards that include measures to promote both the short-term resilience of banks to potential liquidity disruptions and longer-term structural liquidity mismatches. The Liquidity Coverage Ratio – the LCR – will require banks to have sufficient high-quality liquid assets to withstand a stressed funding scenario that is specified by supervisors. This is complemented by the Net Stable Funding Ratio – the NSFR – which is a longer-term structural ratio designed to address liquidity mismatches. It covers the entire balance sheet and provides incentives for banks to use stable sources of funding.

Introducing a new set of standards is a complex process. Unlike the capital framework, for which there is extensive experience and data that help inform calibration, there is no similar track record for liquidity standards. The Committee is therefore taking a carefully considered approach to refine the design and calibration and we will review the impact of these changes to ensure that they deliver a rigorous overall liquidity standard. But let me be clear on this point: the Committee is committed to adopting both the LCR and the NSFR as the international standards for liquidity.

III. Systemic risk and interconnectedness

I now turn to systemic risk and interconnectedness. The capital reforms and new liquidity standards that have been developed by the Committee will help improve the resilience of *individual* firms to stress. While it logically follows that stronger individual banks will lead to a stronger banking system, this firm-specific approach by itself may not be sufficient. Broader measures to strengthen the resilience of the entire banking system are equally important. This will also help address excess interconnectedness and the perception that some banks are too big to fail.

The Committee has taken several measures to address the risks arising from exposures among global financial institutions that include:

- Capital incentives for banks to use central counterparties for over-the-counter derivatives;
- Higher capital for trading and derivative activities, as well as complex securitisations, which are associated with systemic risk and interconnectedness;
- Higher capital for inter-financial sector exposures as these are more correlated; and
- Cross-border bank resolution recommendations as a practical way to begin addressing the systemic risk issue at global banks.

An additional way in which the Committee is addressing the too-big-to-fail problem relates to the use of contingent capital. The Committee recently published a proposal based on a requirement that the contractual terms of capital instruments will allow them – at the option of the regulatory authority – to be written-off or converted to common shares if the bank is judged to be non-viable by the relevant authority. We are also reviewing the potential role of "going concern" contingent capital in the capital framework. The Committee will review a fleshed-out proposal for the treatment of such going-concern contingent capital before year end.

Finally, in collaboration with the FSB, the Committee is assessing the need for a systemic capital surcharge to mitigate the risk that certain banks perceived as too-big-too fail could pose on the system as a whole. This is an area where contingent capital could play a future role.

IV. Next steps

After having agreed on the key design elements of the new capital framework and the definition of capital, the final remaining issue is to determine the calibration of the minimum requirements and regulatory buffers. Next week, the Committee will meet to discuss concrete calibration proposals. The Committee's oversight body, the Group of Central Bank Governors and Heads of Supervision, will meet shortly after that. Our goal is to present to the G20 Leaders in Seoul a fully calibrated set of proposals for their endorsement. A final rules text would be issued at the end of this year. As part of this process, we also will make recommendations for a smooth transition to the new standard.

V. Benefits and conclusion

I think an appropriate way to conclude my remarks is with the benefits we expect these reforms to confer. A few weeks ago, the Committee and the FSB published a report on the macroeconomic implications of the proposed higher regulatory standards during the transition to these new standards. This report was accompanied by an additional study conducted by the Committee on the long-term economic impact of the new standards.

I will readily admit that existing macroeconomic models for understanding the links between the financial sector and the economy are not as well developed as they could be. In the face of this uncertainty, we have drawn on a wide range of models and assessed the central

tendency and the variation across countries and methodologies. Moreover, we have considered factors that might overstate the economic impact and those that understate it. Our bias was to be conservative.

Our work concluded that the *transition* to stronger capital and liquidity standards is likely to have only a modest impact on economic growth. If higher requirements are phased in over four years, we estimated that the level of GDP would decline by 0.19% for each one percentage point increase in a bank's capital ratio once the new rules were in place. This means that the annual growth rate would be reduced by an average of just 0.04 percentage points over a four and a half year period. With respect to the impact of stronger liquidity standards, the study also found these are likely to have only mild transitional effects. In all of these estimates, GDP returns to just below its baseline path in subsequent years.

With regard to the *long-term implications*, the Basel Committee's assessment found that there are clear economic benefits from increasing the minimum capital and liquidity requirements from their current levels. The benefits of higher capital and liquidity requirements accrue from reducing the probability of financial crisis and the output losses associated with such crises. The benefits substantially exceed the potential output costs for a range of higher capital and liquidity requirements.

The balance of evidence suggests that there is substantial room to strengthen capital and liquidity standards in a way that does not jeopardise near term growth, but enhances long term stability and economic output. Moreover, we need to understand that we continue to live in an economic environment with downside risks. In such circumstances, we cannot afford to continue to operate with such thin minimum regulatory capital and liquidity requirements. The system does not have the capacity for another round of bail outs, nor does the public have the tolerance for it.